

INDEPENDENCE OF AUSTRALIAN COMPANY AUDITORS

**Review of Current Australian Requirements
and Proposals for Reform**

Report to the Minister for Financial Services and Regulation

Ian Ramsay

*Harold Ford Professor of Commercial Law and
Director of the Centre for Corporate Law and Securities Regulation
The University of Melbourne*

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Treasury Building
Parkes Place
PARKES ACT 2600

Tel: (02) 6263 3167

Fax: (02) 6263 2770

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ABBREVIATIONS

AAT	Administrative Appeals Tribunal
ASCPA	Australian Society of Certified Practising Accountants (now CPA Australia)
ASIC	Australian Securities and Investments Commission
CALDB	Companies Auditors and Liquidators Disciplinary Board
CPAA	CPA Australia
ICAA	The Institute of Chartered Accountants in Australia
IFAC	International Federation of Accountants
NIA	National Institute of Accountants
SEC	Securities and Exchange Commission of the United States of America

PART 1

INTRODUCTION

There are approximately 7,000 registered company auditors in Australia according to the Australian Securities and Investments Commission. This report examines Australia's existing legislative and professional requirements on independence of company auditors and compares them with equivalent overseas requirements. Where appropriate, the report proposes measures for strengthening the Australian requirements.

The review has been prompted by two developments. Firstly, recent overseas work in the area of audit independence, especially in the United States of America and Europe, has moved independence requirements in those regions ahead of the equivalent requirements in Australia. For example, those parts of the Australian Corporations Act which have as their objective ensuring the independence of auditors by prohibiting certain employment and financial relationships between auditors and their clients, have not been updated for over 40 years. Meanwhile, major developments, including the growth of the largest accounting firms and an increase in non-audit services provided by these firms, highlight the need for Australian requirements to be updated.

The stakeholders consulted as part of this review, including the professional accounting bodies and individual accounting firms, generally acknowledged that Australian requirements dealing with the independence of auditors have fallen behind what is regarded as best practice.

Secondly, following the failure of a number of listed Australian companies during the first half of 2001, the resultant publicity has included audit independence issues and has raised concerns about the adequacy of the Australian rules that ensure the independence of Australian accounting firms from the companies they audit.

The actions of the auditors involved in the recent corporate collapses, and the question whether any failings in the area of audit independence contributed to those collapses, are outside the scope of this report. Such issues will undoubtedly be considered by the Australian Securities and Investments Commission (ASIC) as part of its inquiries into the corporate failures and by the Royal Commission examining the circumstances surrounding the collapse of HIH Insurance Ltd.

PART 2

SUMMARY OF RECOMMENDATIONS

A. KEEPING ACCOUNTING FIRMS INDEPENDENT OF THEIR AUDIT CLIENTS (Part 5 of the report)

GENERAL STATEMENT OF PRINCIPLE REQUIRING INDEPENDENCE

The Corporations Act currently contains several provisions dealing with the independence of auditors (including prohibited employment relationships and prohibited financial relationships). However, it does not contain a general statement requiring an auditor to be independent. It is recommended that the Corporations Act be amended to include a general statement of principle requiring an auditor to be independent.

This provision of the Corporations Act would also provide that an auditor is not independent with respect to an audit client, if the auditor is not, or a reasonable investor with full knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement. In determining whether an auditor is independent, all relevant circumstances should be considered, including all relationships between the auditor and the audit client.

It is also recommended that the auditor must make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Corporations Act and the rules of the professional accounting bodies.

LIST OF CORE CIRCUMSTANCES WHICH CREATE A LACK OF INDEPENDENCE

The following is a list of what can be regarded as core circumstances which, if they exist, necessarily mean that the auditor is not independent. These core circumstances are drawn from key international rules and principles (SEC rules on audit independence, IFAC exposure draft on independence and European Commission consultative paper on audit independence).

It is important to emphasise that these core circumstances are not an exclusive indication of circumstances where an auditor lacks independence. There will be other circumstances where, depending upon the facts, an auditor may lack independence. As is currently the case, it is appropriate that the ethical statements of the professional accounting bodies contain additional guidance for auditors dealing with other circumstances in which an auditor may lack independence.

The definitions relating to these core principles are contained in paragraph 5.35 of Part 5 of the report.

EMPLOYMENT RELATIONSHIPS

Section 324 of the Corporations Act currently deals with employment relationships between auditors and clients. Therefore, it is intended that the following provisions will replace sections 324(1)(f) and 324(2)(g) and (h) of the Corporations Act.

An auditor is not independent if any of the following employment relationships exist with the client. There are exemptions for inadvertent breaches of the rules if certain requirements are met.

The following rules for employment relationships do not apply if the client is a small proprietary company (as defined in section 45A of the Corporations Act).

For the purpose of determining who is an officer of the client, the definitions in sections 9 and 324(4) of the Corporations Act apply.

1 Employment by client of current auditor/employee of auditor

An auditor is not independent if a current partner or professional employee of the audit firm is:

- (a) an officer of the client;
- (b) a partner, employer or employee of an officer of the client; or
- (c) a partner or employee of an employee of an officer of the client.

2 Employment by client of certain relatives of auditor

An auditor is not independent if an immediate family member of a member of the audit engagement team is:

- (a) a director of the client; or
- (b) an officer or employee of the client who is in a position to affect the subject matter of the audit engagement.

3 Employment by client of former auditor/employee of auditor

An auditor is not independent if a former partner or professional employee of an audit firm is:

- (a) a director of the client; or
- (b) an officer or employee of the client who is in a position to affect the subject matter of the audit engagement;

unless the individual:

- (c) does not influence the audit firm's operations or financial policies and does not participate or appear to participate in the audit firm's business or professional activities;
- (d) has no capital balances in the audit firm; and
- (e) has no financial arrangement with the audit firm other than one providing for regular payment of a fixed pre-determined dollar amount which is not dependent on the revenues, profits or earnings of the audit firm.

4 Retired audit partner joining board of audit client

An auditor is not independent if a former partner of an audit firm who was directly involved in the audit of a client becomes a director of the client within a period of two years of resigning as partner of the audit firm.

5 Employment by audit firm of former employee of client

An auditor is not independent if a member of the audit engagement team has, during the period covered by the audit report, been:

- (a) an officer of the client; or
- (b) an employee of the client in a position to influence the subject matter of the audit engagement.

6 Remuneration from audit firm

An auditor is not independent if an officer of the client, or an employee of the client in a position to influence the subject matter of the audit engagement, receives any remuneration from the audit firm for acting as a consultant to it on accounting or auditing matters.

FINANCIAL RELATIONSHIPS

Section 324 of the Corporations Act currently deals with some aspects of financial relationships between auditors and clients. Therefore, it is intended that the following provisions will replace sections 324(1)(e) and 324(2)(f) of the Corporations Act.

There are exemptions for inadvertent breaches of the rules if certain requirements are met.

1 Investments in audit clients

An auditor is not independent if:

- (a) the audit firm, any member of the audit engagement team, or any of his or her immediate family has:
 - (i) a direct financial investment in the client; or
 - (ii) a material indirect financial investment in the client; or
- (b) the audit firm has a material financial interest in an entity that has a controlling interest in the client; or
- (c) any other client service personnel, or any of his or her immediate family, has a direct financial interest or a material indirect financial interest in the client.

2 Loans to and from audit clients

An auditor is not independent if:

- (a) subject to the exception contained in section 324(3) of the Corporations Act, a partner of the audit firm, or an entity which the partner controls, or a body corporate

in which the partner has a substantial holding, owes more than \$10,000 (or such other amount as may be prescribed by regulation) to the client; or

- (b) the audit firm, any members of the audit engagement team, or any of his or her immediate family:
 - (i) accepts a loan from a client; or
 - (ii) makes a loan to a client; or
 - (iii) has a loan guaranteed by a client; or
 - (iv) guarantees a client's loan;

unless the loan is made in the ordinary course of the client's business and the loan is made under normal lending procedures, terms and conditions.

BUSINESS RELATIONSHIPS

Business relationships between auditors and clients are not currently dealt with in the Corporations Act. Therefore, it is intended that the following rule will be included in the revised ethical rules of the professional accounting bodies.

An auditor is not independent if:

- (a) a member of the audit engagement team has a business relationship with the client or any of its officers which is not clearly insignificant to both the member of the audit engagement team, and also the client or the officer; or
- (b) the audit firm has a business relationship with the client or any of its officers which is not clearly insignificant to both the audit firm and also the client or the officer.

A business relationship for this purpose does not include professional services provided by the audit firm, or the audit firm or member of the audit engagement team being a consumer in the ordinary course business.

NON-AUDIT SERVICES

It is recommended that the provision of non-audit services by audit firms to their clients be dealt with in several ways:

- (a) by revised and updated professional ethical rules;
- (b) by mandatory disclosure of non-audit services and the fees paid for these services;
- (c) by strengthening the role of audit committees; and
- (d) by establishing an Auditor Independence Supervisory Board which would have, among its functions, the task of monitoring the adequacy of disclosure of non-audit services.

1 Regulation of non-audit services

It is recommended that the regulation of non-audit services provided by audit firms to their clients be dealt with in professional ethical rules, suitably updated to reflect the IFAC proposals.

2 Disclosure of non-audit services

It is recommended that the following provisions will form part of the Accounting Standards or, if the Accounting Standards are not amended, then they will form part of Chapter 2M (Financial Reports and Audit) of the Corporations Act:

- (a) the financial report for the year must disclose the dollar amount of all non-audit services provided by the audit firm to the client, divided by category of service, with appropriate discussion of those services; and
- (b) the financial report for the year must disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.

Attention is also drawn to the recommendations in this report regarding audit committees and the establishment of the Auditor Independence Supervisory Board as these recommendations affect non-audit services.

B. OTHER MEASURES THAT ENHANCE AUDIT INDEPENDENCE (Part 6 of the report)

ESTABLISHMENT OF AN AUDITOR INDEPENDENCE SUPERVISORY BOARD

1 The AISB

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

2 Composition of the AISB

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

2.1 *AISB members*

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

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

2.2 *AISB employees*

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

2.3 *Process for appointment of initial and future members*

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

3 *Funding for the AISB*

3.1 *Financial support*

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

3.2 *Physical premises*

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

4 Functions of the AISB

4.1 Obligation to prepare an annual report

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

4.2 Monitoring of international developments in auditor independence

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

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

4.3 Advising professional bodies on issues of auditor independence

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

4.4 Monitoring of audit firms

The AISB will monitor the nature and adequacy of systems and processes used by Australian audit firms to deal with issues of auditor independence and advise on the adequacy of these systems and processes. The accountancy bodies should be prepared to enter into an agreement with the AISB to provide reasonable access to people and papers to help the AISB with this monitoring process. The objective is to ensure that the internal systems and processes of audit firms accord with best practice.

4.5 Monitoring of corporations

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

4.6 Monitoring of teaching of professional and business ethics

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

4.7 No role in conducting disciplinary proceedings

It is not appropriate for the AISB to conduct disciplinary proceedings given that disciplinary mechanisms are already in existence. However, as a part of its overall monitoring responsibilities,

the AISB should monitor and assess the adequacy of the existing investigation and disciplinary processes and, if it forms the view that improvements are required, this should be communicated to the Government.

5 Review of the AISB

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

AUDIT COMMITTEES

There can be no doubt that a well structured and well functioning audit committee can play a very important role in ensuring that the auditor is independent of the company. It is recommended that the ASX Listing Rules be amended to require all listed companies to have an audit committee. The new Listing Rule would be accompanied by an ASX Guidance Note. The Listing Rule and associated Guidance Note should govern the structure of this committee, and should reflect international best practice in audit committees as outlined in Part 6 of this report.¹

The Listing Rule should:

- mandate the existence of a qualified audit committee;
- specify the composition of the audit committee as contained in section 3 of Appendix D; and
- require the board of directors to adopt a written charter to govern the audit committee.

The Guidance Note should:

- specify the general requirements, and duties and responsibilities, of a qualified audit committee as contained in sections 4 and 5 of Appendix D; and
- contain such other matters as are considered appropriate by ASX.

The Guidance Note should specify that the audit committee has special responsibilities in relation to the company's auditor. These special responsibilities are outlined in detail in Appendix D of this report (see in particular section 5.4 of Appendix D). Some of these special responsibilities are that the audit committee should:

- state in the annual report whether or not it believes the level of non-audit service provision by the auditor is compatible with maintaining auditor independence, and should include reasons where appropriate;
- make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness, and independence of the auditor;
- review and agree on the terms of engagement for the auditor at the start of each audit;
- review the scope of the external audit with the auditor including identified risk areas and any additional agreed upon procedures;

¹ These principles have been developed from international reports, best practice guides and standards. Particular reliance has been placed on the Blue Ribbon Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (1999); the New York Stock Exchange, *NYSE Listed Company Manual: 303.01 Audit Committee*; and the Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors-Australia, *Audit Committees: Best Practice Guide* (2nd ed, 2001).

- review the auditor's audit fee, and be satisfied that an effective, comprehensive and complete audit can be conducted for that fee (this includes reviewing and assessing fees paid for non-audit service provisions);
- review with the auditor any significant disagreements between the auditor and management, irrespective of whether they have been resolved;
- monitor the number of former employees of the audit firm currently employed in senior positions in the company and assess whether this impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether taken as a whole, the various relationships between the company and the auditor impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether the compensation of the individuals employed by the auditor who are performing the audit of the company is tied to the provision of non-audit services and, if so, consider whether this impairs or appears to impair the auditor's judgment or independence in respect of the company;
- review the economic importance of the company (in terms of fees paid to the auditor for the audit as well as fees paid to the auditor for the provision of non-audit services) to the auditor, and assess whether the economic importance of the company to the auditor impairs or appears to impair the auditor's judgment or independence in respect of the company; and
- at least annually, meet with the auditor without the presence of management.

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

APPOINTMENT AND REMOVAL OF AUDITORS

It is recommended that the following Audit Review Working Party² recommendations (as amended as part of this review) be implemented:

- 1 The auditor of a listed company should be appointed and their remuneration determined on the recommendation of the company's audit committee. (Recommendation 7.2)
- 2 The auditor of a company which is not listed should be appointed and their remuneration determined on the recommendation of the company's audit committee where such a committee exists. (Recommendation 7.3)
- 3 There should be mandatory rotation of the audit partners responsible for the audit of listed companies. (Recommendation 7.7) The rotation is to occur after a maximum of 7 years but may occur sooner if considered appropriate by those involved in the audit. There is to be a period of at least 2 years before the partner can again be involved in the audit of the client.
- 4 The Corporations Act or the ASX Listing Rules (or the ASX Guidance Note relating to continuous disclosure) should be amended to provide that a proposed change to the auditor of a disclosing entity is a continuous disclosure matter. (Recommendation 7.14)
- 5 The Corporations Act should provide that any proposal for appointment of auditors of a disclosing entity must contain information on the proposed fees. (Recommendation 7.15)

² Report of a Working Party of the Ministerial Council for Corporations, *Review of Requirements for the Registration and Regulation of Company Auditors* (July 1997).

DISCIPLINARY MATTERS

It is recommended that:

- 1 The Australian Securities and Investments Commission Act (ASIC Act) be amended to:
 - (a) provide for the appointment of a deputy chairperson for the Companies Auditors and Liquidators Disciplinary Board (CALDB);
 - (b) allow the CALDB to sit in more than one Division simultaneously;
 - (c) provide that a Division of the CALDB be constituted by:
 - (i) the chairperson or deputy chairperson;
 - (ii) a member, deputy of the member or a reserve member nominated by the ICAA; and
 - (iii) a member, deputy of the member or a reserve member nominated by CPA Australia; and
 - (d) provide for the ICAA and CPA Australia to each submit a panel of not less than seven and not more than ten names from which the Minister will appoint:
 - (i) one ICAA member, a deputy of the ICAA member, and up to two ICAA reserve members; and
 - (ii) one CPA Australia member, a deputy of the CPA Australia member, and up to two CPA Australia reserve members.

- 2 In making the appointments, the Minister should have regard to the need to ensure that included in the appointments are some members, deputies or reserves who are current or former insolvency practitioners.

- 3 The ASIC Act or the Corporations Act, as appropriate, be amended to:
 - (a) enable the CALDB to enforce orders made during the pre-hearing period;
 - (b) provide that, in respect of each disciplinary proceeding, the nature of the matter, the decision and the reasons for the decision should be published; and
 - (c) enable the CALDB to provide information obtained by it during the course of a disciplinary proceeding to the investigation and disciplinary committees of the ICAA, CPA Australia and NIA, to facilitate the disciplinary procedures of those bodies.

ATTENDANCE OF AUDITOR AT AGM

It is recommended that the Corporations Act be amended to require the company's auditor or a representative of the auditor to attend the AGM at which the auditor's report is tabled unless

reasonable circumstances preclude the auditor's attendance. This requirement would only apply to AGMs of listed public companies.

C. OTHER ISSUES CONSIDERED DURING REVIEW **(Part 7 of the report)**

The following recommendations of the Audit Review Working Party, which deal with issues not addressed elsewhere in this report, should be implemented:

- 1 Educational requirements for registration as a company auditor should be enhanced by requiring all applicants to have completed a specialist course equivalent to the auditing module currently provided by the ICAA's Professional Year Program or CPA Australia's Certified Practising Accountant Program.
- 2 All registered company auditors, whether members of professional accounting bodies or not, should be required to abide by ethical requirements equivalent to the codes of ethics and other rules of the professional accounting bodies. This can be achieved by those registered company auditors who are not members of professional accounting bodies complying with rules or guidelines issued by ASIC or entering into a written undertaking with ASIC that they will comply with the ethical requirements and other professional rules of the professional accounting bodies as if they were members.
- 3 Competency standards should be adopted as the principal basis for determining whether a person has sufficient practical experience to be registered as a company auditor.
- 4 Where a registered company auditor has not undertaken any substantive audit work during a period of not less than five years, ASIC may require the auditor to show cause why his or her registration should not be cancelled.
- 5 The requirement that registered company auditors lodge a triennial statement with ASIC should be replaced by an annual statement containing the revised information outlined in paragraph 7.13 of this report.
- 6 Registered company auditors should be required to undertake a minimum amount of professional development, with the amount to be prescribed being similar to that required of ICAA and CPA Australia members who hold public practice certificates.
- 7 The work of all registered company auditors should be subject to periodic quality reviews.
- 8 The Corporations Act should be amended to provide that Auditors-General may, subject to any constraints contained in the legislation establishing their respective offices, delegate to a person responsibility for signing an auditor's report or an audit review prepared under Part 2M.3 of the Corporations Act.

PART 3

CONDUCTING THE INQUIRY

3.01 The purpose of the review has been to:

- (a) examine the adequacy of existing Australian legislative and professional requirements about the independence of company auditors, having regard to recent overseas developments; and
- (b) make appropriate recommendations for changes to the Australian requirements.

3.02 In undertaking this review, particular regard has been had to the following overseas developments: the International Federation of Accountant's (IFAC's) proposals for changes to its ethical requirements on audit independence; the existing and proposed regulatory requirements of the European Commission; and the new regulatory requirements in the United States of America. In addition, recent overseas developments concerning the establishment and operation of public oversight arrangements for ensuring the independence of auditors and the use of audit committees have also been considered.

3.03 There has also been an extensive consultative process involving a wide range of stakeholder interests. Meetings were held with the professional accounting bodies, accounting firms and other bodies and individuals listed in Appendix A. Written submissions received during the review are listed in Appendix B.

3.04 An extensive range of published material on auditor independence was also examined during the review. Part 8 of the report reviews literature on auditor independence that was considered during the course of the review.

3.05 The independence policies and procedures of the following accounting firms were also reviewed: Andersen, Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers.

3.06 The significant contribution of all stakeholders who participated in the review process is gratefully acknowledged.

3.07 The expert work provided by Les Pascoe, Specialist Adviser – Accounting Policy, Department of the Treasury, in the drafting of this report is gratefully acknowledged as is the valuable work of Anne-Marie Neagle, Research Associate, Centre for Corporate Law and Securities Regulation, The University of Melbourne.

PART 4

AUDIT INDEPENDENCE

THE IMPORTANCE OF AUDITS

4.01 Audited financial statements are an important part of the financial information that is available to the capital markets and an important part of effective corporate governance. According to the Panel on Audit Effectiveness:

‘Audits improve the reliability of financial statements, make them more credible and increase shareholders’ confidence in them. Auditors constitute the principal external check on the integrity of financial statements. As former SEC Commission Steven M H Wallman has noted, “Without accountants to ensure the quality and integrity of financial information, the markets for capital would be far less efficient, the cost of capital would be far higher, and our standard of living would be lower.” Accordingly, a fundamental assumption underlying the Panel’s study and recommendations is its belief that, for many reasons, the value of audits and the public’s need for effective audits remain undiminished and in fact may be greater than every before.’³

4.02 It has been said that audits:⁴

- (a) add value to financial statements by improving their reliability;
- (b) add value to the capital markets by enhancing the credibility of financial statements;
- (c) enhance the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements; and
- (d) assist to lower the cost of capital to those using audited financial statements by reducing information risk.

THE IMPORTANCE OF AUDITOR INDEPENDENCE

4.03 It is often said that independence is fundamental to the reliability of auditors’ reports.

‘Those reports would not be credible, and investors and creditors would have little confidence in them, if auditors were not independent in both fact and appearance. To be credible, an auditor’s opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principles.’⁵

³ Panel on Audit Effectiveness, *Report and Recommendations* (2000) (chaired by Shaun F O’Malley).

⁴ Independence Standards Board, *A Conceptual Framework for Auditor Independence*, Discussion Memorandum (February 2000), paras 11-14.

⁵ Panel on Audit Effectiveness, above n 3, para 5.1.

4.04 According to Carey, ‘independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession’s strength and its stature’.⁶

THE CURRENT REGULATORY ENVIRONMENT

4.05 The current regulatory environment for the independence of auditors in Australia can be described as co-regulatory. The major role is played by the professional accounting bodies through their professional requirements and codes of ethics. At the same time, the Australian Securities and Investments Commission plays a role in ensuring that auditors of Australian companies remain independent by enforcing those provisions of the Corporations Act (notably section 324) which deal with the independence of auditors. A role is also played by the Companies Auditors and Liquidators Disciplinary Board (CALDB) in the independence of auditors as this body deals with disciplinary matters concerning auditors.

4.06 This type of co-regulatory environment exists in many countries. The recommendations contained in this report have, as one of their key objectives, continuing this co-regulatory environment. We recommend strengthening and updating section 324 of the Corporations Act in relation to the independence of auditors. The requirements in section 324 have not changed in any substantive way for at least 40 years. At the same time we see a strengthened role for the professional accounting bodies in updating their professional requirements and codes of ethics and providing leadership to the profession in terms of auditor independence. We believe the professional accounting bodies are well placed to play a central role in ensuring that auditors remain independent of their clients. It is appropriate to look to these bodies to fulfil this task. Market outcomes can be improved and there can be lower regulatory costs on business where professional bodies are both willing to, and have the ability to, play a key role in regulation.⁷

DEVELOPMENTS IN AUDITOR INDEPENDENCE

4.07 With the increasing globalisation of capital markets, there has been a growing recognition of the desirability of achieving uniformity and harmonisation not only in the areas of financial reporting and auditing, but also in the ethical requirements that underpin the work of members of the accounting profession.

4.08 Key elements of the profession’s ethical rules are those dealing with independence and the circumstances in which independence may be impaired.

4.09 The notion of professional 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. The value of the independent audit lies both in the fact that the auditor is, and is seen to be, independent of the audited entity, and hence is able to carry out the audit free of any externally imposed constraints.’⁸

⁶ John L Carey, *The Rise of the Accounting Profession: To Responsibility and Authority, 1937-1960* (1970) 182, quoted in Panel on Audit Effectiveness, above n 3, para 5.1.

⁷ In relation to the development of effective self-regulation, see the report of the Task Force on Industry Self-Regulation, *Industry Self-Regulation in Consumer Markets* (August 2000).

⁸ Australian Statement of Auditing Practice AUP 32 *Audit Independence*, para 6.

4.10 'Independence requires a freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure, any of which could lead to a belief that the audit opinion was determined other than by reference to the facts of the audit alone.'⁹

4.11 In Australia, interest in the issue of audit independence has been increased by speculation about what, if any, role audit independence matters played in a number of high-profile corporate failures during the first half of 2001.

4.12 Internationally, developments in the area of audit independence have recently been given prominence by:

- (a) the release of proposals by the accounting profession's peak international body, the International Federation of Accountants (IFAC), aimed at updating its ethical requirements on audit independence;
- (b) the release by the European Commission of a consultative paper containing proposals designed to achieve greater uniformity in the requirements in force in the Member States of the European Community; and
- (c) the United States Securities and Exchange Commission's (SEC) decision to remake its rules on audit independence to address issues associated with recent independence violations by auditors in the US.

4.13 The following paragraphs outline the basis on which independence rules are currently set in Australia. An outline is also provided of proposed amendments to IFAC and European Commission requirements and the revised rules made late last year by the SEC.

Australia

4.14 In Australia, measures designed to ensure that accounting firms are independent of their audit clients are contained in the Corporations Act 2001, Professional Statement F1 of the Code of Professional Conduct¹⁰ (issued jointly by the ICAA and CPAA) and Statement of Auditing Practice AUP 32 Audit Independence¹¹ (also issued jointly by the ICAA and CPAA). Statement F1 deals more generally with professional independence of accountants (although it does contain specific requirements in respect of audit work) while AUP 32 is concerned specifically with audit independence.

4.15 Australian legislative provisions on audit independence specify a range of employment and financial relationships which, if they existed, would preclude an individual or accounting firm from accepting appointment as auditor of a company. Details of these relationships, which have seen no substantive changes since the introduction of the Uniform Companies Acts in all States and Territories in the early 1960s, are outlined in Part 5 of this report.

4.16 Following a series of corporate failures in the late 1980s, the Ministerial Council for Corporations (Minco) established a Working Party of Minco officers to prepare a report concerning

⁹ AUP 32, above in n 8, para 8.

¹⁰ The text of Professional Statement F1 is in Appendix E.

¹¹ The text of AUP 32 is in Appendix F.

professional liability in respect of claims arising from the Corporations Law or under related common law.

4.17 One of the recommendations in the professional liability report was that there should be a review of the regulation of company auditors with a view to ensuring that there is an appropriate legal framework for the supervision, independence and disciplining of company auditors in relation to their functions under the Law. This review,¹² which was undertaken by a separate Minco Working Party (referred to throughout this report as the Audit Review Working Party) was completed in July 1997, and contained a series of recommendations addressing a range of issues, including the registration of auditors, post-registration supervision of auditors, appointment, independence and discipline (a list of the recommendations appears in Appendix C). To date, none of the substantive recommendations have been implemented, although most recommendations are supported by Minco and it is understood that it is the intention of the Government to proceed with their implementation.

4.18 Shortly after the review of the regulation of company auditors was completed, the ICAA and the ASCPA issued an exposure draft outlining proposals for revising the bodies' ethical requirements on professional independence. Informal advice from the ICAA indicates that the proposed revision of the ethical requirements was put on hold pending the outcome of both the SEC's proposal to amend its rules on audit independence and IFAC's subsequent proposals for a revision of professional rules on independence. Following the release of a revised IFAC exposure draft in April 2001, the ICAA and CPAA (formerly ASCPA) issued that draft in Australia with the intention of using it as the basis for revising the bodies' ethical requirements on independence. Further action by the professional bodies is dependent on whether IFAC issues revised rules based on the exposure draft.

Overseas developments

4.19 While there are significant differences of approach between the proposals of IFAC and the European Commission and the SEC's rules, there are two broad principles underlying both the rules and the proposals:

- (a) an accounting firm must be, and must be seen to be, independent of its audit clients; and
- (b) an auditor must not audit his or her own work.

4.20 Similarly, in addressing issues of audit independence, the proposals of IFAC and the European Commission and the SEC's rules focus on three key relationships between accounting firms and their audit clients:

- (a) employment relationships;
- (b) financial relationships; and
- (c) provision of non-audit services.

¹² *Review of Requirements for the Registration and Regulation of Company Auditors* (July, 1997).

International Federation of Accountants

4.21 The international accounting community's rules on professional independence are contained in section 8 of IFAC's 'Code of Ethics for Professional Accountants'. In June 2000, IFAC issued an exposure draft which proposed a significant revision of its rules on professional independence. The exposure draft advocated a move to a conceptual framework approach that would require the identification and evaluation of threats to independence and the application of safeguards to reduce any threats created to an acceptable level. The approach proposed by IFAC was supported by respondents and the exposure draft, after revision to reflect comments received, was re-exposed in April 2001 with a comment deadline of 30 June 2001.¹³

4.22 IFAC's conceptual approach to independence uses a framework, built on principles, for identifying, evaluating and responding to threats to independence. The framework establishes principles that the firm and the assurance team should use to identify threats to independence, evaluate the significance of those threats, and identify and apply safeguards to eliminate the threats or reduce them to an acceptable level.

4.23 Table 4.1 lists the threats to independence identified by IFAC and the safeguards that are available for countering those threats.

¹³ The text of IFAC's April 2001 exposure draft is in Appendix G.

TABLE 4.1: THREATS TO INDEPENDENCE IDENTIFIED BY IFAC AND SAFEGUARDS FOR COUNTERING THOSE THREATS	
Threats	
Self-interest	Occurs when a firm or member of the assurance team could benefit from a financial interest or other self-interest conflict with an assurance client.
Self-review	Occurs when any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement, or a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to affect the subject matter of the assurance engagement.
Advocacy	Occurs when a firm, or a member of the assurance team, becomes an advocate for or against an assurance client's position or opinion to the point that objectivity is, or is perceived to be, impaired.
Familiarity	Occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.
Intimidation	Occurs when a member of the assurance team may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.
Safeguards	
Created by the profession, legislation or regulation	Safeguards should include requirements for entry into the accounting profession, continuing educational requirements, professional disciplinary processes, external reviews of a firm's quality control system and legislation governing the independence requirements of the firm.
Within the audit client	Safeguards should include a corporate governance structure, such as an audit committee, to provide appropriate oversight and communications regarding a firm's services. Other safeguards could include the employment of high-quality staff in sufficient numbers to ensure that a member of the assurance team would not be required to make managerial decisions for the entity and having internal procedures to ensure an objective choice when commissioning non-assurance engagements.
Within the firm's own systems and procedures	Safeguards include firm-wide measures, such as firm leadership that stresses the importance of independence, documented independence policies and procedures to monitor compliance with the firm's policies, and engagement specific safeguards, such as carrying out reviews of work done, removing an individual from the assurance team when his or her financial interests or relationships create a threat to independence and discussing independence issues with the audit committee or others charged with governance

Europe

4.24 The European Commission's existing requirements on audit independence are contained in the Eighth Council Directive [84/253/EEC] of 10 April 1984 (approval of persons responsible for carrying out the statutory audits of accounting documents). Under the Directive, Member States were required to enact legislation providing that:

- (a) persons approved for the statutory auditing of accounting documents shall not carry out statutory audits if they are not independent in accordance with the law of the Member State which requires the audit; and
- (b) the members and shareholders of approved firms of auditors and the members of the administration, management and supervisory bodies of such firms who do not personally satisfy the qualification requirements for being an auditor in a Member State must not intervene in the execution of audits in any way which jeopardizes the independence of the natural persons auditing the documents on behalf of such firms of auditors.

4.25 At the time the Eighth Council Directive was adopted, it was not possible to obtain agreement among Member States on a common definition of statutory auditors' independence. As a consequence, this issue has been dealt with differently in Member States, based on different traditions and experiences. Current national rules on statutory auditors' independence differ in several aspects such as scope of persons, within and outside an audit firm, to whom independence rules should apply, the different kind of financial, business or other relationships with an audit client, the type of non-audit services to audit clients that are permitted or prohibited, and the safeguards that need to be put in place.¹⁴

4.26 To overcome these concerns, the Commission proposes issuing a Recommendation providing a principles based approach to audit independence which requires auditors and audit firms to consider:

- (a) the expectations of those directly affected by their work;
- (b) the public interest;
- (c) the threats to independence which may arise in practice; and
- (d) the safeguards available to eliminate those threats or reduce them to an acceptable level.

4.27 The Commission's proposals are divided into two parts: a framework which sets out the basic principles that should apply and specific requirements to apply in particular situations. The framework deals with issues such as objectivity, integrity and independence, responsibility of scope, independence threats and risk and a system of safeguards (which include prohibitions, restrictions, other policies and procedures and disclosures) while the specific requirements deal with financial involvement, business relationships, employment with the audit client, managerial or supervisory role in audit client, establishing employment with the audit firm, family and other personal relationships, non-audit services, audit and non-audit fees, litigation and senior personnel acting for a long period of time.

¹⁴ *Consultative Paper on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles* (European Commission, Brussels, 2000).

4.28 The consultation period for the European Commission's proposals, which, at least in part, appear to be based on IFAC's June 2000 exposure draft, commenced in December 2000 and ended on 2 March 2001.¹⁵

United States of America

4.29 The existing US rules were made in November 2000, when the SEC responded to a range of independence violations by one of the Big 5 firms, as well as a perceived need to update generally its audit independence rules. In doing this, the SEC adopted a strong prescriptive approach to independence. The revised rules were made following a consultative process that commenced in mid 2000 and were effective from 5 February 2001.¹⁶

4.30 Although the SEC's new rules are prescriptive in nature, they were developed using four principles, which are based on the philosophy that auditors must be independent in fact and appearance, for measuring an auditor's independence. Under these principles an accountant is not independent when the accountant:

- (a) has a mutual or conflicting interest with the audit client;
- (b) audits his or her own firm's work;
- (c) functions as management or an employee of the audit client; or
- (d) acts as an advocate for the audit client.

4.31 In addition to the rules on audit independence made by the SEC, the US accounting profession also has ethical requirements in the area of professional independence. However, it is our understanding that many of the requirements in the profession's rules are now addressed in the SEC's rules.

Other developments

4.32 In addition to the abovementioned international developments dealing specifically with audit independence, the last few years have seen the publication of a number of reports which address issues either associated with or having the potential to enhance audit independence. These reports include:

- (a) *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (New York Stock Exchange and the National Association of Securities Dealers, New York, 1999); and
- (b) *Report and Recommendations of the Panel on Audit Effectiveness* (Public Oversight Board, Stamford, 2000).

4.33 There have also been a number of overseas reports dealing more generally with corporate law reform, including issues associated with audit independence. Perhaps the most significant of these has been a series of reports on modern company law for a competitive economy (*Developing*

¹⁵ The text of the European Commission's consultative paper is at Appendix H.

¹⁶ The text of the SEC's amended rules is at Appendix I.

the Framework; Completing the Structure; and Final Report) prepared by the British Company Law Review Steering Group.

PART 5

KEEPING ACCOUNTING FIRMS INDEPENDENT OF THEIR AUDIT CLIENTS

5.01 When considering whether accounting firms are independent of their audit clients, three key issues need to be considered:

- (a) employment relationships;
- (b) financial relationships; and
- (c) provision of non-audit services.

Each of these matters is considered below.

5.02 In addition, regard must also be had to a number of related issues that can affect the independence of an auditor. These issues are discussed in Part 6.

GENERAL STATEMENT OF PRINCIPLE REQUIRING INDEPENDENCE

5.03 It is notable that the Corporations Act currently contains several provisions dealing with the independence of auditors. As discussed below, these include prohibitions on the auditor occupying certain employment positions with the audit client and prohibitions on certain financial relationships between the auditor and the audit client. However, the Corporations Act does not contain a general statement requiring an auditor to be independent. Other countries, such as Canada and New Zealand, which have in their corporations legislation provisions dealing with the independence of auditors, also have in their legislation a general statement requiring an auditor to be independent. For example, section 161 of the Canada Business Corporations Act states that a person is disqualified from being an auditor of a company if he or she is not independent of the company, any of its affiliates, or the directors or officers of any such corporation or its affiliates. Section 204 of the New Zealand Companies Act states that an auditor of a company must ensure, in carrying out the duties of an auditor, that his or her judgment is not impaired by reason of any relationship with or interest in the company or any of its subsidiaries.

5.04 It is recommended that the Corporations Act be amended to include a general statement of principle requiring an auditor to be independent. This provision of the Corporations Act would also provide that an auditor is not independent with respect to an audit client, if the auditor is not, or a reasonable investor with full knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement. In determining whether an auditor is independent, all relevant circumstances should be considered, including all relationships between the auditor and the audit client.

5.05 It is also recommended that the auditor must make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Corporations Act and the rules of the professional accounting bodies.

EMPLOYMENT RELATIONSHIPS

5.06 The expression ‘employment relationships’ is used in this report to cover the following broad areas of involvement between an accounting firm and its audit client:

- (a) employment of an accounting firm’s current and former members and professional staff by an audit client;
- (b) employment of close relatives of an accounting firm’s members and staff by an audit client; and
- (c) employment of directors and senior management of a company by its auditor.

Australian position

5.07 Subsections 324(1), (2) and (4) of the Corporations Act contain provisions dealing with employment relationships. Subsections 324(1) and (2) provide that an individual or accounting firm must not consent to be appointed as auditor of a company, act as auditor of a company or prepare a report required by the Act to be prepared by a registered company auditor or by an auditor of a company if:

- (a) except where the company is a proprietary company, the individual or a member of the firm is:
 - (i) an officer of the company;
 - (ii) a partner, employer or employee of an officer of the company; or
 - (iii) a partner or employee of an employee of an officer of the company; or
- (b) except where the company is a proprietary company, an officer of the company receives any remuneration from the firm for acting as a consultant to it on accounting or auditing matters.

5.08 An officer of a company is defined in section 9 of the Corporations Act to include a director or secretary of the company as well as a person who makes or participates in making, decisions that affect the whole, or a substantial part, of the business of the company. In addition, subsection 324(4) of the Corporations Act provides that, for the purposes of subsections 324(1) and (2), a person is taken to be an officer of a company if:

- (a) the person is an officer of a related body corporate or of an entity that the company controls; or
- (b) except where ASIC, if it thinks fit in the circumstances of the case, directs that this paragraph not apply, the person has, at any time within the immediately preceding period of 12 months, been an officer or promoter of the company, of a related body corporate, or of an entity that the company controlled at that time.

5.09 Professional Statement F1 and AUP 32 both contain requirements that reinforce those in subsections 324(1), (2) and (4). In addition, F1 provides that no person in an accounting firm shall:

- (a) personally take part in the audit of a client if, during the period in respect of which the audit is to be performed or at any time in the 12 months prior to the first day of the period in respect of which the audit is to be performed, a near relative of the person has been an officer (other than an auditor), partner or employee of the client (F1 para 8);
- (b) act as auditor of a company if any person in the practice is an employee of the company (F1 para 9); or
- (c) accept or retain a directorship of a company which, through ownership of shares or otherwise, exerts significant influence over another company of which the firm or any person in the firm is auditor (F1 para 23).

5.10 The ICAA and CPAA have proposed that the professional requirements should be amended along the lines of the proposals in IFAC's April 2001 exposure draft (see below for the IFAC proposals).

Overseas developments

International Federation of Accountants

5.11 IFAC's April 2001 exposure draft identifies five categories of employment relationship that may have the potential to threaten an auditor's independence:

- (a) employment with an assurance client;
- (b) recent service with an assurance client;
- (c) serving as an officer or as a director on the board of an assurance client;
- (d) long association of senior personnel with an assurance client; and
- (e) family and personal relationships.

5.12 Table 5.1 sets out the nature of the threats to independence that may be caused by each of the above categories of employment relationship and the measures that should be adopted to safeguard independence.

**TABLE 5.1: EMPLOYMENT RELATIONSHIPS IDENTIFIED BY IFAC
AS A POTENTIAL THREAT TO INDEPENDENCE**

Category	Nature of threats to independence	Safeguards to protect independence
Employment with an assurance client	Self-interest, familiarity and intimidation threats could arise where an assurance client's director, officer or member of management has been a member of the assurance team or partner of the firm.	Ensuring the individual concerned: (1) is not entitled to any benefits or payments from the firm (unless made in accordance with fixed pre-determined arrangements); and (2) does not continue to participate, or appear to participate, in the firm's business or professional activities.
Recent service with an assurance client	Self-review and self-interest threats could occur where a former officer, director or employee of the assurance client serves as a member of the assurance team.	Where employment with the assurance client ended during the period covered by the assurance report, the individual should not be assigned to the assurance team. In other cases, it may be necessary to conduct additional reviews of the work performed and to discuss the matter with those in the assurance client who are charged with corporate governance.
Serving as an officer or a director on the board of an assurance client	Self-review and self-interest threats would be created by a partner or employee of the firm serving as an officer or director of an assurance client or its related entities.	Refuse to perform, or withdraw from, the assurance engagement.
Long association of senior personnel with an assurance client	A familiarity threat may be created where the same lead audit engagement partner or senior personnel are used over a long period of time.	The lead audit partner should be rotated after a pre-defined period (normally 7 years); such a partner should not resume his or her lead role for at least 2 years. In the case of team members, they could be rotated off the assurance team or additional reviews of work carried out.
Family and personal relationships	Self-interest, familiarity or intimidation threats could occur where there are family and personal relationships between a member of the assurance team	Where the relationship involves an immediate family member of a member of the assurance team, the individual should be removed from the team or the firm should

	and a director, an officer or certain employees of the assurance client.	withdraw from the assurance engagement. Where the relationship involves a close family member of a member of the assurance team, it may be sufficient to remove the individual from the team.
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Europe

5.13 Under the Eighth Council Directive, Member States are required to enact legislation providing that persons approved for the statutory auditing of accounting documents shall not carry out such audits if they are not independent in accordance with the law of the Member State which requires the audit.

5.14 In the United Kingdom, the requirements of the Eighth Council Directive were implemented by the Companies Act 1989. Subsection 27(1) of the Act provides that a person is ineligible for appointment as auditor of a company if he or she is an officer or employee of the company, or a partner or employee of such a person, or a partnership of which such a person is a partner. While subsection 27(2) of the Act provides that the Secretary of State may also make regulations specifying further connections between an audit firm and its audit client that would make the firm ineligible for appointment, no regulations to this effect appear to have been made.

Proposed changes

5.15 The consultative paper issued by the European Commission in December 2000 identifies five employment relationships that are considered to have the potential to affect the independence of auditors. The relationships, and the safeguards that should be used to avoid or minimise the independence risks posed by each relationship, are listed in Table 5.2.

TABLE 5.2: EMPLOYMENT RELATIONSHIPS IDENTIFIED IN THE EUROPEAN COMMISSION'S PAPER AS A THREAT TO INDEPENDENCE	
<i>Category</i>	<i>Safeguards to protect independence</i>
Dual employment	Dual employment of any individual who is in a position to influence the outcome of the audit in either the audit firm or its client should be prohibited.
Member of engagement team joins audit client	Where a member of an engagement team is leaving the audit firm to join an audit client the policies and procedures of the audit firm should provide for the immediate removal of the person from the audit team and the adoption of any other measures needed to ensure independence is not compromised.
Other member of firm joins audit client	Where a former engagement team member, or an individual within the chain of command, joins an audit client the policies and procedures of the audit firm should ensure that there remain no significant connections between itself and the individual.

Director or manager of audit client joins firm	Where a director or manager of an audit client joins the audit firm, the individual should not be involved in the audit of the client for a period of two years after leaving the client. Similar considerations apply where a former employee of the audit client joins the audit firm unless the responsibilities he held and the tasks he performed at the audit client were insignificant in relation to the statutory audit function.
Involvement of close family member	An individual who is a statutory auditor should not accept an audit engagement if a close family member holds a senior management position with the audit client or is in a position to exert direct influence on the preparation of the audit client's accounting records or financial statements.

5.16 The European Commission's paper also notes that independence risks can occur where certain members of the engagement team work regularly and for a long period of time on an audit client engagement. To reduce risks to independence, the paper proposes that the audit partner should be replaced within a reasonable period of time (5 to 7 years is suggested) and the partner should not be allowed to return to the audit until a two-year period of time has elapsed.

United States of America

5.17 The SEC's new rules seek to preserve audit independence in the area of employment relationships by preventing:

- (a) a current member¹⁷ of an accounting firm from being employed by the audit client or serving as a director of the audit client;
- (b) a former member of an accounting firm from being in an accounting role or financial reporting oversight role at an audit client (although exemptions to this requirement are provided where the individual does not influence the accounting firm's operations or financial policies, has no capital balances in the accounting firm and has no financial arrangement with the accounting firm other than one providing for regular payments of a fixed dollar amount such as under a fully funded retirement plan where the payment is independent of the revenue, profits or earnings of the audit firm);
- (c) a former officer, director or employee of an audit client from becoming a member of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client covering any period during which he or she was employed by or associated with that audit client; and
- (d) a close family member of a covered person¹⁸ in the firm from being in an accounting role or financial oversight role at an audit client during a period in which the covered person was involved in the audit of the client.

¹⁷ A member of an accounting firm includes a partner, principal shareholder or professional employee.

¹⁸ 'Covered person' is defined in the SEC rules to mean the following members of an accounting firm: (a) the audit engagement team; (b) the chain of command; (c) any other member of the firm who has provided 10 or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the

Adequacy of Australian requirements

5.18 The existence of employment relationships between an accounting firm and an audit client can give the impression that an auditor is not independent of the client, irrespective of the actual situation. Where such relationships exist, there may be a range of circumstances which, collectively or individually, make it difficult for the auditor to adopt an unbiased approach to the audit engagement, with the result that the audit client could receive a more favourable audit report than the facts or circumstances justify. Consequently, in the English-speaking world at least, legislators have long been minded to include in corporate legislation provisions which have the objective of prohibiting or restricting employment relationships. More recently, professional accounting bodies have also amended their ethical codes to include prohibitions or restrictions on employment relationships.

5.19 In keeping with these broad objectives, the IFAC and European Commission proposals and the SEC rules all seek to safeguard independence by ensuring that:

- (a) partners or professional employees of an accounting firm are not employed by the audit client or serve as a director of the audit client;
- (b) where a former partner or professional employee of an accounting firm is employed in an accounting role or a financial reporting oversight role at an audit client, there are (with limited exceptions) no residual links with the accounting firm;
- (c) where a former officer, director or employee of an audit client becomes a member of an accounting firm, the person is not in a position to audit, or influence the audit, of financial statements concerning a period during which he or she was employed by, or associated with, the audit client; and
- (d) relatives of a member of an audit team are not directors of an audit client or employed by the audit client in a senior management position, in an accounting role, or a financial oversight role.

5.20 The IFAC and European Community proposals also seek to limit long-term associations between members of the audit team and the audit client. In both cases it is proposed that the partners involved should be replaced after not more than 7 years and that they should not be able to return to the audit until a two-year period of time has elapsed.

5.21 The Australian legislative requirements are largely designed to ensure that partners and employees of an accounting firm do not serve as officers of an audit client. In addition, there is a prohibition on an accounting firm being an auditor of a company if an officer of the company receives remuneration from the firm for acting as a consultant to the firm on accounting or auditing matters¹⁹ while paragraph 324(4)(b) of the Corporations Act effectively restricts an accounting firm from employing former officers of an audit client during the period of 12 months after they ceased to be an officer of the client.

date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide 10 or more hours on non-audit services to the audit client on a recurring basis; and (d) any other member from an office of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

¹⁹ While the history of this provision is unclear, it appears to be an attempt to address the issue of former partners of accounting firms who are retained as consultants following their retirement from the firm.

5.22 The requirements of the Australian accounting profession, as set out in Statement F1 and AUP 32, build on the legislative requirements. In particular, the professional requirements prohibit a person in an accounting firm from taking part in the audit of a client if a near relative of the person is, or has recently been, an officer or employee of the audit client and add a more general requirement that an accounting firm will not act as auditor of a company if any person in the firm is an employee of the company.

5.23 Differences in terminology used in the various legislative and professional requirements examined during the course of this review make precise comparisons of Australian and overseas requirements difficult. Nevertheless, it is evident that Australian legislative requirements, in particular, have not been updated to address key issues such as relatives of the auditor or other members of the accounting firm being directors of, or employed by, the audit client. While the profession's ethical requirements deal with some matters not in the Corporations Act, they are in need of revision to reflect the philosophies that underpin the overseas proposals.

5.24 There are three basic ways in which the Australian requirements on employment relationships could be reformed:

- (a) retention of a co-regulation model, in which both the Corporations Act and the ethical rules of the professional bodies contain requirements dealing with audit independence;
- (b) exclusive reliance on independence requirements in the ethical rules of the professional bodies; or
- (c) exclusive reliance on independence requirements in the Corporations Act.

5.25 With a co-regulation model, the legislation would set the core requirements, and the ethical rules of the professional bodies, revised in line with the IFAC proposals, would provide additional guidance for considering the threats to audit independence associated with employment relationships and the safeguards available for eliminating or minimising those threats.

5.26 A model in which exclusive reliance is placed on ethical rules of the professional bodies may not sufficiently reflect the public interest in the important issue of auditor independence and there can also be benefits in terms of enforcement in having some legislative provisions. It is also to be noted that at least one of the recommendations detailed below would be very difficult, if not impossible, to include in the ethical rules of the professional accounting bodies. In particular, the recommendation concerning retired audit partners joining the boards of their former clients could not be enforced by the professional bodies, if it was part of their ethical rules, if retired audit partners were no longer members of the professional bodies.

5.27 At the same time, a model in which exclusive reliance is placed on independence requirements in the Corporations Act does not allow a legitimate role for professional bodies to develop appropriate ethical rules.

5.28 While each of these three options is worthy of consideration, the high level of importance that Australian legislators have previously placed on seeking to ensure audit independence by prohibiting or restricting employment relationships has led us to the view that the preferred option is the retention of a co-regulation model. Under this model the legislative requirements should be revised to include provisions dealing with:

- (a) the employment of current and former professional employees of an accounting firm by an audit client;
- (b) the employment of relatives of partners or employees of an accounting firm by an audit client; and
- (c) the employment by an accounting firm of former employees of an audit client.

5.29 The amendments to the Corporations Act proposed under a revised co-regulation model are detailed below under recommendations.

5.30 We note that a particular concern in Australia has been retired audit partners joining the boards of their audit clients. A significant number of the stakeholders consulted during the course of the review identified this as a concern. Where this occurs, it is often seen as a particular threat to the independence of the audit firm. The threat to independence can arise not only when the former partner joins the audit client but also if the former audit partner retains some financial arrangement with his or her audit firm or continues to exercise influence with the audit firm.

5.31 The potential threats to independence in these circumstances have been summarised as follows:²⁰

‘The concerns expressed when professionals leave firms to join audit clients are generally threefold:

- (a) That partners or other audit team members who resign to accept positions with audit clients may not have exercised an appropriate level of scepticism during the audit process prior to their departure.
- (b) That the departing partner or other professional may be familiar enough with the audit approach and testing strategy so as to be able to circumvent them once he or she begins employment with the client.
- (c) That remaining members of the audit team, who may have been friendly with, or respectful of a former partner or other professional when he or she was with the firm, would be reluctant to challenge the decisions of the former partner or professional and, as a result, might accept the client’s proposed accounting without exercising appropriate scepticism or maintaining objectivity.

The perceived threats to auditor independence when the former partner or professional has retirement benefits or a capital account with the audit firm are as follows:

- (a) It may appear that ties between the audit firm and the partner or other professional have not been severed – that the firm has placed its “own man or woman” at the client, functioning as management, and is in effect auditing the results of its own work.
- (b) If the retirement benefits of the former partner or other professional vary based on the firm’s profits, then the former partner or other professional may

²⁰ Independence Standards Board, *Independence Standard No 3, Employment with Audit Clients* (July 2000).

be inclined to pay the firm higher fees to inflate his or her retirement benefits (or to increase the likelihood of receiving benefits in unfunded plans). As a result, the firm may be less rigorous in its scrutiny of the client's accounting policies because its fees are overly rich.

- (c) If the former partner's or other professional's unfunded retirement benefits or other monies held by the firm are material to the firm and the firm is experiencing cash flow problems, the firm may be less rigorous in its audit of the client's financial statements in exchange for forbearance on the amounts owed to the former partner or other professional.'

5.32 We have formulated recommendations as part of the review which we believe are appropriate to deal with these threats to auditor independence. In particular, to deal with threats to auditor independence when a former partner or professional retains retirement benefits with the audit firm or is in a position to influence the audit firm's operations or financial policies, we recommend that an auditor is not independent if a former partner or professional employee of an audit firm is:

- (a) a director of the client; or
- (b) an officer or employee of the client who is in a position to affect the subject-matter of the audit engagement;

unless the individual:

- (c) does not influence the audit firm's operations or financial policies and does not participate or appear to participate in the audit firm's business or professional activities;
- (d) has no capital balances in the audit firm; and
- (e) has no financial arrangement with the audit firm other than one providing for regular payment of a fixed pre-determined dollar amount which is not dependent on the revenues, profits or earnings of the audit firm.

5.33 To deal with the threat to independence when a retired audit partner joins the board of an audit client, we recommend that there be a mandatory period of two years following resignation from the audit firm before a former partner of an audit firm who is directly involved in the audit of a client can become a director of the client. This proposal received the support of a number of key stakeholders who were consulted during the course of the review, including the support of the big five accounting firms. We are conscious, in formulating this recommendation, of not wanting to unduly impede employment opportunities for those who want to move from audit firms to companies. Indeed, we recognise that it can be of benefit to the economy to allow those who have financial expertise to take this expertise to companies, by becoming directors or employees of those companies. In this regard, we stress the limited nature of our recommendation. It only restricts a former partner of an audit firm directly involved in the audit of a client becoming a director of the client within a period of two years of resigning as partner of the audit firm. This means that it is still possible for:

- (a) someone at the audit firm, other than a former partner of the audit firm directly involved in the audit of a client, to join the client in a capacity as director, officer or employee;

- (b) a former partner of the audit firm directly involved in the audit of a client to join the client in some capacity other than as a director; and
- (c) a former partner of the audit firm directly involved in the audit of a client to become a director of the client once the period of two years has expired since the date of resignation as a partner of the audit firm.

5.34 We believe the recommendations achieve an appropriate balance between the important objective of putting in place mechanisms to ensure auditor independence while, at the same time, not unduly impeding professionals in audit firms joining companies and bringing with them to those companies financial expertise.

Recommendations

5.35 Section 324 of the Corporations Act currently deals with employment relationships between auditors and clients. Therefore, it is intended that the following provisions will replace sections 324(1)(f) and 324(2)(g) and (h) of the Corporations Act.

An auditor is not independent if any of the following employment relationships exist with the client. There are exemptions for inadvertent breaches of the rules if certain requirements are met.

It is important to emphasise that these employment relationships are not an exclusive indication of circumstances where an auditor lacks independence. There will be other circumstances where, depending upon the facts, an auditor may lack independence. As is currently the case, it is appropriate that the ethical statements of the professional accounting bodies contain additional guidance for auditors dealing with other circumstances in which an auditor may lack independence.

The following rules for employment relationships do not apply if the client is a small proprietary company (as defined in section 45A of the Corporations Act).²¹

For the purpose of determining who is an officer of the client, the definitions in sections 9 and 324(4) of the Corporations Act apply.

1 Employment by client of current auditor/employee of auditor

An auditor is not independent if a current partner or professional employee of the audit firm is:

- (a) an officer of the client;
- (b) a partner, employer or employee of an officer of the client; or

²¹ The Corporations Act currently provides that the prohibitions in section 324 on employment relationships between accounting firms and audit clients do not apply if the audit client is a proprietary company. The Audit Review Working Party recommended that the exemption for proprietary companies be removed (recommendation 9.1). This was on the basis that the exemption could provide for two standards of audit. However, the Working Party noted that its recommendation could impose additional cost burdens on closely held family companies and that its major concern was with the independence of auditors of proprietary companies which are substantial in size and likely to have minority shareholders and substantial liabilities. Given these considerations, we believe that the most appropriate way forward is to exclude from the employment prohibitions in section 324 only small proprietary companies (as defined in section 45A of the Corporations Act). This accommodates the main concern of the Working Party to ensure that large proprietary companies are subject to auditor independence rules. However, it does not impose cost burdens on small proprietary companies as they will be exempt.

- (c) a partner or employee of an employee of an officer of the client.

[Note: Paragraphs (a), (b) and (c) are drawn from subsections 324(1) and (2) of the Corporations Act. However, section 324 is limited to members of the firm. The recommendation also applies to professional employees of the audit firm. This is consistent with international rules and proposals which prohibit such relationships (see IFAC proposals, paragraph 8.134 and SEC Rule 210.2-01(c)(2) (i)).]

2 Employment by client of certain relatives of auditor

An auditor is not independent if an immediate family member of a member of the audit engagement team is:

- (a) a director of the client; or
- (b) an officer or employee of the client who is in a position to affect the subject matter of the audit engagement.

[Note: This recommendation is drawn from the IFAC proposals (paragraph 8.124) and the SEC rules (Rule 210.2-01(c)(2)(ii)) which prohibit these employment relationships. The difference between the two is that the IFAC proposal applies to immediate family members while the SEC rule applies to close family members. On balance, we prefer the IFAC proposal and note that this is more consistent with the European Commission proposal.]

3 Employment by client of former auditor/employee of auditor

An auditor is not independent if a former partner or professional employee of an audit firm is:

- (a) a director of the client; or
- (b) an officer or employee of the client who is in a position to affect the subject matter of the audit engagement;

unless the individual:

- (c) does not influence the audit firm's operations or financial policies and does not participate or appear to participate in the audit firm's business or professional activities;
- (d) has no capital balances in the audit firm; and
- (e) has no financial arrangement with the audit firm other than one providing for regular payment of a fixed pre-determined dollar amount which is not dependent on the revenues, profits or earnings of the audit firm.

[Note: This recommendation is drawn from the IFAC proposals (paragraph 8.129) and the SEC rules (Rule 210.2-01(c)(2)(iii)) which prohibit these employment relationships.]

4 Retired audit partner joining board of audit client

An auditor is not independent if a former partner of an audit firm who was directly involved in the audit of a client becomes a director of the client within a period of two years of resigning as partner of the audit firm.

[Note: See paragraphs 5.30 to 5.34 of the report for discussion of this recommendation.]

5 Employment by audit firm of former employee of client

An auditor is not independent if a member of the audit engagement team has, during the period covered by the audit report, been:

- (a) an officer of the client; or
- (b) an employee of the client in a position to influence the subject matter of the audit engagement.

[Note: This recommendation is drawn from the IFAC proposals (paragraph 8.132) and the SEC rules (Rule 210.2-01(c)(2)(iv)) which prohibit these employment relationships.]

6 Remuneration from audit firm

An auditor is not independent if an officer of the client, or an employee of the client in a position to influence the subject-matter of the audit engagement, receives any remuneration from the audit firm for acting as a consultant to it on accounting or auditing matters.

[Note: This recommendation repeats what is currently in subsection 324(2)(h) of the Corporations Act but has been expanded to include employees of the client who are in a position to influence the subject matter of the audit engagement.]

7 Inadvertent breaches

It is appropriate that there be protection for inadvertent breaches of the independence rules concerning employment relationships, provided certain requirements are met. Therefore, an auditor's independence will not be impaired solely because a person in the audit firm is not independent because of a breach of the rules concerning employment relationships provided:

- (a) the person did not know of the circumstances giving rise to the lack of independence;
- (b) the person's lack of independence was corrected as promptly as possible under the relevant circumstances after the person or the audit firm became aware of it; and
- (c) the audit firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the audit firm's practice, that the audit firm and its employees do not lack independence.

[Note: This recommendation is drawn from the IFAC proposals and the SEC rules (Rule 210.2-01(d)) which provide exemptions for inadvertent breaches of the independence rules provided certain requirements are met. This recommendation draws in particular upon the SEC rules but does not go as far as the SEC rules which require specific quality control systems for audit firms

that annually provide audit services to more than 500 companies whose securities are registered with the SEC.]

Key definitions

Audit engagement team:

- (a) all professionals participating in the audit engagement; and
- (b) all others within a firm who can directly influence the outcome of the audit engagement, including:
 - (i) those who supervise or have direct management responsibility for the audit engagement (this includes those at successively senior levels through the firm's chief executive);
 - (ii) those who provide consultation regarding technical or industry-specific issues, transactions or events for the audit engagement;
 - (iii) those who provide quality control or other oversight of the audit; and
 - (iv) those who provide direct supervisory, management, compensation or other oversight of the audit engagement partner including those who evaluate the performance or recommend the compensation of the audit engagement partner.

Client:

An entity in respect of which a firm conducts an audit engagement. When the client is a listed entity, client includes related entities.

Immediate family:

A spouse (or equivalent) or dependent.

Other client service personnel:

Partners and managerial employees who provide non-audit services to a client, except those whose time involvement is clearly insignificant.

Related entity:

- (a) an entity that has direct or indirect control over the client provided the client is material to such entity;
- (b) an entity with a direct financial interest in the client provided that such entity has significant influence over the client and the interest in the client is material to the entity;
- (c) an entity over which the client has direct or indirect control;
- (d) an entity in which the client has a direct financial interest, provided the client has significant influence over such entity and the interest is material to the client; and

- (e) an entity which is under common control with the client (a “sister entity”) provided the sister entity and the client are both material to the entity that controls both the client and sister entity.

[Note: These definitions are drawn from the IFAC proposals (see definitions of audit client, assurance team, immediate family, other client service personnel, and related entity) and the SEC rules (Rule 210.2-01(f)), see definitions of audit client, audit engagement team, immediate family members, covered persons in the firm, and affiliate of the audit client.]

FINANCIAL RELATIONSHIPS

5.36 The expression ‘financial relationships’ is used to cover the following broad categories of transaction between an audit firm and an audit client:

- (a) investments in, or other business relationships with, audit clients; and
- (b) other financial interests in audit clients including loans, savings and cheque accounts and insurance products.

Australian position

5.37 Subsections 324 (1) and (2) of the Corporations Act provide that an individual or accounting firm must not consent to be appointed as auditor of a company, act as auditor of a company or prepare a report required by the Act to be prepared by a registered company auditor or by an auditor of a company if the individual, a body corporate in which the person has a substantial holding, a member of the firm, or a body corporate in which a member of the firm has a substantial holding, owes more than \$5,000 to the company, to a related body corporate or to an entity that the company controls.²²

5.38 Statement F1 provides that a practice must not have as an audit client a company in which any person in the practice, or a near relative of any person in the practice, is:

- (a) the beneficial owner of shares forming a material part of the equity share capital of the company, or forming a material part of the assets of that person;
- (b) a trustee of a trust having a material interest in that company; or
- (c) a director or employee of a company which acts as trustee of a trust having a material interest in the client company.

5.39 Statement F1 also contains a number of general requirements which are applicable to practices that perform audit work. These requirements include that no person in the practice, or near relative of any person in the practice, shall:

- (a) accept or make or guarantee a loan from or to a client except for a loan negotiated at arm’s length in the ordinary course of the client’s business; or

²² Subsection 324(3) provides an exemption from this requirement for home loans by financial institutions for a principal place of residence.

- (b) accept from a client goods or services on terms more favourable than those generally available to others.

5.40 In addition, AUP 32 contains a range of requirements about financial relationships which reinforce, but do not go significantly beyond, those in the Corporations Act and Statement F1.

5.41 The 1997 report of the Audit Review Working Party proposed a number of amendments to the indebtedness levels contained in the corporations legislation:

- (a) the level of indebtedness by an auditor to a client (referred to in paragraphs 324(1)(e) and (2)(f) of the Act) should be increased from \$5,000 to \$10,000 or such other amount as may be prescribed by regulation;
- (b) 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; and
- (c) the monetary indebtedness provisions should only apply to partners of a firm of auditors who are directly engaged on the audit assignment and relatives of such partners.

5.42 In addition to the proposed legislative amendments, ICAA and CPA Australia have proposed that the professional requirements be revised along the lines of the proposals in IFAC's April 2001 exposure draft.

Overseas position

International Federation of Accountants

5.43 The IFAC exposure draft identifies three categories of financial relationship that may have the potential to threaten an auditor's independence:

- (a) financial interests in an assurance client;
- (b) loans and guarantees; and
- (c) close business relationships with an assurance client.

5.44 Table 5.3 sets out the nature of the threats to independence that may be caused by each of the above categories of financial relationship and the measures that should be adopted to safeguard independence.

**TABLE 5.3: FINANCIAL RELATIONSHIPS IDENTIFIED BY IFAC
AS A THREAT TO INDEPENDENCE**

Category	Nature of threats to independence	Safeguards to protect independence
Financial interests in an assurance client	A self-interest threat may be created by having a financial interest in an assurance client.	If a firm has a direct or material indirect financial interest in an assurance client, it should dispose of the interest or refuse to perform the assurance engagement. If a member of the assurance team, or their family member, has a direct or material indirect financial interest in an assurance client, the person should be removed from the assurance team. Other partners and employees, or their immediate family, in the office in which the lead engagement partner practices in connection with the audit should not hold a direct or material indirect financial interest in the audit client.
Loans and guarantees	A self-interest threat may be created where the firm, or a member of the assurance team: (1) makes a loan to an assurance client that is not a bank or similar institution, or guarantees such an assurance client's borrowing. (2) accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution.	Such transactions should not be undertaken. (Modified rules apply for transactions involving banks and similar institutions. Generally, they are acceptable provided they are made under normal lending procedures, terms and requirements.)
Close business relationships with an assurance client	Self-interest and intimidation threats may be created by a close business relationship between a firm or a member of the assurance team and the assurance client or its management.	Such transactions should not be undertaken.

Europe

5.45 The Eighth Council Directive does not specifically refer to financial relationships, although it does provide that persons approved for the statutory auditing of accounting documents shall not

carry out such audits if they are not independent in accordance with the law of the Member State which requires the audit.

5.46 Similarly, the UK Companies Act does not contain provisions dealing expressly with financial relationships between a company auditor and any company the person may audit although subsection 27(2) of the Act provides that the Secretary of State may make regulations specifying connections between an audit firm and its audit client that would make the firm ineligible for appointment. To date, no regulations to this effect appear to have been made.

Proposed changes

5.47 The European Commission's December 2000 consultative paper proposes that Member States significantly strengthen independence requirements in the area of financial relationships. Financial relationships that are identified in the paper as being incompatible with an auditor's independence include:

- (a) the auditor or any other person in a position to influence the outcome of the audit holding a direct or indirect financial interest in the audit client or its affiliates;
- (b) business relationships, or commitments to establish such relationships (unless the relationship is in the normal course of business and insignificant);
- (c) a close family member of the auditor having a financial interest in, or a business relationship with, the audit client; and
- (d) any person who is in a position to influence the outcome of the audit should not be a member of any management or supervisory body in an entity which holds directly or indirectly more than 20% of the voting rights in the client, or in which the client holds directly or indirectly more than 20% of the voting rights.

United States of America

5.48 The SEC's new rules seek to preserve audit independence by preventing:

- (a) an accounting firm, any covered person in the firm, or any of his or her immediate family members:
 - (i) having a direct investment in stocks, bonds, notes, options or other securities of the audit client;
 - (ii) serving as a voting trustee of a trust, or executor of an estate, containing securities of the audit client;
 - (iii) having a material indirect interest in the audit client; and
 - (iv) having other financial interests in audit clients, including loans, saving and cheque accounts, broker-dealer accounts, futures commission merchant accounts, credit cards and insurance products (although the rules provide some relief or exemptions in respect of interests such as loans);

- (b) an audit client having any direct investment in an accounting firm, such as stocks, bonds, notes, options or other securities, or the audit client's officers or directors being owners of more than 5% of the equity securities of the accounting firm; and
- (c) an accounting firm or any covered person in the firm having a direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity such as an audit client's officers, directors, or substantial stockholders.

5.49 The SEC's rules on financial interests have been framed so that, except where the interest is held by the firm, their application is limited to a covered person and his or her immediate family members.

Adequacy of Australian requirements

5.50 As with employment relationships, the existence of financial relationships between an accounting firm and an audit client can give the impression that an auditor is not independent of the client. Legislators in much of the English-speaking world have included in their legislation provisions which have the objective of prohibiting or restricting financial relationships, although the scope of such provisions ranges from general requirements that an auditor's judgment not be 'impaired by reason of any relationship with or interest in the company'²³ to specific provisions about loans and investments. More recently, professional accounting bodies have also amended their ethical codes to include prohibitions or restrictions on a range of financial relationships.

5.51 The IFAC and European Commission proposals and the SEC rules seek to ensure that financial relationships do not impair audit independence by prohibiting or restricting the following categories of relationship:

- (a) investments in audit clients;
- (b) loans to and from audit clients; and
- (c) business relationships with audit clients.

5.52 The Australian legislative requirements are largely concerned with the loans that partners and employees of an accounting firm may have received from an audit client. The requirements of the Australian accounting profession, as set out in Statement F1 and AUP 32, build on the legislative requirements primarily in the area of investments in an audit client.

5.53 Australia's legislative and professional requirements in respect of financial relationships require significant updating to bring them into line with current and proposed overseas requirements. In particular, the Corporations Act contains no requirements in respect of investments in audit clients or about business relationships between auditors and their audit clients. The professional rules contain minimal requirements in respect of business relationships.

5.54 As with employee relationships, there are three basic ways in which the Australian requirements on financial relationships could be reformed:

²³ New Zealand Companies Act, section 204.

- (a) retention of a co-regulation model, in which both the Corporations Act and the ethical rules of the professional bodies contain requirements dealing with audit independence;
- (b) exclusive reliance on independence requirements in the ethical rules of the professional bodies; or
- (c) exclusive reliance on independence requirements in the Corporations Act.

5.55 Under a co-regulation model, the legislation would set the core requirements, while the ethical rules of the professional bodies, revised in line with the IFAC proposals, would provide additional guidance for considering the threats to audit independence associated with financial relationships and the safeguards available for eliminating or minimising those threats.

5.56 Unlike employment relationships, there has not been a consistent approach by legislators on the aspects of financial relationships that need to be regulated to ensure audit independence. Some jurisdictions (such as Australia) have been primarily concerned with transactions involving loans while others (for example, Canada) have focussed on the issues such as material investments in the securities of an investment client. The issue of business relationships, on the other hand, does not appear to have been addressed by legislators or regulators until the inclusion of requirements on such relationships in the SEC rules and the European Commission proposals. However, the ethical rules of professional bodies have generally dealt with all three aspects of financial relationships referred to above.

5.57 It is proposed that a co-regulation model should continue to be used for ensuring financial relationships between an auditor and an audit client do not impair audit independence. In view of the significant effect investments in audit clients and loans to and from clients could have on the independence of an auditor, it is proposed that the basic requirements in respect of these relationships should be included in the Corporations Act rather than left partly or solely to the ethical rules of the accounting bodies. The ethical rules would supplement the legislative requirements of these matters and would deal exclusively with the issue of business relationships.

5.58 The proposed amendments to the Corporations Act and professional ethical rules under a revised co-regulation model are detailed in the recommendations listed below.

Recommendations

5.59 Section 324 of the Corporations Act currently deals with some aspects of financial relationships between auditors and clients. Therefore, it is intended that the following provisions will replace sections 324(1)(e) and 324(2)(f) of the Corporations Act.

Definitions of a number of these terms contained in these recommendations are outlined in paragraph 5.35. For other definitions relevant to the recommendations, see the definitions in the IFAC proposals (Appendix G of this report).

There are exemptions for inadvertent breaches of the rules if certain requirements are met.

It is important to emphasise that these financial relationships are not an exclusive indication of circumstances where an auditor lacks independence. There will be other circumstances where, depending upon the facts, an auditor may lack independence. As is currently the case, it is appropriate that the ethical statements of the professional accounting bodies contain additional guidance for auditors dealing with other circumstances in which an auditor may lack independence.

1 Investments in audit clients

An auditor is not independent if:

- (a) the audit firm, any member of the audit engagement team, or any of his or her immediate family has:
 - (i) a direct financial investment in the client; or
 - (ii) a material indirect financial investment in the client;
- (b) the audit firm has a material financial interest in an entity that has a controlling interest in the client; or
- (c) any other client service personnel, or any of his or her immediate family has a direct financial interest or a material indirect financial interest in the client.

[Note: This recommendation is drawn from the IFAC proposals (paragraphs 8.103, 8.105 and 8.111) which prohibit all these financial relationships. The SEC rules also prohibit these financial relationships (Rule 210.2-01(c)(1)), although the SEC rules are more prescriptive in a number of respects and include additional prohibitions. Both the IFAC proposals and the SEC rules prohibit partners and managerial employees who provide non-audit services to clients, as well as members of their immediate families, from having a direct financial interest or a material indirect financial interest in the client. There is a slight difference in language. The IFAC proposals exclude from the prohibition personnel whose time involvement in providing non-audit services to an audit client is clearly insignificant – see the IFAC definition of ‘other client service personnel’. The SEC rules exclude from the prohibition personnel who provide less than 10 hours of non-audit services to an audit client during the period relating to the relevant financial statements – see the SEC definition of ‘covered person in the firm’.]

2 Loans to and from audit clients

An auditor is not independent if:

- (a) subject to the exception contained in section 324(3) of the Corporations Act, a partner of the audit firm, or an entity which the partner controls, or a body corporate in which the partner has a substantial holding, owes more than \$10,000 (or such other amount as may be prescribed by regulation) to the client; or
- (b) the audit firm, any member of the audit engagement team, or any of his or her immediate family:
 - (i) accepts a loan from a client; or
 - (ii) makes a loan to a client; or
 - (iii) has a loan guaranteed by a client; or
 - (iv) guarantees a client’s loan;

unless the loan is made in the ordinary course of the client’s business and the loan is made under normal lending procedures, terms and conditions.

[Note: Paragraph (a) of this recommendation repeats what is currently in subsections 324(1)(e) and (2)(f) of the Corporations Act. However, two changes have been made. First, the amount of \$5,000 currently in section 324 has been increased to \$10,000, or such other amount as may be prescribed by regulation. This is in line with a recommendation made by the Audit Review Working Party. Secondly, the prohibition currently in section 324 has been extended beyond partners of audit firms and bodies corporate in which partners have a substantial holding, to include entities which partners control. It is appropriate not to restrict the prohibition to bodies corporate.]

Paragraph (b) of this recommendation is drawn from the IFAC proposals (paragraphs 8.114 to 8.118). The recommendation does not go as far as the SEC rules which are more prescriptive and include additional prohibitions concerning loans. However, the recommendation in paragraph (b) does extend the IFAC proposals by applying to the immediate family of members of the audit engagement team. We note that Professional Statement F1 currently provides that no person in a practice or a near relative of any person in the practice, shall accept or make or guarantee a loan from or to a client except for a loan negotiated at arm's length in the ordinary course of the client's business.]

3 Business relationships

Business relationships between auditors and clients are not currently dealt with in the Corporations Act. Therefore, it is intended that the following rule will be included in the revised professional ethical rules of the professional accounting bodies.

An auditor is not independent if:

- (a) a member of the audit engagement team has a business relationship with the client or any of its officers which is not clearly insignificant to both the member of the audit engagement team, and also the client or the officer; or
- (b) the audit firm has a business relationship with the client or any of its officers which is not clearly insignificant to both the audit firm and also the client or the officer.

A business relationship for this purpose does not include professional services provided by the audit firm, or the audit firm or member of the audit engagement team being a consumer in the ordinary course business.

[Note: This recommendation is drawn from the IFAC proposals (paragraph 8.119.)]

4 Inadvertent breaches

It is appropriate that there be protection for inadvertent breaches of the independence rules concerning financial relationships, provided certain requirements are met. Therefore, an auditor's independence will not be impaired solely because a person in the audit firm is not independent because of a breach of the rules concerning financial relationships provided:

- (a) the person did not know of the circumstances giving rise to the lack of independence;
- (b) the person's lack of independence was corrected as promptly as possible under the relevant circumstances after the person or the audit firm became aware of it; and

- (c) the audit firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the audit firm's practice, that the audit firm and its employees do not lack independence.

[Note: This recommendation is drawn from the IFAC proposals and the SEC rules (Rule 210.2-01(d)) which provide exemptions for inadvertent breaches of the independence rules provided certain requirements are met. This recommendation draws in particular upon the SEC rules but does not go as far as the SEC rules which require specific quality control systems for audit firms that annually provide audit services to more than 500 companies whose securities are registered with the SEC.]

PROVISION OF NON-AUDIT SERVICES

5.60 The expression 'non-audit services' is taken, for the purposes of this report, to cover all services not coming within the scope of the audit contract that an audit firm provides to an audit client.

Australian position

5.61 The Corporations Act is silent on the issue of an audit firm providing non-audit services to its audit clients. Australian accounting standard AASB 1034 does, however, require disclosure of amounts paid or payable to the auditor for 'audit services' and to the auditor and any related entity for 'non-audit services'.

5.62 The Audit Review Working Party proposed that 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. While recent amendments to AASB 1034 have addressed the beneficial ownership issue, the proposal that the nature of non-audit services be disclosed was not acted on, mainly on the grounds that this was not a requirement of international accounting standards with which the AASB was seeking to harmonise the relevant Australian standard.

5.63 Professional requirements about firms providing non-audit services to their audit clients are contained in Statement F1 and AUP 32. Statement F1 imposes a range of restrictions designed to ensure the independence of the auditor, including:

- (a) not providing valuation services to an audit client if the valuation is to be referred to as an 'independent' valuation in audited financial statements of the audit client;
- (b) not accepting appointment as liquidator, provisional liquidator, controller, scheme manager or administrator of a company if any person in the practice has, or in the two previous years has had, a continuing professional relationship with the company;
- (c) not participating in the executive function of an audit client when providing management consulting services; and
- (d) not participating in the preparation of books of a public company audit client (although an exception to this requirement is allowed in 'exceptional circumstances' provided the client accepts full responsibility for the books and the auditor does not become involved in the client's executive decision making function).

5.64 AUP 32, in addition to imposing similar restrictions to those contained in Statement F1, also identifies internal audit services as a matter that could affect the independence of the external auditor. However, the statement does not prohibit the provision of such services provided the auditor does not assume the role of management when providing the services and that any recommendations made by the auditor are for implementation by management.

5.65 The only existing proposals for amendments to legislative or professional requirements in respect of non-audit services are:

- (a) possible revision of Statement F1 in accordance with changes to section 8 of IFAC's Code of Ethics and withdrawal of AUP 32; and
- (b) a legislative amendment to implement the Audit Review Working Party's recommendation that disclosure requirements relating to non-audit services be expanded to require a breakdown of the nature of those services.

Overseas position

International Federation of Accountants

5.66 The IFAC exposure draft identifies nine categories of non-audit services as having the potential to pose a threat to an auditor's independence. The services are preparing accounting records and financial statements, valuation services, internal audit services, IT systems services, temporary staff assignments, acting for or assisting an assurance client in the resolution of a dispute or litigation, legal services, recruiting senior management for an assurance client, and corporate finance and similar activities.

5.67 Table 5.4 sets out the nature of the threats to independence that may be caused by each of these services and the measures that should be adopted to safeguard independence.

<i>Non-audit service</i>	<i>Possible threats to independence</i>	<i>Measures to protect independence</i>
Preparing accounting records and financial statements	A self-review threat may be created where a firm assists an audit client in matters such as preparing accounting records or financial statements and the statements are subsequently audited by the firm.	Services should not be provided to listed audit clients except in emergency situations.
Valuation services	A self-review threat may be created when a firm performs a valuation service that directly affects the subject matter of the assurance engagement.	Services should not be provided where they involve the valuation of matters that are material to the subject matter of the assurance engagement.

Internal audit services	A self-review threat may be created when a firm provides internal audit services to an audit client (see note a).	The audit client should be responsible for establishing, maintaining and monitoring the system of internal controls. An employee of the client should be responsible for internal audit activities, with the client approving the scope, risk and frequency of the internal audit work and which recommendations of the firm should be implemented.
IT systems services	A self-review threat may be created when a firm is involved in the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements.	The audit client must be responsible for establishing and monitoring a system of internal controls. The client or one of its employees should have responsibility for all management decisions concerning the design and implementation of the system, for evaluating the adequacy and results of the design and implementation, and for the operation of the system and the data used or generated by it.
Temporary staff assignments	A self-review threat may be created when a firm lends staff to an audit client, especially when the individual is in a position to influence the preparation of the client's accounts or financial statements.	Assistance may be given provided the client is responsible for directing and supervising the activities of the firm's staff and the firm's staff will not be required to make management decisions, approve or sign agreements or similar documents, or exercise discretionary authority to commit the client.

Acting for or assisting an assurance client in the resolution of a dispute or litigation	An advocacy threat may be created when a firm acts for an audit client in the resolution of a dispute or litigation while a self-review threat may be created when the assignment includes the estimation of the possible outcome.	Except where the amounts involved are immaterial or the threat is insignificant, a firm should not provide such services to an audit client.
Legal services	Self-review and advocacy threats may be created by the provision of legal services to an audit client.	Whether the service should be provided will depend on a range of factors, including the nature of the service and whether there would be a material impact on the financial statements.
Recruiting senior management for an assurance client	Self-interest, familiarity and intimidation threats may be created by the recruitment of senior management for an audit client.	While the firm might advertise for and interview prospective staff and produce a list of potential candidates, the decision about who should be hired is one for the client to make.
Corporate finance and similar activities	Advocacy and self review threats may be created by the provision of corporate finance services, advice or assistance to an audit client.	In the case of some corporate finance services (eg promoting, dealing in, or underwriting an audit client's shares), the threat to independence is so great that no adequate safeguards are available. In other cases, adequate safeguards may be available.
(a) Under the IFAC proposals, internal audit services do not include operational internal services unrelated to the internal accounting controls, financial systems or financial statements.		

Europe

5.68 The European Commission's existing requirements on audit independence do not specifically refer to the provision of non-audit services, although they do provide that persons approved for the statutory auditing of accounting documents shall not carry out statutory audits if they are not independent in accordance with the law of the Member State which requires the audit.

5.69 Similarly, the UK Companies Act does not contain provisions dealing expressly with provision of non-audit services. While subsection 27(2) of the Act provides that the Secretary of State may make regulations specifying connections between an audit firm and its audit client that would make the firm ineligible for appointment, no such regulations appear to have been made.

Proposed changes

5.70 The consultative paper released by the European Commission in December 2000 proposes that Member States significantly strengthen independence requirements concerning the provision of non-audit services. Situations that have been identified as having the potential to affect an auditor's independence include preparing accounting records and financial statements, design and implementation of financial information systems, valuation services, internal audit, resolution of litigation, and recruiting senior management. The threats to independence identified in the European Commission's paper and the safeguards that could be adopted to protect independence are similar to those identified by IFAC.

United States of America

5.71 Paragraph c(4) of Part 210.2-01 of the SEC's rules provides that an accountant is not independent if, at any time during the audit and professional engagement period, the accountant provides specified non-audit services to an audit client. The specified services, the scope of the restrictions for each service, and whether any exemptions are permitted are listed in Table 5.5.

<i>Non-audit service</i>	<i>Scope of restriction</i>	<i>Exceptions</i>
Bookkeeping or other services related to the audit client's accounting records or financial statements.	Includes maintaining or preparing the audit client's accounting records; preparing the audit client's financial statements for filing with the SEC; and preparing or originating source data underlying the audit client's financial statements.	Exceptions are allowed in 'emergency or unusual situations' and, subject to strict conditions, for foreign divisions or subsidiaries of an audit client.
Financial information systems design and implementation	Includes: (1) directly or indirectly operating, or supervising the operation of, the audit client's information systems or managing the audit client's local area network; and (2) designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements.	Relief from (2) is available when the audit client's management makes all management decisions concerning the design implementation and is responsible for evaluating the adequacy and results of the system. Provided the auditor does not act as an employee or perform management functions, no limits are placed on services in connection with the assessment, design and implementation of internal accounting controls and risk management controls.
Appraisal or valuation services or fairness	Includes any service involving a fairness opinion where it is	Exemptions include where the accountant reviews the work of

opinions	reasonably likely that the results of these services would be material to the financial statements or where the results of these services will be audited by the accountant during an audit of the audit client's financial statements.	the audit client or a specialist employed by the audit client (provided the client or the specialist provides the primary support for the balances recorded in the client's financial statements) and where the valuation is for non-financial purposes and the results of the valuation do not affect the financial statements.
Actuarial services	Includes any actuarially-oriented advisory service involving the determination of insurance company policy reserves and related accounts for the audit client.	Exceptions are permitted where the audit client uses its own or third-part actuaries to provide management with the primary actuarial capabilities; management accepts responsibility for any significant actuarial methods and assumptions; and the accountant's involvement is not continuous. Subject to conditions, the rules also allow a number of other actuarial-type services (see paragraph (c)(4)(iv)(B) of the rules).
Internal audit services	Includes: (1) providing more than 40% of the total hours expended on the client's internal activities in any one year (unless the client has less than \$200 million in total assets); or (2) any internal audit services, or any operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements, for an audit client.	Some relief is available in respect of (2) when the audit client's management assumes responsibility for various aspects of the internal audit function and a number of other conditions are satisfied.
Management functions	Includes acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.	None permitted.
Human resources	Includes searching for or seeking out prospective	An accountant may interview candidates and advise the

	candidates for managerial, executive or director positions; engaging in psychological testing, or other formal testing or evaluation programs; undertaking reference checks of prospective candidates for an executive or director position; or recommending that the audit client hire a specific candidate for a specific job.	audit client on the candidate's competence for financial accounting, administrative, or control positions.
Broker-dealer services	Includes acting as a broker-dealer, promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.	None permitted.
Legal services	Includes providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.	None permitted.

5.72 In addition, Part 240 of the SEC's rules requires registrants to disclose a range of information about fees billed for professional services.

Adequacy of Australian requirements

5.73 Given the various prohibitions and restrictions on employment and financial relationships between the members of an accounting firm and the firm's audit clients, the provision of a range of non-audit services to an audit client tends to be the principal area of involvement between an accounting firm and an audit client other than the audit itself.

5.74 The issue of whether accounting firms should provide non-audit services to their audit clients generates a wide range of views from stakeholder groups, ranging from calls for a total prohibition on the provision of such services to submissions that there is no evidence that providing the services impairs independence. Audit independence studies examined during the course of this review have reached different conclusions concerning whether the provision of non-audit services impairs audit independence (see Part 8 of this report).

5.75 The growth of non-audit services has tended to derive from requests by clients for additional services their auditors are capable of providing, as well as from the special skills needed to audit new and complex business transactions.²⁴ According to the Panel on Audit Effectiveness, today, effective audits depend more than ever on specialists. Specialists used in audits include:²⁵

- (a) technology and systems specialists;
- (b) actuaries, to help evaluate risk management controls, insurance companies' reserves, and pension and other benefit accruals;
- (c) treasury specialists, to help evaluate controls over cash management, financing, currency and derivatives;
- (d) tax specialists, to help evaluate tax liabilities and deferred tax assets; and
- (e) valuation specialists, to help evaluate the reasonableness of valuations of financial instruments, shares issued for assets or services, and allocations of the purchase price of acquired businesses.

5.76 The growth of non-audit services for the largest audit firms has been substantial. The Panel on Audit Effectiveness provides, in its report, the following statistics for the Big 5 audit firms in the United States, showing these firms' mix of practice as a percentage of gross fees.²⁶

	<u>1990</u>		<u>1999</u>	
	<u>All clients</u>	<u>SEC audit clients</u>	<u>All clients</u>	<u>SEC audit clients</u>
Accounting and auditing	53%	71%	34%	48%
Tax	27	17	22	20
Consulting	<u>20</u>	<u>12</u>	<u>44</u>	<u>32</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

According to the Panel on Audit Effectiveness, this indicates that, for SEC audit clients, the ratio of accounting and auditing revenues to consulting revenues dropped from approximately 6 to 1 in 1990 to 1.5 to 1 in 1999. For 1999, 75% of the big 5 firms' SEC audit clients received no consulting services from their auditors, down from 80% in 1990. Four per cent of those firms' SEC audit clients had consulting fees that exceeded audit fees, up from 1% in 1990.²⁷

5.77 The Australian Securities and Investments Commission has recently announced that it is conducting a survey of Australia's largest 100 listed companies to obtain evidence on the extent of non-audit services provided by the auditors of these companies.²⁸

²⁴ Panel on Audit Effectiveness, *Report and Recommendations* (2000) (chaired by Shaun F O'Malley).

²⁵ *Ibid*, para 5.10.

²⁶ *Ibid*, para 5.13.

²⁷ *Ibid*, para 5.14.

²⁸ ASIC Media Release 01/230, 29 June 2001, 'ASIC to Examine Accounting Standards and Auditing'.

5.78 The arguments supporting and opposing the provision of non-audit services by audit firms to their clients are outlined in a number of reports and other publications. The Panel on Audit Effectiveness is one of the reports that deals with the arguments. The following is a summary of a number of the arguments outlined in Chapter 5 of the report of the Panel on Audit Effectiveness.

Arguments opposing the provision of non-audit services by auditors to their clients

- 1 When an audit firm provides non-audit services to a client it is serving two different sets of clients: management in the case of non-audit services and the audit committee, the shareholders and all those who rely on the audited financial statements in the case of the audit. In serving these different clients the audit firm is subject to conflicts of interest.
- 2 A rule prohibiting audit firms from providing non-audit services to their clients would be relatively easy to administer and would not preclude an audit firm from providing non-audit services, as long as those services are not provided to audit clients.
- 3 Systems of compensation within audit firms may not give adequate weight to performing the audit function and may in fact adversely impact audit effectiveness. Success in marketing an audit firm's consulting services is often a significant factor in firms' compensation systems. The skills that make one successful in marketing non-audit services to management are not generally consistent with the professional demands on an auditor to be persistently sceptical, cautious and questioning in regard to management's financial representations, thereby creating a tension counter-productive to audit excellence.

Arguments supporting the provision of non-audit services by auditors to their clients

- 1 There is no solid evidence of any specific link between audit failures and the provision of non-audit services, and non-audit services have been provided by audit firms to their clients for many years. A ban should not be imposed in the absence of compelling evidence of a problem.
- 2 Many non-audit services are both in the public interest and beneficial to audit effectiveness. For example, 'a company may seek the assistance of its auditors to correct control weaknesses identified during the audit. The public interest is served by the controls (and the company's financial reporting process) having been strengthened through the auditors' knowledge of the company and its operations, and audit effectiveness is enhanced through the auditors' increased understanding of the company's systems'.
- 3 Companies that most need to improve their controls may decide not to do so because of the potential added costs and efforts of identifying and using firms other than their auditors.
- 4 It is not correct to assert that an audit firm has divided loyalties when it provides non-audit services to a client because it serves different clients (ie, management in the case of non-audit services and shareholders, the audit committee and those who rely on audited financial statements in the case of audits). To make this argument is to assert that the interests of management must necessarily be inimical to good financial reporting.
- 5 Audit firms increasingly need specialists such as information technology specialists to provide critical audit support. Attracting and retaining these specialists, and motivating them to provide direct audit support, may be hampered if they were to be prohibited from providing non-audit services to clients. These specialists generally are not accountants and

their primary professional interest is not auditing. Yet they maintain and build their skills by providing non-audit services. Therefore, an unintended consequence of a prohibition on auditors providing non-audit services to their clients could be to reduce audit effectiveness.

5.79 A blanket prohibition on auditors providing non-audit services to their clients would be entirely inconsistent with international practice. Different countries may have different degrees of regulation of non-audit services but a blanket prohibition on the provision of such services has not been adopted in any major capital market.

5.80 It is important to note that regulators, professional accounting bodies, and others who have considered the issue of non-audit services, all agree that there are some services which an audit firm cannot provide to its client. For example, the IFAC proposals state that an audit firm cannot:

- (a) authorise, execute or consummate a transaction, or otherwise exercise authority on behalf of the client, or have authority to do so;
- (b) prepare source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders);
- (c) determine which recommendations of the audit firm should be implemented; or
- (d) report, in a management role, to those charged with governance in the client.

5.81 The IFAC proposals also identify other non-audit services that an audit firm cannot provide to its client. These include:

- (a) valuation services involving the valuation of matters that are material to the subject-matter of the audit and the valuation involves a significant degree of subjectivity; and
- (b) promoting, dealing in, or underwriting a client's shares.

5.82 To date, legislators have generally tended to rely on the requirements of professional accounting bodies to ensure the independence of auditors is not impaired through the provision of non-audit services. Legislators have tended to either remain silent on the issue of non-audit services (for example, Australia and the United Kingdom) or address the issue through the inclusion of a general requirement for auditors to be independent (for example, Canada and New Zealand). The SEC rules represent the only example of which we are aware of a regulator developing very detailed rules in this area.

5.83 The new SEC rules and the IFAC and European Commission proposals seek to safeguard independence by ensuring that auditors are independent in fact and appearance. The rules and proposals seek to achieve this by ensuring the auditor does not:

- (a) have a mutual or conflicting interest with the audit client;
- (b) audit his or her own work;
- (c) function as management of the audit client; or
- (d) act as an advocate for the audit client.

5.84 In keeping with these objectives, prohibitions or restrictions are placed on the provision of a range of non-audit services, including bookkeeping and other services related to the audit client's accounting records or financial statements, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit services, human resources and legal services.

5.85 In addition, as noted above, the SEC's rules require registrants to disclose a range of information about fees billed for professional services.

5.86 As noted above, the Australian legislative requirements are silent on the issue of non-audit services. However, Australian accounting standard AASB 1034 requires disclosure of amounts paid or payable to the auditor of a company for the provision of audit and non-audit services. Proposals exist for the disclosure requirements to be enhanced to include a breakdown of the nature of the non-audit services.

5.87 The only Australian requirements about the provision of non-audit services are contained in Statement F1 and AUP 32 issued by the Australian accounting profession. The professional requirements specifically identify a number of non-audit services which could impair audit independence, including bookkeeping services, valuation services, participating in the executive function of a client when providing management consulting services, and internal audit. The ethical rules of the bodies provide guidance on whether such services should be provided to audit clients.

5.88 Australia's existing requirements on provision of non-audit services could be updated through:

- (a) use of a co-regulation model, in which both the Corporations Act and the ethical rules of the professional bodies contain requirements dealing with audit independence;
- (b) exclusive reliance on independence requirements in the ethical rules of the professional bodies; or
- (c) exclusive reliance on independence requirements in the Corporations Act.

5.89 Exclusive reliance on amending the Corporations Act to deal with non-audit services is inappropriate given the lack of precedent for this in Australia and elsewhere. More fundamentally, the review has not uncovered any evidence to suggest there are systemic failures within the accounting profession in complying with the ethical rules for providing non-audit services to audit clients. In these circumstances, there would appear to be an argument for retaining the professional ethical rules, suitably updated in accordance with the IFAC proposals, as the basic guidance on maintaining audit independence when providing non-audit services to audit clients.

5.90 A further point to note is that of all three key areas examined in Part 5 of the report (employment relationships, financial relationships, and provision of non-audit services) it is in the area of non-audit services that rapid changes in the financial markets and business development make it impossible to draft a list of all circumstances when providing non-audit services to a client threatens the independence of the auditor. The rapidly changing nature of this area, including developments such as some accounting firms deciding to sell their management consulting businesses, means there are very real practical limits to legislating to define what non-audit services can or cannot be provided to audit clients.

5.91 An issue the review has considered is whether it is appropriate to adopt in this country the list of nine non-audit services identified in the SEC's rules which are subject to prohibition or restriction. We are of the view that this is not appropriate. It is clear that a number of the SEC restrictions arose from intense debate and discussion and therefore represent compromises which, to an external observer, may lack principle. An example is the limit on the external auditor providing no more than 40% of the total hours expended on the client's internal audit activities in any one year unless the client has less than \$200 million in total assets. It has been made clear to us that the figure of 40% represents a compromise between the SEC and stakeholders with which it was negotiating as to what would be acceptable. We believe it inappropriate to rely on these types of political compromises, typically reflecting particular US circumstances, as precedents for Australia.

5.92 There is one of the SEC non-audit service prohibitions which could not be adopted in Australia in any practical way. The SEC rules prohibit an auditor providing legal services to a client. This rule reflects particular US circumstances. Australian audit firms have had legal arms for a number of years. This is also the case in many other countries. This reinforces our belief that to adopt the SEC rules on non-audit services is inappropriate.

5.93 There is an important issue concerning disclosure of non-audit services. Australian requirements now lag best practice by not requiring disclosure of amounts spent on non-audit services divided by category of service. Requirements for the disclosure of information about fees paid by a company to its auditors for the provision of non-audit services should be improved.

Recommendations

5.94 It is recommended that the provision of non-audit services by audit firms to their clients be dealt with in several ways:

- (a) by revised and updated professional ethical rules;
- (b) by mandatory disclosure of non-audit services and the fees paid for these services;
- (c) by strengthening the role of audit committees; and
- (d) by establishing an Auditor Independence Supervisory Board which would have, among its functions, the task of monitoring the adequacy of disclosure of non-audit services.

1 Regulation of non-audit services

It is recommended that the regulation of non-audit services provided by audit firms to their clients be dealt with professional ethical rules, suitably updated to reflect the IFAC proposals.

2 Disclosure of non-audit services

It is recommended that the following provisions will form part of the Accounting Standards or, if the Accounting Standards are not amended, then they will form part of Chapter 2M (Financial Reports and Audit) of the Corporations Act:

- (a) the financial report for the year must disclose the dollar amount of all non-audit services provided by the audit firm to the client, divided by category of service, with appropriate discussion of those services; and

- (b) the financial report for the year must disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.

Attention is also drawn to the recommendations in Part 6 of this report regarding audit committees and the establishment of the Auditors Independence Supervisory Board as these recommendations affect non-audit services.

PART 6

OTHER MEASURES THAT ENHANCE AUDIT INDEPENDENCE

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

6.02 This part of the report examines the following issues:

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

OVERSIGHT OF AUDITORS

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

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

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

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

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

Australian position

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

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

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

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

Overseas requirements

International Federation of Accountants

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

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

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

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

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

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

United Kingdom

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

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

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

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

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

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

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

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

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

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

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

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

United States of America

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

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

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

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

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

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

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

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

Adequacy of Australian requirements

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

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

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

Recommendations

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

1 Establishment of the Auditor Independence Supervisory Board

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

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

2 Composition of the AISB

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

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

2.1 AISB members

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

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

2.2 AISB employees

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

2.3 Process for appointment of initial and future members

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

3 Funding for the AISB

3.1 *Financial support*

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

3.2 *Physical premises*

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

4 Functions of the AISB

4.1 *Obligation to prepare an annual report*

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

4.2 *Monitoring of international developments in auditor independence*

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

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

4.3 *Advising professional bodies on issues of auditor independence*

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

4.4 *Monitoring of audit firms*

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

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

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

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

4.5 *Monitoring of corporations*

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

4.6 *Monitoring of teaching of professional and business ethics*

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

4.7 No role in conducting disciplinary proceedings

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

5 Review of the AISB

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

AUDIT COMMITTEES

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

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

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

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

Australian position

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

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

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

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

³¹ *Ibid*, 4.

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

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

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

Overseas position

United Kingdom

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

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

United States

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

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

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

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

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

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

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

Canada

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

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

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

Adequacy of Australian requirements

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

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

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

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

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

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

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

Role of audit committees in ensuring financial market integrity

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

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

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

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

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

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

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

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

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

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

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

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

³⁷ Above n 33.

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

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

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

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

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

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

Inadequate incentives to voluntarily form audit committees

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

Need for more than mere existence of audit committees

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

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

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

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

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

⁴⁶ Birkett, above n 36.

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

⁴⁸ *Ibid.*

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

⁵⁰ Levitt, above n 34, 52.

⁵¹ Above n 49.

Relationship between audit committee composition and effectiveness

Independence of audit committee members

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

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

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

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

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

⁵² Blue Ribbon Committee, above n 42, 22.

⁵³ Above n 40.

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

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

⁵⁶ *Ibid* 48.

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

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

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

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

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

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

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

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

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

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

⁶² Chtourou, Bedard and Courteau, above n 60.

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

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

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

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

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

Expertise of audit committee members

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

Recommendations

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

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

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

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

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

⁶⁹ *Ibid.*

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

⁷¹ DeZoort and Salterio, above n 58.

⁷² Chtourou, Bedard and Courteau, above n 60.

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

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

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

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

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

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

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

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

APPOINTMENT AND REMOVAL OF AUDITORS

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

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

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

Australian position

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

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

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

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

Overseas position

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

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

Adequacy of Australian requirements

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

Appointment

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

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

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

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

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

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

Tenure

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

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

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

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

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

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

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

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

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

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

Resignation and removal

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

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

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

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

Recommendations

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

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

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

DISCIPLINARY PROCEDURES

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

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

Australian position

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

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

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

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

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

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

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

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

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

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

Overseas position

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

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

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

Adequacy of Australian requirements

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

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

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

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

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

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

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

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

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

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

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

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

Recommendations

6.122 It is recommended that:

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

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

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

ATTENDANCE OF AUDITOR AT AGM

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

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

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

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

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

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

Recommendation

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

PART 7

OTHER ISSUES CONSIDERED DURING REVIEW

7.01 During the course of the review, some stakeholders also raised a number of issues concerning the registration and regulation of auditors (including some previously considered by the Audit Review Working Party) which did not fall directly within the scope of the audit independence issues commented on elsewhere in this report. It is appropriate to briefly mention these matters raised by stakeholders and some other matters considered by the Working Party and comment on them.

RECOMMENDATIONS OF THE AUDIT REVIEW WORKING PARTY

7.02 The Audit Review Working Party considered the following issues during its review of requirements for the registration and regulation of auditors:

- (a) Who should perform the registration and supervisory functions?
- (b) What should be the appropriate pre-requisites for registration?
- (c) What form should post registration supervision take?
- (d) How should the appointment of company auditors be undertaken and their subsequent independence be ensured?
- (e) What are the appropriate procedures for the removal of a company auditor?
- (f) Who should undertake the disciplinary function and what should be the disciplinary body's functions and powers?
- (g) The resource implications of the Working Party's preferred approach to performing the registration and supervisory functions and undertaking the disciplinary function.

7.03 A number of these issues (for example, appointment and removal of auditors, independence and discipline) have already been considered elsewhere in this report and, accordingly, are not dealt with in this section of the report.

Performing the registration and supervisory functions

7.04 The Working Party recommended that ASIC should be empowered to delegate its functions for the registration and regulation of company auditors to each professional accounting body that satisfied a series of requirements to be specified in legislation and was a party to a memorandum of understanding between an accounting body and the regulator. The Working Party also made a series of recommendations on conditions that would need to be satisfied by an accounting body before ASIC could delegate functions to it.

7.05 The issue of delegating ASIC's functions to accounting bodies was not considered during the course of the review of audit independence, primarily on the grounds that the question of who should undertake the registration function does not directly affect audit independence in the way

that other issues considered as part of the review affect independence. Similarly, stakeholders did not raise it as an issue during the consultative process.

7.06 In these circumstances, we express no views either for or against implementation of the Working Party's recommendations on this issue.

Pre-requisites for registration

7.07 The Working Party considered three issues concerning the requirements for registration for company auditors:

- (a) educational qualifications;
- (b) professional qualifications; and
- (c) the appropriate level of practical experience in auditing.

7.08 The Working Party recommended that the educational requirements for registration as a company auditor be enhanced by requiring all applicants to have completed a specialist course equivalent to the auditing module currently provided by the ICAA's Professional Year (PY) Program or CPA Australia's Certified Practising Accountant (CPA) Program.

7.09 The Working Party recommended that all registered company auditors should be required to abide by ethical requirements equivalent to the codes of ethics and other rules of the professional accounting bodies. It envisaged that where registered company auditors were members of a professional body they should comply with the rules of that body. In other cases, registered company auditors would be required to comply with rules or guidelines issued by ASIC or enter into a written undertaking with ASIC to comply with the ethical requirements and other professional rules of the professional accounting bodies as if they were members. A particular concern of the Working Party in this respect was the fact that there is a significant minority of auditors who do not belong to the professional bodies.

7.10 The question of what should be the appropriate level of practical experience for registration as a company auditor was one of the more difficult issues to confront the Working Party during the course of its review. The Working Party concluded that competency standards should ultimately be adopted as the principal basis for determining whether a person has sufficient practical experience in company auditing and auditing techniques to be registered as a company auditor. The Working Party also recommended retention of a revised time-based registration regime as an interim measure pending approval of a competency-based regime.

7.11 Adoption of the Working Party's recommendations on educational and professional qualifications have merit in terms of initially raising and then retaining an awareness of audit independence issues among company auditors. Adoption of a competency-based registration regime may also offer greater scope for ensuring applicants for registration have a greater awareness of independence and other ethical issues than may be case under the existing regime.

Post-registration supervision

7.12 Issues considered by the Working Party in the context of post-registration supervision of registered company auditors included:

- (a) the adequacy of the existing requirements for reporting to ASIC;

- (b) the need for registered company auditors to undertake continuing education; and
- (c) whether registered company auditors should be required to undertake a minimum level of audit work in order to maintain their registration.

7.13 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 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 revised statement should provide information about:

- (a) the auditor's personal particulars (serving the purpose of confirming or updating ASIC's records);
- (b) details of the nature and complexity of major audit work undertaken by the auditor; and
- (c) particulars of professional development undertaken by the auditor during the year.

7.14 The Working Party concluded that registered company auditors should be required to undertake a minimum amount of professional development, with the amount to be prescribed being similar to that required of ICAA and CPA Australia members who hold public practice certificates.

7.15 The Working Party also recommended that registered company auditors should not be required to undertake a specified level of audit work in any one year, but should be required to maintain their competence in audit work. The Working Party also recommended that where a registered company auditor has not undertaken any substantive audit work during a period of not less than five years, ASIC may require the registered company auditor to show cause why his or her registration should not be cancelled.

7.16 Finally, the Working Party recommended that the work of all registered company auditors should be subject to periodic quality reviews.

7.17 We consider that, as recommended by the Working Party, the Corporations Act should be amended to:

- (a) require an annual statement from registered auditors; and
- (b) allow ASIC to require a registered company auditor to show cause why his or her registration should not be cancelled if the auditor has not undertaken any substantive audit work during a period of not less than five years.

However, the areas of continuing education and the conduct of quality reviews, should be part of the ethical codes and other requirements of the professional accounting bodies.

Delegation by Auditors-General

7.18 The Working Party also recommended that consideration should be given to amending the Corporations legislation to make it clear that an Auditor-General may, subject to any constraints contained in the Commonwealth, State or Territory legislation establishing his or her office, delegate to a person nominated by him or her responsibility for signing an auditor's report or an audit review prepared under Part 2M.3 of the Corporations Act. This recommendation has merit as its implementation would facilitate the operation of the offices of the Auditors-General.

PROFESSIONAL LIABILITY

7.19 During the course of the audit independence review, the ICAA raised the issue of auditor's unlimited professional liability and its impact on auditors. The ICAA, after noting Australian developments during the 1980s and 1990s and recent developments in Canada, proposed that a modified proportionate liability regime similar to the one now in operation in Canada be implemented in Australia.

7.20 In Australia, there have been a number of proposals for reforming the existing regime of joint and several liability in its application to company auditors. These proposals have included the introduction of a capping regime, proportionate liability and allowing auditors to incorporate.

7.21 We note that the issue of the liability of auditors is part of ongoing discussions between the Commonwealth and State governments, and between the professional accounting bodies and government. We also note developments in this area. For example, a proposal that auditors be allowed to incorporate has been approved by the Ministerial Council for Corporations. Given the ongoing developments and discussions in this area, we do not believe it appropriate for this review to put forward recommendations concerning the liability of auditors.

RECOMMENDATIONS

7.22 The following recommendations of the Audit Review Working Party, which deal with issues not addressed elsewhere in this report, should be implemented:

- 1 Educational requirements for registration as a company auditor should be enhanced by requiring all applicants to have completed a specialist course equivalent to the auditing module currently provided by the ICAA's Professional Year Program or CPA Australia's Certified Practising Accountant Program.
- 2 All registered company auditors, whether members of professional accounting bodies or not, should be required to abide by ethical requirements equivalent to the codes of ethics and other rules of the professional accounting bodies. This can be achieved by those registered company auditors who are not members of professional accounting bodies complying with rules or guidelines issued by ASIC or entering into a written undertaking with ASIC that they will comply with the ethical requirements and other professional rules of the professional accounting bodies as if they were members.
- 3 Competency standards should be adopted as the principal basis for determining whether a person has sufficient practical experience to be registered as a company auditor.

- 4 Where a registered company auditor has not undertaken any substantive audit work during a period of not less than five years, ASIC may require the auditor to show cause why his or her registration should not be cancelled.
- 5 The requirement that registered company auditors lodge a triennial statement with ASIC should be replaced by an annual statement containing the revised information outlined in paragraph 7.13 of this report.
- 6 Registered company auditors should be required to undertake a minimum amount of professional development, with the amount to be prescribed being similar to that required of ICAA and CPA Australia members who hold public practice certificates.
- 7 The work of all registered company auditors should be subject to periodic quality reviews.
- 8 The Corporations Act should be amended to provide that Auditors-General may, subject to any constraints contained in the legislation establishing their respective offices, delegate to a person responsibility for signing an auditor's report or an audit review prepared under Part 2M.3 of the Corporations Act.

PART 8

REVIEW OF AUDITOR INDEPENDENCE STUDIES

INTRODUCTION

8.01 ‘The significance of independence in the work of the independent auditor is so well established that little justification is needed to establish this concept as one of the cornerstones in any structure of auditing theory.’⁷⁹ Independence, however, is an imprecise and ambiguous concept, and there is much debate as to the appropriate level of auditor independence and how this should be achieved.

‘The reality of public concern on this issue is that when company failure exists there is an immediate outcry of “Where were the auditors?” and questions as to whether they were truly objective.’⁸⁰

8.02 This Part of the report investigates the concept of auditor independence, its desirability and means of achieving it. It also examines factors that could potentially harm independence. Independence risk, defined as ‘the risk that an auditor’s independence may be compromised or may be perceived to be compromised’⁸¹ and the factors that impact or mitigate this risk, are central to determining appropriate policy on auditor independence.

8.03 Johnstone, Sutton and Warfield⁸² develop a framework for considering independence risk. The authors argue that a precondition to the existence of this risk is the presence of certain environmental conditions. At the outset, there must be some incentive to the auditor, whether actual or perceived, and, in addition, there must be an element of judgment-based decision making in the situation. However, independence is a complex field of competing influences, and a reduction in audit quality may not result if other factors are present that moderate or offset the environmental conditions.⁸³ That is, there exists some set of factors that have the potential to impact or compromise auditor independence, but these factors need to be considered in light of other mechanisms or influences that may enhance auditor independence. The diagram from Johnstone Sutton and Warfield on the next page provides an outline of the framework for considering these competing factors.⁸⁴

⁷⁹ R K Mautz and Hussein Sharaf, *The Philosophy of Auditing*, Monograph No 6 (1961) 204.

⁸⁰ Auditing Practices Board (APB), *The Audit Agenda* (1994).

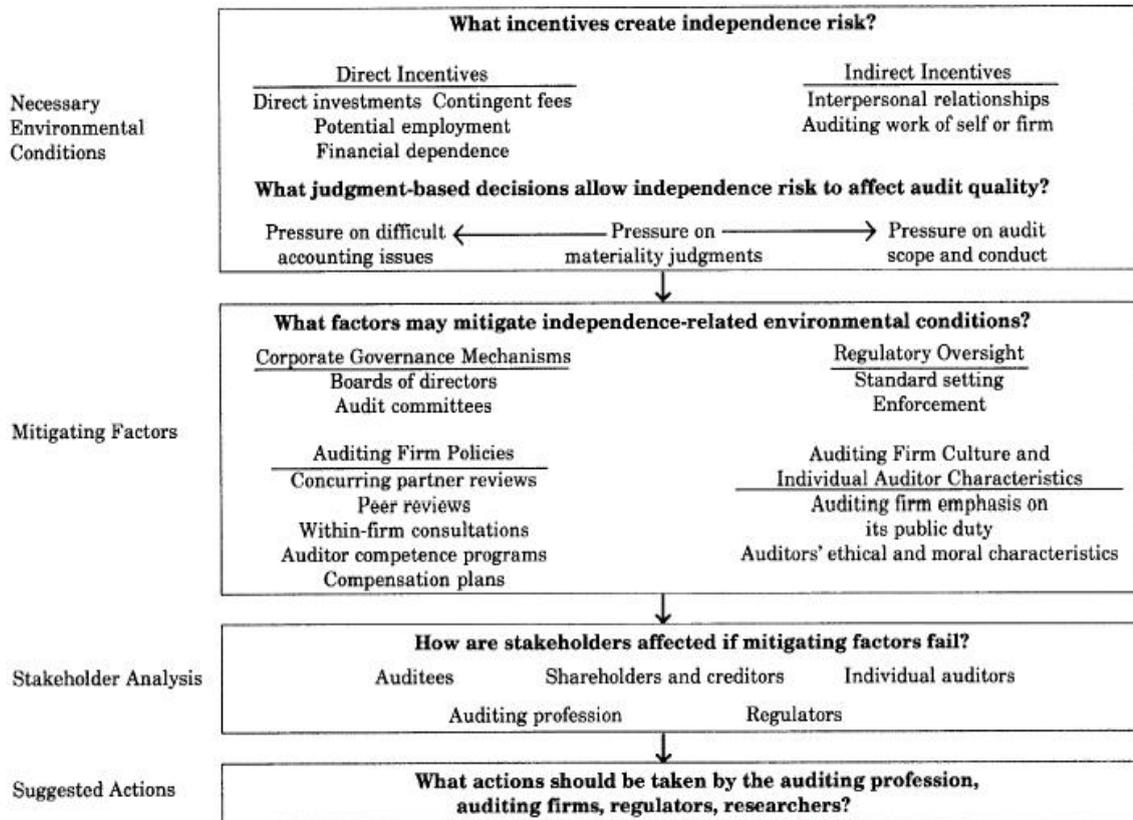
⁸¹ Karla Johnstone, Michael Sutton and Terry Warfield, ‘Antecedents and Consequences of Independence Risk: Framework for Analysis’ (2001) 15(1) *Accounting Horizons* 1.

⁸² *Ibid.*

⁸³ *Ibid.*

⁸⁴ *Ibid* 4.

FIGURE 1
A Framework for Understanding the Antecedents and Consequences of Independence Risk



*Source: Karla Johnstone, Michael Sutton and Terry Warfield, 'Antecedents and Consequences of Independence Risk: Framework for Analysis' (2001) 15(1) *Accounting Horizons* 1, 4.

8.04 This Part of the report considers some of the key influences on auditor independence. Section two discusses the definition of independence; section three examines the importance of auditor independence; section four considers the factors that can compromise independence and the empirical evidence relating to those factors; section 5 presents the mechanisms for enhancing independence and related empirical research; and section 6 provides an overview of the alternative approaches to auditor independence found in the literature.

WHAT IS AUDITOR INDEPENDENCE?

8.05 Auditor independence is a complex concept with many interrelated layers. Although there is no clear definitional accord, there are certainly some common conceptual threads. 'While many definitions of auditor independence exist in the literature, in general the concept implies that the auditor has the ability to act impartially and provide an unbiased report of the client's financial health.'⁸⁵ It 'denotes the admirable quality of "not being influenced or controlled by others in matters of opinion or conduct."⁸⁶ This section endeavours to outline the key aspects of auditor independence in light of the clear impact of the perspective chosen on policy implications.

⁸⁵ Gary Kleinman, Dan Palmon and Asokan Anandarajan, 'Auditor independence: A synthesis of theory and empirical research' (1998) 12 *Research in Accounting Regulation* 3, 4.

⁸⁶ John Carey, 'The independence concept revisited' (1985) *Ohio CPA Journal* 5.

“Independence is an abstract concept, and it is difficult to define either generally or in its peculiar application to the public accountant. Essentially it is a state of mind. It is partly synonymous with honesty, integrity, courage, character. It means, in simplest terms, that the certified public accountant will tell the truth as he sees it, and will permit no influence, financial or sentimental, to turn him from that course.”⁸⁷

8.06 Independence may be a state of mind or a behaviour. According to AUP 32, ‘independence requires a freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure.’⁸⁸ This suggests that an auditor possessing the requisite *state of mind* will act in the correct fashion. Alternatively, auditor independence may be defined as ‘the conditional probability that, given a breach has been discovered, the auditor will report the breach.’⁸⁹ That is, independence is a function of the auditor’s *behaviour*, where behaviour is measured by the likelihood of reporting errors if they are discovered. Other approaches include defining independence as the outcome of reactions to conflicts of interest and the balance of power between the concerned parties, whereby independence is a result of a cost-benefit calculation based on inputs into these struggles.⁹⁰

8.07 All of these approaches to defining independence, although enlightening, have their shortcomings. Independence as a *state of mind* can never be shown. There is no demonstrable way of proving that an auditor possesses it. Further, possession of the right attitude will not automatically lead to the correct behaviour, just as an incorrect attitude will not necessarily result in incorrect behaviour. However, if we were to focus solely on the resultant *behaviour*, we ignore the influences leading to it. Rather than attempting to pigeon hole the concept of independence, it may be more informative to separate independence into its various elements. The next section examines the different aspects of the auditor independence construct.

The elements of independence

8.08 Many attempts have been made to demark auditor independence into logical and containable categories. Traditional literature has partitioned independence into *independence in fact* and *independence in appearance*.⁹¹ This division emphasises that independence must not only be real, but must also be evident. Writers such as Michael Power⁹² have developed further aspects to the term, extending it to the inherent capacity of *auditing* to be independent. Power calls this type of independence *operational independence*, and groups independence in fact and appearance together as *organisational independence*. There are many ways to divide independence, and the examination

⁸⁷ John Carey, *Professional Ethics of Public Accountants* (1946).

⁸⁸ Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia, ‘Statement of Auditing Practice AUP 32 “Audit Independence”’ in *Auditing Handbook, Volume 2 of the Accounting and Auditing Handbook* (2001) 955-6.

⁸⁹ Linda DeAngelo, ‘Auditor Independence, low balling and disclosure regulation’ (1981) 3(2) *Journal of Accounting and Economics* 113, 116.

⁹⁰ Arie Goldman and Benzion Barlev, ‘The Auditor-Firm Conflict of Interests: Its Implications for Independence’ (1974) 49 *Accounting Review* 707 and Donald Nichols and Kenneth Price ‘The Auditor-Firm Conflict: An Analysis Using Concepts of Exchange Theory’ (1976) 51 *Accounting Review* 335.

⁹¹ Mautz and Sharaf describe these two groups as ‘practitioner-independence’ and ‘profession-independence’ respectively, above n 1, 205. Other writers add the dimension of independence in appearance of the *individual auditor* to that of the profession (See eg Michael Power *The Audit Society: Rituals of Verification* (1997) 131-4).

⁹² Power, above n 91.

below draws broadly from the seminal work of R K Mautz and Hussein Sharaf⁹³ and from the more recent exposition by Power.⁹⁴

Independence of the individual auditor

8.09 Many theorists⁹⁵ consider the *real* or *in fact* component of independence of the individual auditor to be a state of mind. However, where independence itself was being described as a state of mind above, in this division the requisite mental attitude is only one element of the overall concept of independence. The appropriate state of mind can be characterised by ‘probity of character and belief in and adherence to an ethical code of behaviour’⁹⁶ and necessarily involves moral or ethical factors.

8.10 Mautz and Sharaf divide the real independence of an individual auditor into three dimensions: programming independence, investigative independence and reporting independence. Respectively, these require that the auditor has freedom from ‘interference or friction’ to develop his or her own audit program and to choose the range and nature of audit techniques to be used within it; free and direct access to all legitimate sources including business and other records and co-operation from personnel; and freedom to choose what and how to express through recommendations culminating from the audit.⁹⁷

8.11 Further to independence in fact, the individual auditor must have ‘a public reputation for those attributes of character’⁹⁸ and appropriately visible and credible monitoring and sanctions, or, individual independence in *appearance*.

‘Similar to judges, who not only must be just but must seem to be just, these accountants must seem to be independent of their client corporations. This aura of independence is crucial to the accountants’ credibility in the public’s eyes.’⁹⁹

8.12 The relative importance of independence in appearance is a matter of contention. For example, Robert Elliott and Peter Jacobson argue that the ‘appearance of independence should not be the separate coequal of the fact of independence,’ as no immediate public threat is posed by a faltering in perceived independence.¹⁰⁰ However, others have argued that ‘appearance of impropriety is only slightly less dangerous than the impropriety itself.’¹⁰¹

⁹³ Above n 79.

⁹⁴ Above n 91.

⁹⁵ See, eg, David Flint, *Philosophy and Principles of Auditing- An Introduction* (1988) 59-61.

⁹⁶ *Ibid* 60.

⁹⁷ Above n 79, 206-8.

⁹⁸ Flint, above n 95.

⁹⁹ Tamar Frankel, ‘Accountants’ Independence- the Recent Dilemma’ (2000) *Columbia Business Law Review* 261, 261.

¹⁰⁰ Robert Elliott and Peter Jacobson, ‘Audit Independence: Concept and Application’ (1992) *CPA Journal* 34, 35-37.

¹⁰¹ Frederick Hurdman, ‘Independence of Auditors’ (1942) *Journal of Accountancy* 60.

Independence of the profession

8.13 Perceived independence is not confined to the individual auditor, but must extend to the profession as a whole in order for the audit function to be valuable.¹⁰² The nature of the relationship between auditing and business can cause scepticism, and this public concern needs to be addressed. This necessitates the creation and maintenance of a 'general public trust in the independence and integrity of the audit profession.'¹⁰³ The means of achieving this advancement in public image involves 'proscribing observable relations between auditors and clients which, to the community at large, may *appear* to impede the exercise of impartial judgement by auditors,'¹⁰⁴ and having meaningful and credible sanctions and monitoring in place.¹⁰⁵

Independence of auditing

8.14 The traditional literature omits this final category of auditor independence, presumably as a result of an initial premise that auditing itself is inherently endowed with impartiality. However, recent works have challenged this notion,¹⁰⁶ and seek to redefine the nature of auditing in a modern society. In defining operational independence, Power¹⁰⁷ draws attention to its two components: *informational* and *epistemic* independence. Informational independence will never be truly achievable, as the auditor must, in spite of attempts at substantiation, rely on some representations made by management through the information supplied. Epistemic independence relates to the source and development of the knowledge base of the auditor. The learning foundations from which the auditor formulates his or her opinion must be unrelated to the auditee.

WHY SHOULD AUDITORS BE INDEPENDENT?

8.15 The importance of independence in the auditing context has become such that the terms 'independent' and 'auditor' can no longer be separated- independence appears to be endogenous to auditing. The inseparability of the concepts has been observed from many academic perspectives,¹⁰⁸ and independence has been described as the 'essence',¹⁰⁹ 'foundation',¹¹⁰ and 'raison d'être',¹¹¹ of auditing, amongst other similar imagery.

¹⁰² D R Carmichael and R J Swieringa, 'The Compatibility of Auditing Independence and Management Services- An Identification of Issues' (1968) *Accounting Review* 697, 699.

¹⁰³ Kim Klarskov Jeppesen, 'Reinventing auditing, redefining consulting and independence' (1998) 7(3) *European Accounting Review* 517, 529.

¹⁰⁴ Peter Wolnizer, *Auditing as Independent Authentication* (1987) 130.

¹⁰⁵ Flint, above n 95.

¹⁰⁶ See, eg, Jeppesen, above n 103.

¹⁰⁷ Above, n 91.

¹⁰⁸ See, eg, a professional perspective in Flint, above n 95 and an economic perspective in Wanda Wallace, *The Economic Role of the Audit in Free and Regulated Markets* (1980).

¹⁰⁹ E Stamp and M Moonitz, *International Auditing Standards* (1978).

¹¹⁰ O R Whittington and K Pany, *Principles of Auditing* (11th ed, 1995).

¹¹¹ E Woolf, *Auditing Today* (1979).

‘Independence is an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements which are primarily representations by management. If the accountant were not independent of the management of his clients, his opinion would add nothing.’¹¹²

8.16 The role of the external auditor is to independently attest as to whether or not the accounts prepared by the client comply with accounting standards and present a ‘true and fair view’ of the financial performance and condition of the firm.¹¹³ ‘If the audit opinion is to provide the desired degree of assurance, the auditor must be able to form and express an opinion without bias.’¹¹⁴

‘...[T]he public path in the reliability of a corporation’s financial statements depends upon the public perception of the outside auditor as an independent professional... if investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.’¹¹⁵

8.17 Indeed, being a major source of accounting expertise is only one part of the auditor’s function. These days, the accounting knowledge and capabilities of internal financial personnel rival those of auditors.¹¹⁶ For auditing to exist as a profession, it must add value. ‘If this condition [independence] does not exist, the degree to which the audit opinion can be trusted as an objective statement is limited.’¹¹⁷ And if the opinion cannot be trusted it adds little value.¹¹⁸ As the relationship determined by the market to exist between the auditor and the client gets closer, the auditor’s incentives to divulge the truth may decrease, as can the value the market places on the auditor’s opinion.¹¹⁹ If the capital market did not expect auditors to challenge management on at least some issues, it would value the opinion of the auditor as null. Without independence, ‘auditing simply becomes meaningless.’¹²⁰

Integrity of financial markets

8.18 The requirement to present externally verified financial statements stems from the need to ‘obviate the fear of loss from reliance on inaccurate information, thereby encouraging public

¹¹² Robert Kane, Jnr (ed), *CPA Handbook* (1952) Chapter 13, 8 quoted in Mautz and Sharaf, above n 79.

¹¹³ Michael Sutton, ‘Auditor independence: the challenge of fact and appearance’ (1997) 11(1) *Accounting Horizons* 86, 86.

¹¹⁴ Max Bazerman, Kimberly Morgan and George Loewenstein, ‘The Impossibility of Auditor Independence’ (1997) *Sloan Management Review* 89, 91.

¹¹⁵ Abraham Briloff, ‘Accountancy and Society: A Covenant Desecrated’ (1990) 1 *Critical Perspectives on Accounting* 5, 29, quoting former United States Supreme Court Chief Justice Burger.

¹¹⁶ Ralph Saul, ‘What ails the accounting profession?’ (1996) 10(2) *Accounting Horizons* 131, 133.

¹¹⁷ T A Lee, ‘A Stakeholder Approach to Auditing’ (1998) 9(2) *Critical Perspectives on Accounting* 217, 223.

¹¹⁸ DeAngelo, above n 89, 116 notes that an audit opinion is not worthless just because an auditor doesn’t always tell the truth.

¹¹⁹ Linda DeAngelo, *The Auditor-Client Relationship: An Economic Analysis* (1981), 34.

¹²⁰ Jeppesen, above n 103.

investments in the Nation's industries.'¹²¹ A lack of confidence in financial markets engenders fear and reluctance to invest, to the detriment of the economy. The accuracy of security prices relies on the provision of and the efficient dissemination of information such that it becomes reflected in security prices,¹²² and the pricing of their associated risk.¹²³ Confidence in the integrity of security prices requires not only the provision of information, but credible attestation as to its truth, fairness and compliance.

'Corporate governance depends upon "gatekeepers" to protect the interests of investors and shareholders by monitoring the behavior of corporate "insiders" and by reporting the financial results of corporate performance in an accurate and unbiased fashion that permits objective valuation of the firm.'¹²⁴

8.19 Without effective watchdogs, 'it is reasonable to believe that market efficiency would be lower, the cost of capital higher, and our structure of corporate governance imperilled.'¹²⁵ This gate keeping function is clearly the role required of the auditor for the profession to add value to our markets, but the gatekeeper cannot be effective unless he or she is independent. The gate must be staffed with objectivity and impartiality, or the point of the gatekeeper becomes lost. 'Without accountants to ensure the quality and integrity of financial information, the markets for capital would be far less efficient, the cost of capital would be far higher, and our standard of living would be lower.'¹²⁶

¹²¹ Walter Schuetze, 'A Mountain or a Molehill?' (1994) 8(1) *Accounting Horizons* 69, 70 quoting from the US Supreme Court in the *Arthur Young* case in 1984.

¹²² Eugene Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383.

¹²³ Marcel Kahan, 'Securities Law and the Social Costs of Inaccurate Stock Prices' (1992) 41 *Duke Law Journal* 977, 979.

¹²⁴ John Coffee, Jr. 'The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting,' (Working Paper, Columbia Law School, 2001) 2.

¹²⁵ *Ibid.*

¹²⁶ Steven Wallman, 'The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change' (1995) 9(3) *Accounting Horizons* 81.

Reduction of agency costs

8.20 Auditing and the relevance of independence can be analysed drawing from the seminal work by Jensen and Meckling,¹²⁷ which models the relationship between a *principal* and an *agent*. Working from one of the basic premises of classical economic theory- that individuals are rational, self-interested utility maximisers- we can describe the auditing problem from the perspective of agency theory. This construct has frequently been used in the literature to model or examine the demand for auditing and the role of independence within this framework.¹²⁸

8.21 Agency theory describes the conflicts that arise as a result of the separation of ownership and control. Managers, who control the firm, are agents of the shareholders (principals), who own it. However, since both parties are rationally self-interested, there is a misalignment of interests, which results in agency costs.¹²⁹ It is generally argued that the agent will ultimately bear the agency costs,¹³⁰ and therefore has an incentive to reduce them.

8.22 Agency conflicts, and therefore costs, arise because management have the incentive act to maximise their own self-interest, to the detriment and expense of the principal. Further, there is considerable information asymmetry between the agent and the principal. Auditors serve to reduce agency costs by reducing this information asymmetry. It is costly for principals to directly discern the accuracy with which management has prepared the financial reports and represented the financial position of the firm. Independent verification in the form of an audit opinion makes this more observable. However, the resultant reduction in agency costs will not occur unless the audit report is credible in the eyes of the shareholders, and auditor independence is crucial to this credibility.

8.23 A further problem arises from the use of auditors as a 'solution', as it adds another layer of conflict to the existing agency relationship.¹³¹ Auditors, who are also seen as agents, possess the same rational self-interest as the other parties. To the extent that siding with management gives rise to the potential for future economic benefit, an auditor has the incentive to conform to management wishes. However, for the auditor to actually 'cheat' 'it is also necessary that auditors perceive the

¹²⁷ M C Jensen and W H Meckling, 'Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

¹²⁸ See, eg, Rick Antle, 'The Auditor as an Economic Agent' (1982) 20(2) *Journal of Accounting Research* 503; Rick Antle, Auditor Independence (1984) 22(1) *Journal of Accounting Research* 1; Tad Miller, 'Do We Need to Consider the Individual Auditor when Discussing Auditor Independence?' (1992) 5(2) *Accounting, Auditing & Accountability Journal* 74; and Carolyn Levine and Laura Kornish, 'Discipline with Common Agency: The Case of Audit and Non-audit Services' (Working Paper, Duke University, 2000); D S Ng and J Stoeckenius, 'Auditing, Incentives and Truthful Reporting' (1979) Supplement, *Journal of Accounting Research* 1; J Evans, 'Optimal Contracts with Costly Conditional Auditing' (1980) Supplement, *Journal of Accounting Research* 108; F Gjesdal, 'Accounting for Stewardship' (1981) *Journal of Accounting Research* 208. For an economic perspective see, eg, Linda DeAngelo, above n 119; Linda DeAngelo, above n 89.

¹²⁹ Jensen and Meckling, above n 127, 308, describe these costs as including monitoring costs, bonding costs and a residual loss.

¹³⁰ See, eg, Jensen and Meckling, above n 127; William Beaver, *Financial Reporting: An Accounting Revolution* (2nd ed, 1989). This point is not, however, without contention, and generally revolves around the ability of the principal to achieve price protection.

¹³¹ Miller, above n 128, extends the analysis by considering the audit firm itself as a further organisation of *several* economic agents, rather than a *single* economic agent as per DeAngelo, above n 89 and n 119; and Antle, above n 128.

marginal benefits from misrepresentation to exceed the marginal cost,¹³² which, amongst other things, may include reputational damage, enforcement action by regulators and legal claims for compensation. Absent this ‘economic interest’, the auditor has no economic incentive to conceal a discovered breach.¹³³ A truly independent auditor, of course, should be void of this economic interest.

Auditing as a public responsibility

‘A public accountant acknowledges no master but the public, and thus differs from the bookkeeper, whose acts and statements are dictated by his employers. A public accountant’s certificate, though addressed to the president or directors, is virtually made to the public, who are actually or prospectively stockholders. He should have ability, varied experience, and undoubted integrity.’¹³⁴

8.24 Some theorists argue that auditors should act in the interests of external users of financial statements.¹³⁵ Many papers¹³⁶ take the perspective that these users are auditors’ ‘true’ clients, as opposed to the popular notion that the client is the management or board of directors.

8.25 Other writers take this view even further. Professor Briloff argues that auditors have a covenant with society to perform services which involve ‘signing, delivering or issuing or causing to be signed, delivering or issued,’¹³⁷ financial statements, opinions and reports. “Moreover, he contends that the accounting profession owes a unique responsibility to society as a whole to assure full, fair, open and timely disclosure regarding the governance and accountability of the corporate enterprise.”¹³⁸ This perspective maintains that auditors owe a special duty to society that prevails over the simple quest for economic profit.

WHAT FACTORS CAN COMPROMISE INDEPENDENCE?

8.26 ‘Everyone would applaud this ideal [of independence], but a cynical world requires more than a mere declaration of intention if it is to stake its money on the accountant’s word.’¹³⁹ Whereas it has been established that independence is an essential attribute for an auditor, there is great public scepticism as to the ability of auditors to preserve their independence, absent some mechanism, be it incentive based or regulatory, to bond them to this standard. This disbelief is exacerbated by the existence of a number of factors or influences that have the potential to impair auditor

¹³² DeAngelo, above n 119, 34.

¹³³ DeAngelo, above n 89, 116-117. Note this conclusion was drawn under the perfect market conditions of zero transactions costs and perfect substitutes.

¹³⁴ Andrew Barr, ‘The Independent Accountant and the SEC’ (1959) *Journal of Accountancy* 32 quoting Charles C Reckitt’s definition of public accounting.

¹³⁵ See, eg, Bazerman, Morgan and Loewenstein, above n 114, 90.

¹³⁶ See, eg, Goldman and Barlev, above n 90, and Steven Zeff, ‘Does the CPA Belong to a Profession?’ (1987) *Accounting Horizons* 65.

¹³⁷ Briloff, above n 115, 5.

¹³⁸ Brendan O’Connell, ‘An analysis of Key Issues arising from Professor A. J. Briloff’s Paper entitled, “Garbage In/Garbage Out: A Critique of Fraudulent Financial Reporting: 1987-1997 (The COSO Report, 1999) The SEC Accounting Regulatory Process (AAERs)”’ (2001) 12(2) *Critical Perspectives on Accounting* 167, 178.

¹³⁹ Carey, above n 87.

independence. Indeed, Bazerman, Morgan and Loewenstein¹⁴⁰ argue that given the close working relationship between auditors and clients and the fact that auditors are paid by their clients, it is psychologically impossible for an auditor to be free from bias. Numerous factors of concern have been noted in the literature for many years:

‘...[A] member would not be considered independent with respect to any enterprise if he or any of his partners during the period of the professional engagement or at any time of expressing his opinion had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise or was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee.’¹⁴¹

8.27 There is a substantial amount of academic literature, which examines, either empirically or analytically, the impact of these many factors on auditor independence. Kleinman, Palmon and Anandarajan¹⁴² categorise the empirical research in this field as being either perceptual or archival. Perceptual research arises from the inherent difficulties in measuring the relevant variables directly. Therefore, these variables are investigated in terms of the perception of various user groups as to their impact. Whilst such research provides valuable insights, especially in the realm of independence in appearance, it should be viewed with caution due to the shortcomings of such a research methodology.¹⁴³ Many of the variables examined in this vein stem from a model by Randolph Shockley.¹⁴⁴

8.28 Archival research, on the other hand, endeavours to discover and measure relationships between these variables, or close proxies, where they are available. For example, archival research may try to ascertain the relationship between the level of management advisory services provided by the audit firm and the tenure of that firm with the client.¹⁴⁵

8.29 The factors examined in this section which may adversely affect auditor independence include:

- (a) the scope of services provided by the audit firm;
- (b) the audit fee, and, in particular, the practice of low balling; and
- (c) employment relationships.

¹⁴⁰ Above, n 114.

¹⁴¹ Carey, above n 86, 186-7.

¹⁴² Above n 85, 9-27.

¹⁴³ Kleinman, Palmon and Anandarajan, above n , 9 discuss a study by Orren which warns perceptions are ‘notoriously inaccurate’.

¹⁴⁴ Randolph Shockley, ‘Perceptions of Audit Independence: A Conceptual Model’ (1982) *Journal of Accounting, Auditing and Finance* 126.

¹⁴⁵ A study of this type was undertaken in P J Beck, T J Frecka and I Soloman, ‘An Empirical Analysis of the Relationship Between MAS Involvement and Auditor Tenure: Implications for Auditor Independence’ (1988) *7 Journal of Accounting Literature* 65.

Scope of services

8.30 There 'is an inherent scepticism about how close the relationship between the auditor and the management of the audit client can be without creating, in fact or in perception, a mutuality of interest that could impair the auditor's independence.'¹⁴⁶ As the scope of the services performed for the client by the audit firm broadens, the relationship between management and auditor becomes more proximate. The literature has debated the impact of the provision of non-audit services ('NAS'), and, in particular, at great length a common form, management advisory services ('MAS') on auditor independence.

'Of fundamental importance in understanding the conflict of interest that arises from the provision of non-audit services to audit clients is the fact that in so doing the audit firm is really serving two different sets of clients: management in the case of management consulting services and the audit committee, shareholders and all those who rely on the audited financials and the firm's opinion in deciding whether to invest, in the case of the audit.'¹⁴⁷

8.31 Theorists generally hypothesise that the concurrent provision of NAS to audit clients poses a threat to auditor independence. These arguments are based broadly on notions of 'economic dependency and mutuality of interest.'¹⁴⁸ As the relative importance of NAS increase, a loss of impartiality may ensue from the client dependency that results. Further, the frame of mind required for NAS provision requires more promotion than objectivity. Schulte¹⁴⁹ pointed out that this attitude could evoke auditor empathy for management, which could compromise independence.

8.32 However, advocates of NAS point out the benefits of dual service provision. 'The provision of non-audit services by auditors to their audit clients reduces total costs, increases technical competence and motivates more intense competition.'¹⁵⁰ These benefits take form in the significant economies of scope,¹⁵¹ and thus cost savings, that can arise in these situations. Advocates of NAS further contend that the provision of such services does not necessarily impair auditor independence, and can, in fact, enhance professional judgment through the increased familiarity the auditor will have with the client, especially in relation to areas such as intangible assets, and through the efficient use of experts.¹⁵²

¹⁴⁶ Sutton, above n 113.

¹⁴⁷ Levine and Kornish, above n 128, 5 quoting the Panel on Audit Effectiveness.

¹⁴⁸ Graeme Wines, 'Auditor Independence, Audit Qualifications and the Provision of Non-Audit Services: A Note' (1994) *Accounting and Finance* 75, 76.

¹⁴⁹ A Schulte Jr, 'Management Services: A Challenge to Auditor Independence?' (1966) *Accounting Review* 721.

¹⁵⁰ Benito Arrunada, 'The Provision of Non-audit Services by Auditors: Let the Market Evolve and Decide' (1999) 19(4) *International Review of Law and Economics* 513.

¹⁵¹ J J Gaver and K M Gaver, 'Simultaneous Estimation of the Demand and Supply of Differentiated Audits' (1995) 5(1) *Review of Quantitative Finance and Accounting* 55 point out the difficulties in measuring these production efficiencies.

¹⁵² *Ibid.*

8.33 Joint service provision has a documented popularity with audit firms and client management. Antle and Demski¹⁵³ note the enduring interest in joint service provision from auditors and client firms. To illustrate, Wines documented an increase in average NAS remuneration to audit firms in his sample from \$64,500 in 1980 to \$617,800 in 1989.¹⁵⁴ Palmrose¹⁵⁵ found 75% of a sample of 298 companies purchased other services from their audit firm. Indeed, it has been argued that in the absence of restrictions, audit firms 'have an incentive to strive for competitive advantage by developing concentrations of multiple-service expertise.'¹⁵⁶ Where all categories of services are provided, a position where value is shared between the auditor and the client in the most advantageous fashion can be attained. The benefit borne of economies of scope and increased client awareness can, it is argued, reduce the costs of the audit firm, and, in turn, the fees charged to the client for service provision.¹⁵⁷ This can be complimented by a greater meeting of client needs.

8.34 The 'value adding' opportunities for the audit firm increase with joint-service provision. Over time, the nature of the audit function has changed in recognition of this. Although many writers¹⁵⁸ have previously defined consulting services by carving out audit services, Jeppesen argues that auditing has been 'reinvented', eroding this separation. In today's 'value-added' culture, a 'successful commodity must take into account the needs of the customer.'¹⁵⁹ Indeed, it has been argued, controversially, that the nature of auditing has now changed to such an extent that the possibility of auditor independence is precluded. 'The *auditor* can no longer be independent because *auditing* is no longer an independent discipline.'¹⁶⁰

8.35 The association between audit fee and NAS is important due its potential to impact auditor independence. The bond between management and auditor has been analytically documented to increase with the provision of NAS.¹⁶¹ Where services are provided concurrently, economies of scope will result in cost savings that may be distributed between the audit firm and the client. Where knowledge is transferred between audit and non-audit staff, the production efficiencies attained, if retained by the audit firm, can increase the relative bargaining power of the client and thereby threaten auditor independence. This arises because where the audit firm retains the cost savings, the reliance of the audit firm on the client increases, as these cost savings represent

¹⁵³ R Antle and J Demski 'Contracting Frictions, Regulation and the Structure of CPA Firms' (1991) 29(Supplement) *Journal of Accounting Research* 1.

¹⁵⁴ Above, n 148, 78.

¹⁵⁵ Z Palmrose, 'The Effect of Non-Audit Services on the Pricing of Audit Services: Further Evidence' (1986) *Journal of Accounting Research* 405.

¹⁵⁶ Alain Mikol and Peter Standish 'Audit Independence and Nonaudit Services: A Comparative Study in Differing British and French Perspectives' (1998) 7(3) *European Accounting Review* 541.

¹⁵⁷ *Ibid* 548-550.

¹⁵⁸ See, eg, Mautz and Sharaf, above n 79.

¹⁵⁹ Above n 103.

¹⁶⁰ *Ibid*.

¹⁶¹ See, eg, P J Beck, T J Frecka and I Solomon, 'A Model of the Market for MAS and Audit Services: Knowledge Spillovers and Auditor-Auditee Bonding' (1988) 7 *Journal of Accounting Literature* 50; D Simunic, 'Auditing, Consulting and Auditor Independence' (1984) *Journal of Accounting Research* 679.

increased future economic interest in the client. This, according to Davis, Ricchiute and Trompeter, creates 'incentives for the auditor to resolve disputes in the client's favour.'¹⁶²

8.36 On the whole, however, the results of studies on the impact of NAS provision on auditor independence are diverse. Wines¹⁶³ studied financial statements to investigate the existence of any relationship between their content and the level of NAS provision. Using a ten-year sample of 76 companies, the author found a potential for the appearance of damaged auditor independence where there was high NAS provision. This inference derived from the finding that companies not receiving a qualified opinion during the sample period were associated with higher NAS provision, which could suggest the appearance of compromised independence. The results of Wines were consistent with earlier studies by Simunic¹⁶⁴ and Palmrose.¹⁶⁵ This vein of research stemmed from concerns relating to auditors prioritising their own economic benefit over independence.¹⁶⁶

8.37 Using a sample of 263 'Big Eight' clients from 1976 to 1977, Simunic¹⁶⁷ investigated the pricing effects of knowledge spillovers to determine whether cost savings arising from economies of scope in NAS provision were retained by the auditor or passed on to the audit client. The author found that not only were the production efficiencies not passed on to the client in the form of lower fees, but that joint service clients actually paid increased fees relative to audit-only clients. Palmrose¹⁶⁸ examined the issue further by separating NAS into several categories such as tax and management advisory services. Findings in this study supported the positive relationship between NAS and audit fee documented by Simunic. Abdel-Khalik,¹⁶⁹ however, argued that the result of these studies was counter-intuitive. Using a survey methodology, the author concluded that the provision of NAS did not impact audit fee.

8.38 The studies providing support for a positive relationship between audit fees and NAS provision raise concerns due to the analytical results¹⁷⁰ discussed above that predict where the benefits of cost savings are retained by the auditor, the auditor becomes more dependent on the client, posing a threat to independence. Results from Davis, Ricchiute and Trompeter,¹⁷¹ however, attribute the fee increase to an increase in audit effort. Parkash and Venable¹⁷² ascribe the

¹⁶² Larry Davis, David Ricchiute and Greg Trompeter, 'Audit Effort, Audit Fees, and the Provision of Nonaudit Services to Audit Clients,' (1993) 68(1) *Accounting Review* 135.

¹⁶³ Above n 148.

¹⁶⁴ D A Simunic, 'Auditing, Consulting and Auditor Independence' (1984) *Journal of Accounting Research* 679.

¹⁶⁵ Palmrose, above n 155.

¹⁶⁶ See, eg, P Barnes and H D Huan, 'The Auditor's Going-Concern Decision: Some UK Evidence Concerning Independence and Competence' (1993) 20(2) *Journal of Business Finance & Accounting* 213.

¹⁶⁷ Above n 164.

¹⁶⁸ Above n 155.

¹⁶⁹ A R Abdel-Khalik, 'The Jointness of Audit Fees and Demand for MAS: A Self-Selection Analysis' (1990) *Contemporary Accounting Research* 295.

¹⁷⁰ See eg, Beck, Frecka and Solomon, above n 161.

¹⁷¹ Davis, Ricchiute and Trompeter, above n 162.

¹⁷² Mohinder Parkash, and Carol Venable, 'Auditee Incentives for Auditor Independence: The Case of Nonaudit Services' (1993) 68(1) *Accounting Review* 113.

inconsistencies between these studies to methodological faults such as survey response bias and inconsistent NAS definition.

8.39 In light of the above inconsistencies, Barkess and Simnett¹⁷³ tested the relationship between audit fees and the provision of NAS. A large Australian sample, from 1986 to 1990, was employed in their study. In each year, between 371 and 466 of the Top 500 listed companies were drawn into the sample, with a total of 2,094 observations. Using regression analysis, the authors rejected the null hypothesis of no relationship between audit fees and the provision of NAS predicted by Abdel-Khalik,¹⁷⁴ and found results consistent with the earlier studies by Simunic and Palmrose.

8.40 The existence of a positive relationship between NAS fees and audit fees has also been documented in the UK.¹⁷⁵ Using a random process to select a sample of the 1,083 UK quoted companies named in the 1992 *Quality of Markets: Companies Book*, Ezzamel, Gwilliam and Holland¹⁷⁶ constructed a final sample of 314 companies. At the outset, the authors note that in the 1992-1993 period, up to 87% of total audit fees could be traced to NAS provision. Further, consistent with many of the US and Australian studies, a positive relationship between fees for NAS and audit service provision was found.

8.41 Another stream of research has looked to explain pricing issues in terms of the existence or non-existence of audit fee premia. Competitiveness is a documented feature of the market for audit services,¹⁷⁷ and in such an environment, these premia can be interpreted as returns to quality-differentiated features offered by an audit firm.¹⁷⁸ Craswell, Francis and Taylor¹⁷⁹ examined brand name reputation and industry specialization as two possible sources of fee premia. Using auditor remuneration data for 1,484 publicly listed Australian companies during 1987, the authors found evidence of both sources in audit fees. On the other hand, Craswell and Peiris¹⁸⁰ did not find evidence of a service-quality premium, where this represents the management's internal opinion as to the value added by the audit.¹⁸¹ The sample used, however, only covered 111 Australian companies.

¹⁷³ Lynn Barkess and Roger Simnett, 'The Provision of Other Services by Auditors: Independence and Pricing Issues' (1994) 24(94) *Accounting and Business Research* 99.

¹⁷⁴ Above n 169.

¹⁷⁵ M Ezzamel, D R Gwilliam and K M Holland, 'Some Empirical Evidence from Publicly Quoted UK Companies on the Relationship Between the Pricing of Audit and Non-Audit Services' (1996) 27(1) *Accounting and Business Research* 3.

¹⁷⁶ *Ibid.*

¹⁷⁷ See, eg, Allen Craswell, Jere Francis and Stephen Taylor, 'Auditor Brand Name Reputations and Industry Specializations' (1995) 20 *Journal of Accounting and Economics* 297, 312-313.

¹⁷⁸ *Ibid.*

¹⁷⁹ *Ibid.*

¹⁸⁰ Allen Craswell and David Peiris, 'Pricing Service Quality in Audit Engagements' (Working Paper, University of Sydney, 1999).

¹⁸¹ *Ibid* 3.

8.42 A recent study by Frankel, Johnson and Nelson¹⁸² provides empirical evidence on the effect of NAS provision on auditor independence and whether the market values fee disclosure. The authors collected fee information from 4,000 proxies filed with the SEC between February and June 2001, after the introduction of the new US disclosure requirements. A significant negative market reaction was found with respect to firms with the highest unexpected NAS fees. Looking at earnings management, the authors document that companies with higher levels of NAS provided by their audit firms are more likely to meet or beat earnings benchmarks. The authors conclude that the provision of NAS can threaten auditor independence. However, although the number of observations was large, the small sample period of four months may limit the ability to generalize these results.

8.43 The study by Barkess and Simnett¹⁸³ investigated questions beyond the pricing matters discussed above. In relation to independence issues, the authors included an examination of the association between the provision of NAS and the issuance of qualified audit reports. The *t*-tests for the relationship between the amount of NAS provided by the audit firm and the type of audit report (ie, qualified or unqualified) were insignificant, indicating that there is no relationship between audit qualification and the level of NAS provided by the incumbent auditor. A final experiment tested the hypothesis that the stability of audit tenure increases with the provision of NAS.¹⁸⁴ A binary variable measuring 0 or 1 depending on whether the client had changed audit firms within the period was used. For the tests, the sample was restricted to those 194 companies that were represented in the database for each of the five sample years. On this level, no relationship between the stability of auditor tenure and NAS provision was found.

8.44 The association between NAS provision and other events of interest has also attracted research. DeBerg, Kaplan and Pany¹⁸⁵ studied the effects of NAS provision on the auditor-client relationship. Using an archival approach, the authors collected an experimental group and a control group sample and tested research questions to determine the relationship between NAS provision and client propensity to change auditors. Further, in the event of a change, the level of NAS service provision purchased from the new auditor was also investigated. The authors relied on disclosures mandated by ASR No 250.¹⁸⁶ Under this provision, the SEC required, amongst other things, disclosure of NAS fees as a percentage of total audit fees, but not as an absolute value. Decisions to change auditors and NAS provision were found to be unrelated, mitigating concerns that audit firms may attempt, potentially to the detriment of independence, to retain high NAS clients. Immediately following an auditor change, clients were found to purchase a lower proportion of NAS from the new auditor. The authors suggest that this could be driven by a desire to reduce total professional fees, or by reticence to involve the auditor in NAS provision until a relationship is established.¹⁸⁷

¹⁸² Richard Frankel, Marilyn Johnson and Karen Nelson, 'Auditor Independence and Earnings Quality' (Working Paper, Stanford University, 2001).

¹⁸³ Above n 173.

¹⁸⁴ Where stability increases with the provision of NAS, a threat to independence might result.

¹⁸⁵ Curtis DeBerg, Steven Kaplan and Kurt Pany, 'An Examination of Some Relationships Between Non-Audit Services and Auditor Change' (1991) *Accounting Horizons* 17.

¹⁸⁶ This rule was only in effect between September 30, 1978 and February 1982.

¹⁸⁷ DeBerg, Kaplan and Pany, above n 185, 28.

8.45 Craswell¹⁸⁸ tested the link between NAS provision and the nature of the audit opinion. Using a logit model to analyse Australian data for 1984, 1987 and 1994, the author concluded that the results indicate that NAS provision may not pose a threat to auditor independence. This inference derived from the finding that the decision to qualify an audit opinion is unrelated to NAS provision.

8.46 Many other studies have examined the perceptions of external parties to gauge the impact of NAS provision on auditor independence.¹⁸⁹ For example, Pany and Reckers¹⁹⁰ related auditor independence to the type of NAS and the existence of any separation between the consultancy and audit arms by examining the perceptions of shareholders and financial analysts. Perceived threats to independence were found to vary with the type of NAS, and to decrease with separation of functions. These results were, however, countered by those of Glenzen and Millar,¹⁹¹ which indicated that NAS provision did not threaten the appearance of auditor independence.

8.47 Lowe and Pany¹⁹² extended the perceptual research to determine how NAS provision *with* the client differed from NAS provision *for* the client. That is, in situations where the audit firm teams with an auditee to provide consultancy services for a mutual client. The authors considered a number of types of services provided in this fashion in order to provide results enabling comparison. 2,100 questionnaires were mailed to financial analysts, as representatives of a key group of financial statement users, resulting in 304 useable responses. The subjects were asked to evaluate an investment decision based on information given in a case study format. Results indicated that the type of relationship used to provide services with a client did not impact perceptions of auditor independence, investment decisions or the reliability of financial statements. These results were consistent with an earlier study by Lowe and Pany,¹⁹³ which examined the perceptions of loan officers.

8.48 In the more recent study, the authors analysed three possible levels of relationship. Firstly, where there was no relationship, secondly, where there was an immaterial relationship, and, finally, where a material relationship with the client existed. Perceptions of independence and reliability were found to be greater where the relationship fell into either of the first two groups, that is, where the relationship was non-existent or immaterial, as compared to where the relationship was material. However, no discernible difference was found between perceptions where there was no relationship and where the relationship was immaterial, indicating that the existence of an immaterial business

¹⁸⁸ Allen Craswell, 'Does the Provision of Non-Audit Services Impair Auditor Independence?' (1999) 3 *International Journal of Auditing* 29.

¹⁸⁹ See, eg Abraham Briloff, 'Old Myths and New Realities in Accountancy' (1966) *Accounting Review* 48; R V Hartley and T L Ross, 'MAS and Audit Independence: An Image Problem' (1972) *Journal of Accountancy* 42; Kurt Pany and Philip Reckers, 'Non-Audit Services and Auditor Independence: A Continuing Problem' (1984) 3(2) *Auditing: A Journal of Practice and Theory* 89; D J Lowe and Kurt Pany, 'CPA Performance of Consulting Engagements with Audit Clients: Effects on Financial Statement Users' Perception and Decisions' (1995) 14(2) *Auditing: A Journal of Practice and Theory* 35.

¹⁹⁰ Above n 189.

¹⁹¹ G Glenzen and J A Millar, 'An Empirical Investigation of Stockholder Reaction to Disclosures Required by ASR No 250' (1985) 23 *Journal of Accounting Research* 859. This study compared auditor approval voting by stockholders before and after the SEC issued ASR No 250.

¹⁹² D Jordan Lowe and Kurt Pany, 'An Examination of the Effects of Type of Engagement, Materiality and Structure on CPA Consulting Engagements with Audit Clients' (1996) 10(4) *Accounting Horizons* 32.

¹⁹³ Above n 189.

relationship may not impact perceptions of auditor independence. Staff separation in performing these functions was found to have a significant effect on user perceptions.

8.49 Perceptual studies, however, are often subject to academic criticism. Response rates are notoriously low,¹⁹⁴ leading to potential non-response bias. Further, the theoretical setting lacks many elements and pressures of reality. Following psychological literature, Gul¹⁹⁵ further contended that the results of perceptual studies can be driven by the characteristics of the subjects.

8.50 Arrunada contends that the decision whether to source NAS from an audit firm, and if so, how much, should be a matter governed by freedom of contract between the audit firm and management,¹⁹⁶ both of whom are informed market participants. Limitations on joint-service supply restrict management and auditors from arriving at the economically 'optimal' mix of service provision. Mikol and Standish¹⁹⁷ note that where restrictions on NAS provision are imposed, the probable result from the perspective of both the manager and the auditor is a reduction in utility. However, the managers, in negotiating contracts for NAS provision, are agents of the shareholders, who, due to information asymmetries, are not necessarily as 'informed' as managers. As described in Section 3.2 above, this separation of ownership and control can lead to agency conflicts, and incentives for managers to maximise their own self-interest at the expense of shareholders. Mikol and Standish highlight the agency conflicts that may arise over 'measures affecting audit quality, objectivity and value.'¹⁹⁸ This arises because each party, seeking to self-maximise, may prefer different levels of these attributes in an audit process. Shareholders, for example, may require a higher level of objectivity than management, due to the difficulty in direct observation of the truth of management statements. Given the existence of these conflicts, any welfare reduction suffered by managers and auditors where services are restricted may not extend to shareholders, who, in fact, may benefit from limitation.

8.51 The mixed results found in the literature makes it difficult to draw firm conclusions from these sources regarding the provision of NAS to audit clients. The disaccord amongst theoretical proponents carries through into the empirical results. Some theorists use this lack of conclusive evidence to conclude that the 'available empirical evidence does not support the contention that auditor independence is harmed by providing such services, even to audit clients.'¹⁹⁹ Others conclude that heed should be taken of the evidence that does imply impairment to auditor independence. Carmichael and Swieringa point out that 'to say that the performance of management services and independent auditing for the same client is incompatible is not the same as saying that the auditor has lost his independence.'²⁰⁰ That is to say, although the *potentiality* for impairment of independence exists, this does not necessarily imply that it can, or will, occur.

¹⁹⁴ See, for example, Lowe and Pany, above n 192, which had a response rate of 14.5%. In another example, the response rate in J M Lacey, 'Auditor/Client Joint Investments and Independence' (1990) 4 *Research in Accounting Regulation* 129 was 11%.

¹⁹⁵ Ferdinand Gul, 'Qualified Audit Reports, Field Dependence Cognitive Style, and their Effects on Decision Making' (1990) *Accounting and Finance* 15.

¹⁹⁶ Above, n 150.

¹⁹⁷ *Ibid.*

¹⁹⁸ Above n 156.

¹⁹⁹ Arrunada, above n 150.

²⁰⁰ Above n 102.

8.52 However, regardless of the eventuality of an actual impairment to independence in fact, damage to independence in appearance has been documented.²⁰¹ And, given the development of the importance of this element of independence above, this should be cause at least for some notice. As noted by Wines, ‘it is the signal to financial statement users and others which is of paramount importance.’²⁰²

Audit fee

8.53 As noted in Section 3.2 above, where an auditor has an ‘economic interest’ in a client, he or she may have incentives for misrepresentation. DeAngelo has identified the start-up costs of an audit as one situation that can create the ‘economic interest’ necessary to impair auditor independence.²⁰³ These initial costs may arise as a result of the initial lack of familiarity with the client and the necessity to verify details such as beginning balances and the particulars of certain assets, including fixed assets.²⁰⁴ However, given the advantage the auditor will gain through performing this initial audit, and assuming the auditor has some bargaining power, he or she can increase fees beyond total costs in future audits.²⁰⁵ With this knowledge, an auditor may ‘low ball’²⁰⁶ as a competitive response.

8.54 This practice of low balling, and its impact on auditor independence, has caused considerable contention in the literature. Some theorists argue that the practice, of itself, impairs independence.²⁰⁷ Others, such as DeAngelo²⁰⁸ argue that while the concept is related to the existence of future economic interest, the practice itself does not damage independence. Finally, some theorists contend that it is, in fact, beneficial to the public.²⁰⁹

8.55 The *Cohen Report*,²¹⁰ in denouncing low balling, likened the resulting situation to giving management a bail bond which could be used to induce docility in the auditor through threats of replacement. Lee and Gu²¹¹ criticise this argument in that it implies that the auditor is only the agent

²⁰¹ See, eg, P L Titard, ‘Independence and MAS- Opinions of Financial Statement Users’ (1971) *Journal of Accountancy* 47; Randolph Shockley, ‘Perceptions of Audit Independence: An Empirical Analysis’ (1982) 56(4) *Accounting Review* 785.

²⁰² Above n 148, 77.

²⁰³ Above n 119, 35-38.

²⁰⁴ A Arens and James Loebbecke, *Auditing, an Integrated Approach* (1976).

²⁰⁵ DeAngelo, above n 119, 36.

²⁰⁶ ‘Low balling’ is a term used to describe the practice of introductory pricing whereby an auditor is willing to price the initial engagement below total costs in the knowledge that they can increase their fee above total costs in future periods. One reason for concern is that introductory pricing can be indicative of a predatory pricing strategy. See, eg, P Areeda and D F Turner, ‘Predatory Pricing and Related Practices Under Section 2 of the Sherman Act’ (1975) 88 *Harvard Law Review* 697 in relation to predatory strategies in auditing.

²⁰⁷ See, eg, Commission on Auditors’ Responsibilities, *Report, Conclusions and Recommendations* (1978) (‘*Cohen Report*’).

²⁰⁸ Above, n 89.

²⁰⁹ See, eg, Arrunada, above n 150.

²¹⁰ Above n 207.

²¹¹ Chi-Wen Jevons Lee and Zhaoyang Gu, ‘Low Balling, Legal Liability and Auditor Independence’ (1998) 73(4) *Accounting Review* 533, 535.

of management,²¹² and not of the owners. Further, it disregards the existence of legal liability. They develop a multi-agent moral hazard model,²¹³ under which hiring and firing the auditor is the responsibility of the owners/shareholders, and find that low balling enhances independence. Their model shows that low balling ‘creates the same kind of disincentive for unscrupulous auditor behaviour as does auditors’ legal liability, but it does so for less cost.’²¹⁴

8.56 However, this result is largely contingent on the assumption that the power to hire and fire rests with shareholders. As the authors themselves are cognisant,²¹⁵ this is not entirely consistent with the institutional reality. If this assumption is reversed and the power is handed to management, low balling is found to be deleterious to auditor independence, consistent with the *Cohen Report*.²¹⁶ The authors note²¹⁷ that the reality ‘lies somewhere between these extremes: the owners or their representatives are actively involved and the managers also have limited power to hire and fire the auditors.’²¹⁸ They conclude that to the extent the actuality lies at least in this middle ground, and therefore the power is not entirely with management, low balling, as demonstrated by their model, can enhance the monitoring process and lead to improved independence.

8.57 DeAngelo²¹⁹ argues that low balling does not impair independence as the price reduction is a sunk cost in future periods. The competitive advantages of the incumbent auditor described above are identified by DeAngelo as assets specialised to the specific client and the auditor. The creation of these assets has implications for the future relationship between the parties, as where they exist, termination by one party will be costly to the other. With this knowledge, both the auditor and the client can procure gains (higher fees and acquiescence on some matters respectively) through the *threat* of termination. DeAngelo terms this situation a ‘bilateral monopoly’.²²⁰ Where these potential gains to incumbency are coupled with a competitive initial audit market, low balling may result.

8.58 DeAngelo uses the analytical model developed in the study to examine regulation intended to enhance independence through augmenting the disclosure requirements when an auditor is changed.²²¹ The author contends that the *Cohen Report*²²² is ‘over simplistic’. She claims that

²¹² Cf Antle, above n 128.

²¹³ Moral hazard may arise in this multi-agent situation because the auditor, as the monitoring agent, may have the incentive to conceal or misrepresent information about the manager, the monitored agent, in exchange for a ‘side payment’: Lee and Gu, above n 211, 533.

²¹⁴ Lee and Gu, above n 211, 534.

²¹⁵ *Ibid* 535.

²¹⁶ Above, n 207.

²¹⁷ Lee and Gu, above n 211, 550-551.

²¹⁸ *Ibid*.

²¹⁹ Above n 89, 115.

²²⁰ *Ibid* 118.

²²¹ DeAngelo examines the US initiatives from the 1970s, ASR-165 and ASR-250. Where there has been a change of auditor, ASR-165 requires disclosure of significant disagreements within the last two financial years and their effect if material, the auditor resignation and new appointment, and a response by the former auditor. ASR-250 relates to the fee relationship, and requires the services provided to be disclosed, along with the percentage non-audit fees represents in relation to audit fees and any non-negotiable audit fee limits: DeAngelo, above n 89, 124.

although it is correct that the effectiveness of client threats decreases with increased external scrutiny, such as disclosure of significant disagreements between the auditor and client, the report fails to acknowledge that the optimal level of independence is also reduced due to the increase in future economic interest from the client that will occur, all else held constant. This increase in future 'rents' occurs because such legislation increases the costs of changing auditors. DeAngelo extends this line of reasoning to suggest that the net effect of such rules is therefore inconclusive, and, further, as the initial bidding for these increased future profits increases, more low balling will occur. The author concludes that regulation restricting low balling, such as the initiatives considered in her paper, must either result from a mistaken belief that decreasing introductory pricing enhances independence, or it is a veiled attempt to preserve monopoly profits for auditors.²²³

8.59 Benito Arrunada agrees that a lack of understanding of low balling has led to several incorrect regulatory initiatives,²²⁴ and claims that 'such rules are self defeating...in terms of both independence and competition.'²²⁵ He reiterates the resultant increase in 'quasi-rents' and notes the negative impact on competition arising from the increased costs of changing auditors. He also concludes that the push to restrict low balling may have arisen through the desire to preserve 'monopolistic rents than with the alleged objective of preserving independence.'

8.60 Magee and Tseng²²⁶ extend the work of DeAngelo by taking into account the level of agreement between auditors in the market as to the acceptability of a client's choice of accounting policy, before considering independence. This will depend, to some extent, on the level of discretion available within generally accepted accounting principles (GAAP). They find that although low balling will occur whether or not there is agreement between auditors as to the appropriate choice of policy, independence will only be damaged where there is auditor disagreement.

8.61 The model proposed by Magee and Tseng was tested by Calegari, Schatzberg and Sevik.²²⁷ The authors note that the Magee and Tseng model did not predict cooperation between management and auditor for mutual gain. Using an experimental design creating eight markets representing agreement, and eight for disagreement they tested the predicted effect of auditor agreement. Next, they partitioned the sample into a control and treatment group and tested the price-independence prediction. In this experiment, they provided an incentive to cooperate through imposing only a low penalty on an auditor who impaired his or her independence. The findings in the control group and half of the treatment group are consistent with the model predictions and imply that auditor independence is greater where there is agreement as to appropriate policy, and that a high penalty need not be imposed to prevent damage to independence. However, in the other half of the treatment group, evidence of cooperative strategies is evinced, and, under further tests, that auditors may damage independence even where there is inter-auditor accord. Where the penalty for impaired

²²² Above n 207.

²²³ Above n 89, 125.

²²⁴ Arrunada, above n 150, 5, uses the example of the EU Green Paper item 4.11 in Official Journal of the European Communities, *Green Paper on the Role, the Position and the Liability of the Statutory Auditor within the European Union* (96/C 321/01) (1996).

²²⁵ *Ibid.*

²²⁶ R Magee and N Tseng, 'Audit Pricing and Independence' (1990) *Accounting Review* 315.

²²⁷ Michael Calegari, Jeffrey Schatzberg and Galen Sevik, 'Experimental Evidence of Differential Auditor Pricing and Reporting Strategies' (1998) 73(2) *Accounting Review* 255.

independence is increased, findings indicate that auditors remain independent, suggesting penalties may be required to bond auditors to independence.

8.62 Dye's²²⁸ model, contrary to that of DeAngelo²²⁹ above, predicts that where audit pricing is disclosed, low balling will not occur. The author contends that the driver of DeAngelo's results is the underlying assumption that the auditor controls fees for periods subsequent to the initial audit. Dye tests the effect of this auditor-client power relationship on pricing and independence. He concludes that low balling results from non-transparent audit fees rather than contracting costs as determined by DeAngelo.

8.63 Craswell and Francis²³⁰ document studies that found significant low balling in the United States under non-disclosure conditions.²³¹ That is, where audit fees were not normally publicly disclosed in the United States at the time the studies were undertaken.²³² Furthering these results by investigating a similar sample of Australian companies under disclosure conditions, the authors found little evidence of low balling. These results are consistent with Dye as opposed to DeAngelo. However, where the auditor change was from non-Big eight to Big Eight (as it then was), low balling was documented. Craswell and Francis posit the notion of experience goods²³³ to explain this phenomenon.

8.64 Butterworth and Houghton²³⁴ also investigated the presence of low balling in the Australian market. The authors tested for low balling using a regression model of audit fees on a sample of Western Australian companies. Although they found that the initial audit fee was lower than subsequent billings, this difference was insignificant, leading to the rejection of the proposition that new auditors charge less than incumbents.

Employment relationships

8.65 The threat posed to auditor independence by former employees of audit firms gaining employment with clients is an issue that has 'been discussed by the SEC and the profession for years, as the frequency of partners and other senior professionals leaving their firms to join audit clients has increased.'²³⁵ From a client's perspective, there are many advantages to hiring a former

²²⁸ R Dye, 'Informationally Motivated Auditor Replacement' (1991) 14 *Journal of Accounting and Economics* 347.

²²⁹ Above n 89.

²³⁰ Allen Craswell and Jere Francis, 'Pricing Initial Audit Engagements: A Test of Competing Theories' (1999) 74(2) *Accounting Review* 201.

²³¹ See, eg, M Etteredge and R Greenberg, 'Determinants of Fee Cutting on Initial Audit Engagements' (1990) 28 *Journal of Accounting Research* 198.

²³² The two principal studies considered in the paper, Etteredge and Greenberg, above n 231, and D Simon and J Francis, 'The Effects of Auditor Changes on Audit Fees: Tests of Price Cutting and Price Recovery' (1988) 63 *Accounting Review* 255, used samples covering the early to mid-1980s. The lack of audit fee disclosure in this era can be contrasted to the position since the adoption by the Securities and Exchange Commission of new audit rules in November 2000.

²³³ Experience goods exist where higher priced and quality goods are sold at a low introductory price to induce consumers to 'experience' them such that uncertainty as to quality can be settled: Craswell and Francis, above n 230, 203.

²³⁴ S Butterworth and K A Houghton, 'Auditor Switching: The Pricing of Audit Services' (1995) 22(3) *Journal of Business Finance and Accounting* 323.

²³⁵ Independence Standards Board (ISB), *Annual Report* (1998).

auditor. Auditors in the large firms are commonly distinguished graduates from the best schools,²³⁶ and possess other appealing attributes including breadth of experience²³⁷ and exposure to varied and complex financial transactions.²³⁸ Further, the ‘former auditor is intimately familiar with the client’s business strategy, financial reporting processes, and industry peculiarities.’²³⁹ Indeed, a recent study by Behn *et al.*,²⁴⁰ observed that among Fortune 1000 companies, 33% of financial controllers had prior experience with the current audit firm.

8.66 Auditor employment with client firms raises a number of issues with respect to independence. At the outset, there is a question as to the ability of remaining auditors to be independent and exercise proper due diligence when dealing with the ex-colleague,²⁴¹ especially where that ex-colleague held a senior position within the audit firm. This may arise through a reticence to query the former colleague.²⁴² This is exacerbated by the inside knowledge the former auditor will hold with respect to the practices of the audit firm.²⁴³ Knowing exactly what the auditors are looking for and the strategy they are likely to follow can facilitate concealment. Further, in the period preceding employment with the client, the auditor may attempt to ingratiate him or herself with the client through taking a more lenient approach to the client’s compliance with the relevant accounting standards.²⁴⁴

8.67 On the whole, empirical studies have supported the concerns raised above with regards to the damage to real or perceived independence caused by auditor employment with clients. The literature is not as saturated with empirical research as was the case for NAS, but several studies have examined the issue, primarily on a perceptual level. In an early study, Imhoff²⁴⁵ used a questionnaire approach to gauge the perceptions of users of financial statements, represented by (i) bankers and financial analysts, and (ii) CPAs, where an auditor gained employment in a client firm. The hypothetical situations posed to the respondents explored two dimensions: firstly, the nature of the role of the auditor while auditing the client, and whether this was supervisory or not, and secondly, the time lag between the audit engagement and accepting the appointment within the client firm. Results indicated that as the length of time to employment increased or where the nature of the auditor’s role was non-supervisory, less of a threat was posed to independence. In all cases examined, the group of bankers and financial analysts perceived a higher threat to independence than the CPA group, with the greatest difference being where an employment offer was accepted within six months of an audit supervisor working as an auditor of the client firm (68% of users queried independence compared to 40% of CPAs).

²³⁶ Mark Beasley, Joseph Carcello and Dana Hermanson, ‘Should you offer a job to your external auditor?’ (2000) 11(4) *Journal of Corporate Accounting & Finance* 35, 35.

²³⁷ Eugene Imhoff, Jr, ‘Employment Effects on Auditor Independence’ (1978) 53(4) *Accounting Review* 869.

²³⁸ Beasley, Carcello and Hermanson, above n 236, 36.

²³⁹ *Ibid.*

²⁴⁰ Bruce Behn, Joseph Carcello, Dana Hermanson and Roger Hermanson, ‘Client Satisfaction and Big 6 Audit Fees’ (1999) 16(4) *Contemporary Accounting Research* 587.

²⁴¹ Imhoff, above n 237, 870.

²⁴² Beasley, Carcello and Hermanson, above n 236, 37.

²⁴³ *Ibid.*

²⁴⁴ Beasley, Carcello and Hermanson, above n 236, 36. See also Imhoff, above n 237, 870.

²⁴⁵ Above, n 237.

8.68 The next major study was completed by Michael Firth in 1981.²⁴⁶ In his paper, he explored the influence of certain facets of the auditor-client relationship on the lending decision of bankers. A questionnaire approach was used, sending financial statements with audit reports to 1700 members of the Institute of Bankers and receiving a 74% response rate. Attached to the information was a note on the auditor-client relationship, covering nine different situations.²⁴⁷ Results on the relationship where a former audit firm partner was now the financial director of the client indicated that bankers were concerned that independence could be compromised in this situation, evidenced by an intention to grant a smaller loan. These results were supported by Schleifer and Shockley.²⁴⁸

8.69 Koh and Mahathevan²⁴⁹ used a different experimental design for their examination of the employment relationship. Following a between-subjects methodology as opposed to a with-subjects methodology,²⁵⁰ the authors add to the previous study by Imhoff²⁵¹ by adding the two additional factors of the type of opinion issued by the auditor prior to leaving the audit firm, and the position of the former auditor within the client. Using a case study questionnaire, managers' perceptions were analysed in relation to the last audit performed by the ex-auditor and subsequent audits performed after the ex-auditor took up the position within the client. In relation to the nature of the ex-auditor's role, two key findings on perceptions on the threat to independence arose. Firstly, perceptions were found to increase where the auditor's previous role in the audit firm was supervisory, and secondly, where the current role in the client involves preparation of financial statements. With regards to the time lag before appointment, perceptions of threats to independence were found to increase as the time between the last audit and appointment within the client decreased.

8.70 The above studies should be viewed in light of their limitations.²⁵² Of primary concern is their reliance on perceptions, which will not necessarily be translated into actions. Further, a survey-style approach necessarily creates an artificial situation that may not contain all the

²⁴⁶ Michael Firth, 'Auditor-Client Relationships and their Impact on Bankers' Perceived Lending Decisions' (1981) 11 *Accounting and Business Research* 179.

²⁴⁷ These relationships were (1) an independent relationship; (2) the accounting firm receives 15% of gross fees from the client; (3) audit partner has been in sole charge of a large audit; (4) the financial director was previously a partner for 10 years with the audit firm; (5) the partner in charge owns 1000 shares (out of one million) in the client; (6) a partner in the audit firm who is not involved in the audit is the trustee of a trust that owns 10% of the client firm; (7) a partner in the audit firm managed a building owned by the client; (8) the audit firm provided other services including preparation of financial statements; and (9) the audit firm provides the client MAS from a separate consultancy arm, Firth, above n 246, 181.

²⁴⁸ Linda Schleifer and Randolph Shockley, 'Policies to Promote Auditor Independence; More Evidence on the Perception Gap' (1990) *Journal of Applied Business Research* 10.

²⁴⁹ Hian Chye Koh and Premila Mahathevan, 'The Effects of Client Employment on Auditor Independence' (1993) 25 *British Accounting Review* 227.

²⁵⁰ A between-subjects methodology requires subjects to respond to only one level of manipulated variables, whereas a within-subject methodology solicits a response to more than one level: Kurt Pany and Philip Reckers, 'Within - Vs. Between-Subjects Experimental Designs: A Study of Demand Effects' (1987) 7(1) *Auditing: A Journal of Practice & Theory* 39, 39. The results in this study, which examined the provision of MAS, indicated that the experimental design might affect the results obtained.

²⁵¹ Above, n 237.

²⁵² Firth, above n 246, 184 is cognisant of these limitations.

information or conditions that would be required in a real case. Finally, the impact of non-response bias on the validity of results should be considered in any survey-style experimental design.²⁵³

8.71 The issue of client employment was further developed by Parlin and Bartlett²⁵⁴ through the consideration of real independence, as opposed to independence in appearance. In the study, the auditor-subjects were asked to determine an initial estimate of materiality. Each auditor was provided with background information, which, amongst other things, advised as to whether or not the controller of the company was a recent ex-auditor of the audit firm. The findings, which established a larger materiality estimate was made where the controller was a former auditor, were consistent with ex-auditor employment having an adverse effect on independence.

8.72 Beasley, Carcello and Hermanson²⁵⁵ discuss a study of instances of fraudulent reporting they were commissioned to undertake by the Committee of Sponsoring Organizations of the Treadway Commission. In this report, the authors found some connection between client employment of ex-auditors and financial fraud. In a final sample of 44 fraud-related SEC enforcement actions, the current CFO had joined the client immediately post leaving the audit firm in five, or 11 percent of cases. The authors discussed an anecdote where Livent, a producer of Broadway shows hired an ex-auditor from their audit firm, Deloitte, and quoted the following passage from an article in the *National Post* (January 19, 1999) to highlight the concerns that arise from employing an ex-auditor:

‘Having a top officer who knew how Deloitte [the external audit firm] worked, and what its auditors were looking for, no doubt made it easier for the company to keep auditors from finding evidence of any fraud. She [the new CFO] also had credibility with former colleagues when questions arose, which may have been used to reassure them if something suspicious was noticed.’

8.73 The above studies indicate that employment of an ex-auditor with a client poses a threat to auditor independence, to a degree varying depending on the particulars of the situation. These results have policy implications. Imhoff²⁵⁶ raised the concern, however, that prohibitions against auditors considering taking up employment with a client during the term of an audit would be ineffective due to hesitance on the part of other auditors in the team to disclose the situation.

8.74 A recent article by Kaplan and Whitecotton²⁵⁷ found results consistent with these concerns. The authors examined the reporting intentions of other auditors where an audit team member had been offered employment with the client firm, and, contrary to ethics rulings, was considering that offer without withdrawing from the audit commitment. Extending a model by Schultz, Johnson, Morris and Dyrnes,²⁵⁸ the authors predict that where an auditor appreciates that a ‘questionable’ act has transpired, the likelihood that the act will be reported will be related to three factors. Firstly, the

²⁵³ F N Kerlinger, *Foundations of Behavioural Research* (1973) examines the effects of non-response bias.

²⁵⁴ J C Parlin and R W Bartlett, ‘Prior Employment and Independence in Fact’ (1994) 13 (1&2) *Business & Professional Ethics Journal* 185.

²⁵⁵ Above, n 236, 38-41.

²⁵⁶ Above, n 237.

²⁵⁷ Steven Kaplan and Stacey Whitecotton, ‘An Examination of Auditors’ Reporting Intentions When Another Auditor is Offered Client Employment (2001) 20(1) *Auditing: A Journal of Practice & Theory* 45.

²⁵⁸ J J Schultz Jr, D A Johnson, D Morris and S Dyrnes, ‘An Investigation of the Reporting of Questionable Acts in an International Setting’ (1993) 31(Supplement) *Journal of Accounting Research* 75.

gravity of the act in question, secondly, the level of reporting responsibility the particular individual believes they are subject to, which may be related to their position or personal factors, and, finally, the costs they feel they will incur at a personal level as a result of reporting the act.

8.75 Seventy-five audit seniors from a large international firm were asked to participate in the study, resulting in 73 useable responses. Each subject was asked to provide an anonymous response to a case study. They were provided with information concerning the client company, and informed that the audit manager had been involved in three previous audits of the particular company, and was liked by the company. The auditors were then told that the manager had been offered employment with the client company but had not removed himself from the engagement. The auditors were also given information on both the ethics ruling and the potential for the situation to impair independence. The reporting obligations of other auditors observing the behaviour were not explained to the subjects, who were then asked to provide responses to several variables. These included a scaled response of the likelihood they or others would report the behaviour, the seriousness of the act, their responsibility to report and the costs of doing so. They further included 'manipulated' variables relating to the character of the CEO of the client company and the audit manager.

8.76 Results established that the auditors considered the personal costs of reporting were quite high, but that the gravity of the act was only moderate, as was their responsibility to report. The measured likelihood of reporting the incident was low for both the auditor personally, and for the perceived position of other auditors, indicating that auditors are not likely to report this type of behaviour in colleagues.

8.77 The authors point out that '[t]his result is somewhat paradoxical since a primary role of the auditor is to seek out and report the questionable behavior of clients.'²⁵⁹ They propose that the issue be tackled by audit firms encouraging reporting through two methods. Initially, by working to strengthen perceptions of personal responsibility within the firm, and, next, by reinforcing the notion that reporting this type of situation will be at little cost to the employee.

Other factors

8.78 The above discussion covers several of the major areas for concern in relation to auditor independence. There are further factors that have been argued in the academic literature to impact independence. These include length of auditor tenure, financial interests in auditees, ambiguity of accounting rules and opinion shopping by auditees.

Length of auditor tenure

8.79 Theorists have hypothesised that as tenure increases, so too do perceptions that the auditor may be more accommodating to the client.²⁶⁰ This may arise for many reasons,²⁶¹ but Mautz and Sharaf warn that the 'greatest threat to...independence is a slow, gradual, almost casual erosion of [the auditor's] honest disinterestedness'.²⁶² Teoh and Lim²⁶³ and Beck, Frecka and Solomon²⁶⁴

²⁵⁹ *Ibid* 61.

²⁶⁰ See, eg, Shockley, above n 201.

²⁶¹ Shockley cites 'complacency, lack of innovation, less rigorous audit procedures, and a learned confidence in the client' as key dangers arising as tenure increases: above n 201, 789. Following DeAngelo, above n 119, another explanation could be the desire not to lose future economic interest in the client.

²⁶² Above n 79, 208.

considered the relevance of the length of auditor tenure to independence. The latter authors provide some evidence that when certain MAS services are provided by the auditor, tenure increases, whilst the variability of tenure decreases.²⁶⁵

8.80 Shockley tested the hypothesis that perceptions of impaired auditor independence increase when the period of tenure surpasses five years. The author used a sample comprising firstly certified public accountants (CPAs), and then bank loan officers and financial analysts to represent creditors and investors respectively, two key groups of financial report users. The subjects completed a questionnaire, which required them to rate the risk to independence under a number of scenarios. This information was then analysed using analysis of variance (ANOVA). The effect of tenure overall was not found to be significant, but for the sub-group of bank loan officers, increased tenure was perceived to impair independence. A study by Knapp²⁶⁶ also found that groups of CPAs and financial analysts did not consider auditor tenure a threat to independence.

8.81 Wright²⁶⁷ used a laboratory setting to investigate the relationship between factors including tenure and the type of audit report that would be issued where material uncertainties existed. The type of report was found to be related to the length of the auditor-client relationship, but not to a significant level. Barkess and Simnett²⁶⁸ examined the relevance of the stability of auditor tenure, and whether this increased with the provision of NAS. However, no relationship between the stability of auditor tenure and NAS provision was found.

8.82 Carey and Simnett²⁶⁹ investigated audit partner tenure and the potential impact this might have on audit quality. Using a sample of Australian listed companies during the period from 1987 to 1993, the authors tested the relationship between tenure and the probability of audit qualification. Findings suggested a negative association between the two variables, implying a potential threat to independence with increased tenure. However, the tests relied on audit qualification as a proxy for quality, and this may be influenced by numerous other factors.²⁷⁰

Financial interest in auditees

8.83 Financial interest in the auditee has been considered by Pany and Reckers²⁷¹ and Lindsay, Rennie, Murphy and Silvester,²⁷² although such interests are widely prohibited. Pany and Reckers,

²⁶³ H Y Teoh and C C Lim, 'An Empirical Study of the Effects of Audit Committees, Disclosure of Non-Audit Fees, and Other Issues on Auditor Independence: Malaysian Evidence' (1996) 5(2) *Journal of Accounting, Auditing and Taxation* 231.

²⁶⁴ Beck, Frecka and Soloman, above n 145.

²⁶⁵ *Ibid.*

²⁶⁶ Michael Knapp, 'Factors that Audit Committee Members Use as Surrogates for Audit Quality' (1991) 62(3) *Accounting Review* 578.

²⁶⁷ A Wright, 'The Impact of CPA Firm Size on Auditor Disclosure Preferences' (1983) *Accounting Review* 621.

²⁶⁸ Above n 173.

²⁶⁹ Peter Carey and Roger Simnett, 'Audit Partner Tenure: Implications for Audit Quality and Mandatory Rotation Policy' (Working Paper, Monash University, 2001).

²⁷⁰ Indeed, the authors are currently revising the paper, including changing the proxy for quality to the level of discretionary accruals.

²⁷¹ Kurt Pany and Philip Reckers, 'The Effects of Gifts, Discounts and Client Size on Perceived Auditor Independence' (1980) 55(1) *Accounting Review* 50.

for example, considered the impact of gifts and purchase discount arrangements on perceptions of auditor independence. The authors obtained a random sample of shareholders who had recently purchased a block of shares, and asked the subjects to evaluate the ability of an auditor to withstand client pressure. Gifts and purchase discount arrangements were found to significantly impact perceptions of independence.²⁷³

8.84 Firth²⁷⁴ examined the perceptions of bankers in relation to financial interests²⁷⁵ including where a partner owns 1000 out of a total one million shares on issue. Using a random sample of 1700 members of the Institute of Bankers in the United Kingdom, the author found that the responses were widely varied. 10% of respondents believed that where such an interest was held, loan prospects were, in fact, enhanced.²⁷⁶ However, the average response was in line with the wider view, which fears a threat to independence.

Ambiguity of accounting rules

8.85 Research has also been directed at the complexity of rules and the level of discretion available in generally accepted accounting principles (GAAP). These studies generally indicate that as the level of ambiguity increases, so to does the risk of impairment to auditor independence.²⁷⁷ In the context of a tax audit, Klepper, Mazur and Nagin²⁷⁸ submit a model that indicates that involvement of an expert will encourage compliance where there is no ambiguity, but will have the opposite effect where discretion exists. Where discretion exists, it is difficult to draw a direct conclusion that the auditor acted as a result of compromised independence, as their decision fell within the 'accepted' framework. When there is no ambiguity, auditors are likely to remain independent for fear of the detriment to their reputation if they did not report the truthful value.²⁷⁹ In the auditor context, Magee and Tseng²⁸⁰ find that low balling will occur whether or not there is ambiguity in the appropriate accounting policy choice, but that independence will only be damaged if there is disagreement amongst auditors in relation to the appropriate accounting treatment. Testing the model offered by the previous authors, Calegari, Schatzberg and Sevik²⁸¹ found that independence might be impaired in some cases even where there is agreement between auditors. These results build on the model by Magee and Tseng by incorporating a dimension allowing for cooperative strategies between management and auditor. The authors suggest that under some

²⁷² D Lindsay, M Rennie, G Murphy and H Silvester, 'Independence of External Auditors: A Canadian Perspective' (1987) 1 *Advances in International Accounting* 169.

²⁷³ Pany and Reckers, above n 271.

²⁷⁴ Above n 246.

²⁷⁵ Other interests were also examined, see above n 247.

²⁷⁶ Firth posits that this may be because bankers interpret the holding of shares by the auditor as an inside 'expression of confidence' in the company, *ibid* 187.

²⁷⁷ See, eg, S Klepper, M Mazur and D Nagin, 'Expert Intermediaries and Legal Compliance: The Case of Tax Preparers' (1991) 34(1) *Journal of Law and Economics* 205.

²⁷⁸ *Ibid*.

²⁷⁹ Brian Mayhew, Jeffrey Schatzberg and Galen Sevcik, 'The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Independence' (Working Paper, University of Wisconsin at Madison, 2000).

²⁸⁰ Above n 226.

²⁸¹ Above n 227.

conditions penalties might need to be imposed to deter auditors from compromising their independence.

Opinion shopping by auditees

8.86 Finally, opinion shopping by clients, whereby an auditor change may follow a qualified audit report, is another area for concern. In this respect, Bell and Tabor note that the fact ‘that auditors do not qualify every client experiencing financial difficulty...indicates that qualifying is not costless.’²⁸² Several studies have found that an increased likelihood to switch auditors is associated with receipt of a qualified opinion.²⁸³ However, in many of these cases, the new auditor was found to also provide a qualified opinion.²⁸⁴ In addition, conservatism amongst auditors has been documented.²⁸⁵ Conservatism refers broadly to following a less accommodating approach to accounting policy choice and measurement. Further, the results of Jeter and Shaw²⁸⁶ suggest, contrary to speculation that auditors may try to entice clients through accommodating their wishes, that where solicitation of audit clients is permitted, more qualified opinions are issued than where solicitation is disallowed. Beattie and Fearnley²⁸⁷ documented a statistically significant relationship between unsolicited approaches by audit firms and either a subsequent competitive tender or a contemplation of auditor change. This could indicate that even if clients attempt to opinion shop, auditors will not be led to compromise their independence as a result.

8.87 Butterworth and Houghton²⁸⁸ considered opinion shopping as an alternative explanation for the anecdotal evidence of fee-cutting. Opinion shopping would indicate that competition between auditors is driven by the nature of the audit opinion rather than price. However, with insignificant results, the authors concluded that this phenomenon was not a driving factor of the results.

8.88 A common research formulation for studying opinion shopping attempts to relate audit opinions to audit fees. These papers are generally premised upon the argument that audit fees may influence or impact the opinion issued by the auditor. Houghton and Jubb,²⁸⁹ on the other hand, investigate the converse of this theme. That is, they study the influence of the audit opinion on audit fees. In particular, the authors argue that a qualified opinion is associated with higher production costs and that these costs may be recovered through an increase in fees. However, given the relative

²⁸² P Bell and P Tabor, ‘Empirical Analysis of Audit Uncertainty Qualifications’ (1991) 29 *Journal of Accounting Research* 350, 367.

²⁸³ See, eg, D Jeter and P E Shaw, ‘Solicitation and Auditor Reporting Decisions’ (1995) 70 *Accounting Review* 293; J Krishnan, ‘Auditor Switching and Conservatism’ (1994) 69(1) *Accounting Review* 200.

²⁸⁴ Cf A T Craswell, ‘The Association Between Qualified Opinions and Auditor Switches’ (1988) *Accounting and Business Research* 23, which found that unqualified opinions were issued by the new auditor.

²⁸⁵ J Krishnan and R G Stephens, ‘Evidence on Opinion Shopping from Audit Opinion Conservatism’ (1995) 14(3) *Journal of Accounting and Public Policy* 179.

²⁸⁶ Above n 283.

²⁸⁷ Vivien Beattie and Stella Fearnley, ‘Audit Market Competition: Auditor Changes and the Impact of Tendering’ (1998) 30 *British Accounting Review* 261.

²⁸⁸ Above n 234.

²⁸⁹ K A Houghton and C A Jubb, ‘The Cost of Audit Qualifications: The Role of Non-Audit Services’ (1999) 8(2) *Journal of International Accounting, Auditing and Taxation* 215.

inflexibility of audit fees alone,²⁹⁰ NAS fees may also be employed in the recapture of these costs. Consistent with the constraints imposed on audit fees, they posit that increased NAS fees will be observable concurrently with the qualified opinion, but that the increase in audit fees will be subject to a lag.

8.89 The theories used to develop this hypothesis are based upon the idea that qualified opinions are associated with higher audit risk. Quoting Dopuch, Holthausen and Leftwich,²⁹¹ and, amongst others, Simunic and Stein,²⁹² Houghton and Jubb²⁹³ link this higher risk to uncertainty often being associated with auditees likely to receive qualified opinions, and increased litigation risk for the auditors of these clients.²⁹⁴ The argument that qualified opinions attract higher fees, then, stems from the idea²⁹⁵ that auditors who take on high-risk clients will require compensation for assuming the additional risk. Further, they note that a qualified opinion will usually require more hours to complete the audit, and that audit fees are likely to reflect hours used.

8.90 The authors investigated the annual reports of 270 companies for the years 1987 and 1988. After controlling for factors such as size and complexity, their findings suggest a significant positive relationship between qualified opinions and increased fees (both audit and NAS) in the year of the opinion and the following year. However, the 270 companies in the sample were dominated by mining companies in the limited area of Western Australia, which could impact the ability to generalise the results.

8.91 On the whole, the results of the opinion shopping papers highlight the concerns raised by opinion shopping by auditees, but also mitigate them to some extent. Although auditor 'switching' has been documented to occur following qualification,²⁹⁶ the literature, as discussed above, demonstrates a number of possible explanations for this phenomenon.

WHAT FACTORS CAN ENHANCE INDEPENDENCE?

8.92 Section 4 identified several threats to auditor independence. This section identifies several mechanisms that have been documented to have a positive effect on auditor independence. They include:

- (a) moral or ethical factors;
- (b) reputation of the auditor; and

²⁹⁰ The authors assert that two factors that may lead to inflexibility in audit fees are audit fee tendering and fixed audit fee billing: *ibid* 216.

²⁹¹ N Dopuch, R W Holthausen & R W Leftwich, 'Predicting Audit Qualifications with Financial and Market Variables' (1987) 52(3) *Accounting Review* 431.

²⁹² Dan Simunic and M T Stein, 'The Impact of Litigation Risk on Audit Pricing: A Review of the Economics and the Evidence' (1996) 15 (Supplement) *Auditing: A Journal of Theory and Practice* 119.

²⁹³ Above n 289.

²⁹⁴ The authors note that financial distress increases chances for errors, motivation for management manipulation, auditor/client dispute, the probability of non-routine management changes and lags in the timeliness of filing auditor change announcements: above n 289, 217.

²⁹⁵ Simunic and Stein, above n 292.

²⁹⁶ See eg Jeter and Shaw, above n 283.

(c) legal liability.

Moral or ethical factors

8.93 The following passage from the April 1933 Hearings (US Congress, Senate Committee on Banking and Currency, 58) is widely quoted with respect to the public accountant requiring some overseeing ethical dimension:

Senator Barkley: You audit the controller?
Mr Carter: Yes, the public accountant audits the controller's account.
Senator Barkley: Who audits you?
Mr Carter: Our conscience.

8.94 Some theorists argue, contrary to classical economic theory, that economic rationality or self-interest may be tempered by a broader social purpose. Hausman and McPherson²⁹⁷ note that 'the morality of economic agents influences their behavior and hence influences economic outcomes.' In a recent study by Barry Cushing, a new approach was taken by incorporating a moral cost into the utility function of the auditor.²⁹⁸ Maury emphasises that the 'ethical decisions that accountants make about their independence and objectivity need to be more than just compliance decisions, they need to be based on a very strong sense of public integrity'.²⁹⁹ Some studies have found that the degree of ethical behaviour demonstrated by an auditor is significantly related to the culture of the audit firm.³⁰⁰

8.95 An experimental study presented by Falk, Lynn, Mestelman and Shehata³⁰¹ attempted to extend the current literature by assessing the prior beliefs and expectations of the auditor as a part of a laboratory experiment on independence. They concluded that 'amoral, self-interested profit maximizing behavior does not generally characterize the subjects in this experiment.' Such results suggest that an auditor's ethics or conscience may override profit maximisation motives in certain circumstances. However, using an ethical decision process model they outlined, Lampe and Finn³⁰² concluded that the Code of Conduct developed by the American Institute of Certified Public Accountants (AICPA) was generally inadequate to stimulate ethical behaviour. This conclusion was drawn from a comparison of their decision process model for auditors and the AICPA Code decision model.

²⁹⁷ D M Hausman and M S McPherson, 'Taking Economics Seriously: Economics and Contemporary Moral Philosophy' (1993) 31(2) *Journal of Economic Literature* 671.

²⁹⁸ See, eg, Barry Cushing, 'Economic Analysis of Accountants' Ethical Standards: The Case of Audit Opinion Shopping' (1999) 18 *Journal of Accounting and Public Policy* 339.

²⁹⁹ Mary Maury, 'A Circle of Influence: Are all the Stakeholders Included?' (2000) 23(1) *Journal of Business Ethics* 117.

³⁰⁰ See, eg, L A Poneman and A Glazer, 'Accounting Education and Ethical Development: The Influence of Liberal Learning on Students and Alumni in Accounting Practice' (1990) 5(2) *Issues in Accounting Education* 195.

³⁰¹ Haim Falk, Bernadette Lynn, Stuart Mestelman, and Mohamed Shehata, 'Auditor Independence, Self-Interested Behavior and Ethics: Some Experimental Evidence' (1999) 18(4/5) *Journal of Accounting and Public Policy* 395.

³⁰² J C Lampe and D W Finn, 'A Model of Auditors' Ethical Decision Processes' (1992) 11(Supplement) *Auditing: A Journal of Practice and Theory* 33.

Reputation

8.96 The role of reputation as a deterrent to compromising independence has been widely acknowledged. DeAngelo, for example, notes that even where the incentive to ‘cheat’ exists, if costs such as those to the reputation of the auditor outweigh the benefits of misrepresentation, ‘cheating’ will not occur.³⁰³ This discouragement derives from the notion that the value of an audit hinges on the reputation or ‘brand name’ of the audit firm³⁰⁴ as well as the individual auditor. Were this to be impaired, the value of the audit would suffer. As outlined in section three, if the market does not believe the auditor has some incentive to tell the truth, market participants will consider the audit meaningless.

8.97 Mayhew, Schatzberg and Sevcik³⁰⁵ used an experimental design to study the role of reputation in conjunction with the level of certainty regarding the appropriate accounting treatment. They found that reputation did provide an incentive to maintain independence, but only where the accounting market was certain. That is, where GAAP was unambiguous as to the proper accounting treatment. Where uncertainty existed, inferences drawn by the markets were noisy, weakening the role of reputation as a deterrent and providing incentives to compromise independence.

8.98 Mayhew, Schatzberg and Sevcik highlight that there may be a role for reputation to enhance independence, but this role may not provide a perfect set of incentives.³⁰⁶ Coffee³⁰⁷ notes the danger that where a firm with a well established reputation might be deterred, this disincentive does not necessarily extend to all of the individuals within the firm. Further, Flint³⁰⁸ notes that this conflict extends to auditors taking a ‘free ride’ on the reputation of the profession as a whole, but notes that all auditors have a collective interest in preserving the reputation of auditing if the utility of the profession is to continue.

8.99 A further concern is that although theorists may emphasise the deterrent aspect of reputation, the profession may not embrace the concept entirely for the same purpose of ensuring independence. Coffee notes that although ‘academia still largely views the gatekeeper as a reputational intermediary, the industry increasingly perceives the paradigmatic gatekeeper (the auditor) as a portal for entry into the client.’³⁰⁹

Legal liability

8.100 The threat of legal liability for the auditor can provide a strong disincentive to misbehaviour. Although legal liability has been analysed from many perspectives,³¹⁰ of interest here is the

³⁰³ Above n 119, 34.

³⁰⁴ Miller, above n 128, 76.

³⁰⁵ Brian Mayhew, Jeffrey Schatzberg and Galen Sevcik, ‘The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Independence’ (Working Paper, University of Wisconsin at Madison, 2000).

³⁰⁶ *Ibid.*

³⁰⁷ Above n 124, 11.

³⁰⁸ Above n 95, 62.

³⁰⁹ John Coffee, Jr. ‘The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting,’ (Working Paper, Columbia Law School, 2001) 57.

³¹⁰ See, eg, factors leading to litigation in K E St Pierre and J Anderson, ‘An Analysis of the Factors Associated with Lawsuits Against Public Accountants’ (1984) *Accounting Review* 242; and the relationship between audit firms,

influence and effect of liability on audit firms. Davis and Simon,³¹¹ for example, found that where litigation is disclosed, a loss of reputation resulting in a reduction of new client fees ensues. A 1984 study found that breaches of independence have not been a major cause of litigation against auditors.³¹² The level of legal risk auditors are exposed to, however, has been criticised as having exploded,³¹³ which is not without its social cost.³¹⁴

8.101 Acemoglu and Gietzmann³¹⁵ develop an analytical model to investigate the role of legal liability as a commitment mechanism for auditors. They conclude that if legal liability is set either too high or too low, the audit market will collapse. Where liability is too low, the value of the audit evaporates as the credibility of auditor independence is reduced. If liability is too high, the cost of an audit will increase to an insupportable level as auditors incorporate the cost of insurance into their fees.

8.102 Most of the research suggests there is a role for legal liability in encouraging auditor independence, but that imposing too high a level will either cause the audit market to collapse or impose excessive costs. The difficulty in assessing what is the appropriate level of legal liability implies that litigation needs to be supported by other incentive mechanisms to maintain auditor independence.

Other factors

8.103 Many other factors and initiatives have been investigated in relation to their impact on auditor independence. The size of the audit firm, for example, is considered to affect auditor incentives. As size increases, the importance of each client, and therefore auditor dependence, decreases. Research indicates that perceptions of auditor independence increase with the size of the audit firm.³¹⁶ In addition, even where fee dependence exists, Craswell, Laughton and Stokes³¹⁷ provide evidence that this does not impact the propensity of an auditor to issue a qualified opinion.

business failures and fraud in Z Palmrose, 'Litigation and Independent Ausitors: The Role of Business Failures and Management Fraud' (1987) *Auditing: A Journal of Practice and Theory* 90.

³¹¹ L R Davis and D T Simon, 'The Impact of SEC Disciplinary Actions on Audit Fees' (1992) 11(1) *Auditing: A Journal of Practice and Theory* 58.

³¹² K E St Pierre, 'Independence and Auditor Sanctions' (1984) 7(3) *Journal of Accounting, Auditing and Finance* 257, found that only 7 out of 334 actions against auditors included compromised independence as a cause.

³¹³ R Mednick and JJ Peck, 'Proportionality: A Much Needed Solution to the Accountants' Legal Liability Crisis' (1994) 23(3) *Valparaiso University Law Review* 867.

³¹⁴ J W Hill, M B Metzger and J G Werment, 'The Spectre of Disproportionate Auditor Liability in the Savings and Loan Crisis' (1994) 5(2) *Critical Perspectives on Accounting* 133.

³¹⁵ Daron Acemoglu and Miles Gietzmann, 'Auditor Independence, Incomplete Contracts and the Role of Legal Liability' (1997) 6(3) *European Accounting Review* 355.

³¹⁶ See, eg, Knapp, above n 266.

³¹⁷ Allen Craswell, Janet Laughton and Donald Stokes, 'Auditor Independence and Fee Dependence' (Working Paper, University of Sydney, 2000).

8.104 Other systems, such as second partner review, are argued to improve independence. Tucker and Matsumera³¹⁸ developed and tested a model of second partner review. The authors found that in general these reviews reduced bias and improved independence, but that this could be compromised by the effect of incentive schemes. Incentives were incorporated into the model as economic pressures to bias judgments. Auditors may also be compulsorily rotated, but this imposes costs.³¹⁹ These costs may include lower audit quality from lessened client expertise and the financial costs of the new partner gaining client familiarity.³²⁰

8.105 Establishing audit committees is argued to reinforce independence. To be effective, these committees should have powers including making recommendations regarding the external auditor; scope of the external audit and appropriate fee review; liaising with internal auditors, including making recommendations necessary to enhance internal control; reviewing financial statements, reports, external auditor communications and accounting policy selection; and oversight of special investigations.³²¹

WHAT ARE THE ALTERNATIVE APPROACHES?

8.106 It is evident from the discussion above that although the importance of auditor independence is clear, ‘the incentives...are not always adequate to the task.’³²² This raises substantial concern, because as ‘the independence of the gatekeeper is thus eroded, externalities are likely to follow: the cost of capital may rise slightly, market efficiency should suffer, and corporate governance will be increasingly distorted by inaccurate informational inputs.’³²³ Auditor independence in its purest form, however, is a theoretical construct.

‘Audit independence requires not only freedom of investigation and freedom in reporting, but also the absolute independence of the auditor in the sense of absence of previous or present involvement in the subject of audit, absence of interest in the outcome or its consequences, and absence of bias or susceptibility to influence by considerations extraneous to the matter at issue.... Absolute independence is, however, a theoretical concept. It is an ideal to be strived for; but the actuality is compromise. Auditors cannot be made completely socially aseptic...’³²⁴

8.107 This leads to the issues of what level of auditor independence should be required, and how it should be achieved. There are many perspectives, ranging from strict regulation to a ‘laissez faire’ approach, using market forces as a control mechanism. Further, there is an issue of whose

³¹⁸ E M Matsumera and R R Tucker, ‘Second Partner Review: An Analytical Model’ (1995) *Journal of Accounting, Auditing and Finance* 173; R R Tucker and E M Matsumera, ‘Second Partner Review: An Experimental Economics Investigation’ (1997) 16(1) *Auditing: A Journal of Practice and Theory* 79.

³¹⁹ Vincent O’Reilly, Patrick McDonnell, Barry Winograd, James Gerson and Henry Jaenicke, *Montgomery’s Auditing* (12th ed, 1998), 3.42.

³²⁰ Carey and Simnett, above n 269.

³²¹ *Ibid.*

³²² Coffee, above n 124.

³²³ *Ibid.*

³²⁴ David Flint, ‘Social and ethical issues in auditing’ in A Hopworth, M Bromwich and J Shaw (eds), *Auditing Research: Issues and Opportunities* (1982).

perspectives need to be accounted for in determining the appropriate solution. Maury³²⁵ argues that the perspectives of all stakeholders, including ‘investors, suppliers, creditors, employees, customers, professional organizations, and government authorities’ should be considered. ‘It would be hoped that the highest ethical standards will be identified and practiced to meet the needs of decision makers and all stakeholders to move the accounting profession into the next millennium as the repository of consumer trust.’³²⁶ Others argue that the auditor is simply the agent of the owners.

8.108 Complete prohibition of NAS provision is argued to negatively impact competition and quality, and may suffer from enforcement difficulties.³²⁷ Under strict regulation, audit firms may split different functions into separate, but centrally controlled, entities to thwart the prohibition. Arrunada argues that market forces should be combined with an enhanced incentive system for self-regulation. The goal of these structures should be ‘to allow audit firms, self-regulatory bodies and audit clients to discover through competitive market interaction both the efficient mix of services and the corresponding quality safeguards, adjusting for the costs and benefits of each possibility.’³²⁸ Rules should only be used to encourage competition and to improve market incentives. He contends that ‘regulators... lack both the required knowledge and the right incentives to define the efficient framework.’ Regulators are neither clients nor producers, and may be swayed by external interest groups to legislate a sub-optimal solution to the auditor independence problem.³²⁹ The author concludes that regulation aimed at causing auditors to maintain a diversified client base such that the correct incentives are stimulated could aid the pursuit of auditor independence.

8.109 Levine and Kornish³³⁰ also emphasise the costs of prohibitive regulation. They note that strict restrictions may destroy production efficiencies, and may even cause a talent deficiency in the human capital attracted by audit firms. The authors argue that a less regulated approach can achieve the desired level of independence, and at less cost. They provide a ‘starfish’ analogy to illustrate the problems faced by restrictions. When the leg of a professional service firm is severed, another grows back in its place. This implies that where one type of service provision, such as MAS, is restricted, it will be replaced with another, such as global risk management.

8.110 Self-regulation is often supported on a cost-benefit basis. It is offered by some proponents as a solution of itself, and by others as a supplement to other mechanisms such as legal liability and regulation. Self-regulation exploits the inherent incentives of competitors to monitor each other. Some studies on the ethical dimension of auditing would suggest that Codes of Conduct would provide a sufficient bond to auditor independence.³³¹ However, sometimes these incentives are overborne by the incentive to collude.³³² Therefore, some authors conclude that regulation is a necessary cost.

³²⁵ Above n 299.

³²⁶ *Ibid.*

³²⁷ Arrunada, above n 150, 12.

³²⁸ *Ibid* 13.

³²⁹ *Ibid.*

³³⁰ Above n 128.

³³¹ See, eg, Lamp and Finn, above, n 302.

³³² Coffee, above n 124, 59.

8.111 The findings of DeFond, Wong and Li³³³ in a Chinese context suggest that regulation alone is ‘insufficient to create financial markets that foster independence.’³³⁴ It is important that all of the incentive structures for ensuring auditor independence are given due consideration. There are important roles for systems such as extra reviews, audit committees and legal liability. An environment conducive to the ethical standards underpinning independence needs to be fostered at the educational and firm levels. In summary, because of the incentives that exist to compromise independence, a range of structures, be they imposed through self or mandatory regulation, are needed to maintain the standard of independence required to preserve the integrity of the financial markets.

³³³ Mark DeFond, T J Wong and Shuhua Li, ‘The impact of improved auditor independence on audit market concentration in China’ (2000) 28(3) *Journal of Accounting & Economics* 269.

³³⁴ *Ibid.*

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APPENDIX A

STAKEHOLDERS CONSULTED DURING REVIEW

Andersen

Auditing and Assurance Standards Board of the Australian Accounting Research Foundation

Australian Institute of Company Directors

Australian Securities and Investments Commission

Australian Shareholders' Association

Australian Stock Exchange

Companies Auditors and Liquidators Disciplinary Board

CPA Australia

Deloitte Touche Tohmatsu

Ernst and Young

The Institute of Chartered Accountants in Australia

Institute of Internal Auditors - Australia

Investment and Financial Services Association

Joint Committee of Public Accounts and Audit [of the Commonwealth Parliament]

KPMG

Law Council of Australia

PricewaterhouseCoopers

Securities Institute of Australia

APPENDIX B

WRITTEN SUBMISSIONS

Alfredson, Keith

Andersen, Deloitte Touche Tohmatsu, Ernst and Young, KPMG, and PricewaterhouseCoopers
(joint submission)

Auditor-General of Queensland

Australasian Council of Auditors-General

Australian Stock Exchange

Companies Auditors and Liquidators Disciplinary Board

Fowler, John

Murray, Senator Andrew

The Institute of Chartered Accountants in Australia

Smith, Kimberly

Turnbull, Shann

Walter, Don

Wolnizer, Peter, Graeme Dean and Frank Clarke (joint submission)

APPENDIX C

RECOMMENDATIONS OF THE AUDIT REVIEW WORKING PARTY DEALING WITH REQUIREMENTS FOR THE REGISTRATION AND REGULATION OF COMPANY AUDITORS

List of recommendations

No.	Recommendation	Comments
4.1	The <i>Australian Securities Commission Act 1989</i> (the ASC Act) and the Law should be amended to authorise the ASC to delegate responsibility for the registration and supervision of company auditors to one or more Australian accounting bodies that satisfy specified conditions.	
4.2	The conditions set out in the Law would provide that the ASC must be satisfied that each authorised accounting body has and will continue to maintain: <ul style="list-style-type: none"> (a) sufficient resources to enable the delegated functions to be performed in an efficient and effective manner; (b) a comprehensive and mandatory code of ethics and other rules dealing with the conduct of members who provide auditing services; (c) mandatory requirements for the continuing professional development of its members and for professional indemnity insurance for those members in public practice; (d) a comprehensive program for the periodic review of the work of members who provide auditing services; (e) appropriate disciplinary procedures for dealing with complaints and other matters concerning members who provide auditing services; and (f) adequate indemnity insurance arrangements in respect of its performance of the delegated functions. 	
4.3	The Law should provide that a decision of an authorised accounting body made during the course of performing a delegated function may be the subject of an appeal to the ASC. The decision taken by the ASC may, in turn, be the subject of an appeal to the AAT.	
4.4	The Law should provide that the ASC may set such additional conditions in a Memorandum of Understanding (MOU) as it considers are necessary to enable it to ensure that the delegated functions are performed in accordance with the requirements of the Law and in an effective and efficient manner.	
4.5	The Law should provide that the ASC may only delegate responsibility for the registration and supervision of company auditors to an accounting body when written agreement has been reached with that body on the conditions set down in the Law and any additional conditions that may be imposed by the ASC.	
4.6	The Law should provide that, where an authorised accounting body fails to comply with any of the conditions set out in either the Law or the MOU, the ASC may revoke the delegation.	

4.7	The Law should provide that, notwithstanding the delegation of registration and supervisory functions to one or more authorised accounting bodies, the ASC may continue to perform registration and supervisory functions in circumstances in which it would be unreasonable to expect a person to apply to an authorised accounting body for registration (for example, where the person has a conscientious objection, based on religious grounds, to the membership of a professional organisation). The registration of such a person should be subject to rules and conditions that are adopted by the ASC and which are equivalent to those imposed by an authorised accounting body.	
4.8	The Law should provide that particulars of all RCAs are to be entered in a single Register of Auditors which is to be maintained in a manner and at a place approved by the ASC.	
4.9	Subject to appropriate safeguards concerning the protection of information from unauthorised use or disclosure, section 127 of the ASC Act should be amended to allow the ASC to provide information to: (a) authorised accounting bodies concerning individuals who are members of one or more of the bodies; (b) authorised accounting bodies about non-members who are RCAs or who are known to be making application for registration as an RCA.	
5.1	The existing educational pre-requisites for registration as a company auditor (ie tertiary qualifications in accountancy and commercial law) are considered to be adequate, subject to the introduction of an additional requirement that all applicants have completed a specialist course equivalent to the auditing module currently provided by the ICAA's Professional Year (PY) Program or the ASCPA's Certified Practising Accountant (CPA) Program.	
5.2	Relief from the requirement to undertake the course of study referred to in recommendation 5.1 should be granted to an applicant who holds suitable overseas qualifications or who can demonstrate to the registering body that he or she has qualifications that are equivalent to the auditing module.	
5.3	Where a person who is not a member of an accounting body that is an authorised accounting body seeks registration as a company auditor, he or she must agree to abide by the code of ethics and other rules of the authorised accounting body to which they submitted their application on the same basis as members of that body.	
5.4	Where an authorised accounting body has in place a competency standard in auditing that has been approved by the ASC, an applicant must satisfy the audit component of the competency standard in order to be registered.	
5.5	The ASC must be satisfied about the appropriateness and workability of the audit component of an authorised accounting body's competency standard before that standard may be approved for use by the authorised accounting body as a basis for deciding whether an applicant meets the practical experience requirements for registration as a company auditor.	
5.6	Where an authorised accounting body does not have an approved competency standard in auditing the level of practical experience required for registration as a company auditor should be:	

	<p>(a) at least 2,000 hours work in auditing over five years under the supervision of an RCA; and</p> <p>(b) a minimum of 500 hours of this time should be spent on work that involves a senior level of responsibility for audits.</p>	
5.7	Subsection 324(12) of the Law, which provides that the ASC may appoint a suitably qualified or experienced person as auditor of a proprietary company where it is impractical for the company to obtain the services of an RCA because of the location where it carries on business, should be retained.	
5.8	There should be simplified criteria for re-registration as a company auditor where the applicant had voluntarily relinquished his or her original registration.	
5.9	<p>An applicant for re-registration as a company auditor must meet the following conditions:</p> <p>(a) the applicant voluntarily relinquished his or her original registration;</p> <p>(b) the applicant was not subject to disciplinary proceedings in respect of an auditing-related matter following the relinquishment of the original registration or that the voluntary relinquishment did not occur in order to avoid disciplinary proceedings; and</p> <p>(c) the relinquishment of the original registration was not more than five years before the date of the application for re-registration.</p>	
6.1	The existing triennial statement should be replaced by a new annual statement.	
6.2	<p>The new annual statement should provide information about:</p> <p>(a) an RCA's personal particulars;</p> <p>(b) details of the nature and complexity of major audit work undertaken, including the aggregate hours, showing separately the work in respect of companies and other entities; and</p> <p>(c) professional development undertaken by the RCA during the year.</p>	
6.3	If the registration and supervision of RCAs is undertaken by authorised accounting bodies, the annual statement should be combined with the authorised accounting bodies' membership renewal forms.	
6.4	RCAs should be required to undertake a minimum amount of professional development, calculated on either an annual or triennial basis, and their annual statement should include particulars about the audit content of that professional development.	
6.5	Failure to comply with a requirement to undertake a minimum amount of profession development should be grounds for disciplinary action against the RCA.	
6.6	RCAs should not be required to undertake a specified level of audit work in any one year, but should be required to maintain their competence in audit work. Where an RCA has not undertaken any substantive audit work during a period of not less than five years or has failed to maintain competency in audit work, the supervisory body may require the RCA to show cause why his or her registration should not be cancelled.	

6.7	The work of all RCAs should be subject to periodic quality reviews conducted by authorised accounting bodies.	
6.8	Subject to privacy considerations, the Law should provide that all files in respect of audits that have been undertaken by an RCA must be available for inspection as part of a quality review.	
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.	
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.	
7.3	Auditors of an unlisted company should be appointed on the recommendation of the company's audit committee where such a committee exists.	
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.	
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.	
7.6	The monetary indebtedness prohibition should only apply to partners of a firm of auditors who are directly engaged on the audit assignment and relatives of such partners.	
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 Statement of Auditing Practice AUP 32 — Audit Independence (AUP 32).	
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 internal control reviews to strengthen independence in these areas.	
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.	
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.	
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.	
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.	
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, matters should be referred to either the accounting bodies or the CALDB or both for appropriate disciplinary action.	
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.	
7.15	The Law should provide that any proposal for appointment of auditors of a disclosing entity must contain information on the proposed fees.	
7.16	The Law should be amended to require an auditor, or a representative of the auditor, to attend the annual general meeting (AGM) at which the auditor's report is tabled unless reasonable circumstances preclude his or her attendance.	
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.	
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.	
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.	
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.	
8.1	The CALDB should be retained for dealing with those disciplinary matters that the Law provides should be brought before an independent disciplinary body.	

8.2	Where the ASC has delegated the registration of auditors to authorised accounting bodies, those bodies should be permitted to bring conduct matters directly before the CALDB.	
8.3	The ASC Act should be amended to provide for the appointment of a deputy chairperson for the CALDB.	
8.4	The ASC Act should be amended to allow the CALDB to sit in more than one Division simultaneously.	
8.5	The ASC Act should be amended to provide that a Division of the CALDB is constituted by a member nominated by an authorised accounting body, a legal practitioner and one other person.	
8.6	The requirement that the chairperson of the CALDB be a legal practitioner should be repealed.	
8.7	The ASC Act should be amended to provide that the membership of the CALDB is to be constituted as follows: (a) each authorised accounting body is to submit a panel of four names, with one person being appointed from each panel of names; (b) two persons selected from a panel of five names submitted by the Law Council of Australia; and (c) two persons selected from panels of names submitted by business and professional organisations that are invited by the Minister to make nominations.	
8.8	Disciplinary matters of an administrative nature (as defined in paragraph 851) are to be dealt with by the registering body.	
8.9	Where the registration function has been delegated to an authorised accounting body, guidelines approved by the ASC should cover such matters as: (a) The procedures for giving notice of the authorised accounting body's intention to deal with a matter; (b) allowing the RCA who is the subject of the action to be heard; and (c) the publication of the authorised accounting body's decision	
8.10	Where the registration function has been delegated to an authorised accounting body, a person whose registration is cancelled by the registering body may lodge an appeal against that body's decision with the ASC.	
8.11	A decision made by the ASC in respect of an administrative matter may be the subject of an appeal to the AAT.	
8.12	The CALDB should only deal with cases involving conduct matters or combined conduct and administrative matters.	
8.13	Where the ASC has delegated the registration function to authorised accounting bodies, those bodies may, subject to the approval of the Commission, deal with specified types of conduct matter within their own disciplinary systems.	
8.14	Where civil or criminal proceedings have been commenced against a person, such proceedings are not to act as a bar to disciplinary proceedings against the same person and arising out of the same matter being	

	commenced or continued by an authorised accounting body, the ASC or the CALDB.	
8.15	The CALDB should be permitted to impose fines up to a limit of \$100,000. Consideration should also be given to amending the Law to enable the CALDB to enforce orders made during the pre-hearing period.	
8.16	The nature of the matter, the decision in respect of each disciplinary proceeding and the reasons for the decision should be published.	
8.17	The CALDB should be permitted to provide information obtained by it during the course of a disciplinary proceeding to the investigation and disciplinary committees of the authorised accounting bodies to facilitate the disciplinary procedures of those bodies.	
9.1	Paragraphs 324(1)(f) and (2)(g) of the Law should be amended to remove the exemptions which currently permit proprietary companies to appoint as their auditors persons who are officers of the company or persons who are related to officers of the company.	
—	Consideration should be given to amending the Law to make it clear that an Auditor-General may, subject to any constraints contained in the Commonwealth, State or Territory legislation establishing his or her office, delegate to a person nominated by him or her responsibility for signing an auditor's report or an audit review prepared under Part 3.7 of the Law.	

APPENDIX D

AUDIT COMMITTEES - RECOMMENDATIONS

1 OBLIGATION TO HAVE A QUALIFIED AUDIT COMMITTEE

A listed company must have a qualified audit committee.

2 OBLIGATION TO HAVE A WRITTEN CHARTER FOR THE AUDIT COMMITTEE

The Board of Directors of a listed company must adopt a written charter to govern the audit committee. The charter must be available to shareholders of the company upon request and the key features of the charter outlined in the Annual Report.

2.1 Specification of scope of audit committee responsibilities

This formal charter must identify and explain the scope of the audit committee's responsibilities and duties. The charter must stipulate matters including:

- the structure of the audit committee;
- the requirements for membership of the audit committee;
- the nature and scope of the audit committee's duties; and
- the processes to be used by the audit committee in discharging its duties.

2.2 Specification of the relationship with the external auditor

The charter must specify that the final responsibility for nominating the external auditor to be proposed for shareholder approval and for evaluating the external auditor will lie with the audit committee and the Board of Directors. It must further outline that the external auditor is ultimately responsible to the audit committee and the Board of Directors, as representatives of the shareholders.

The audit committee is to make recommendations to the Board of Directors on the appointment, remuneration and replacement of the external auditor. If the Board of Directors disagrees with any of those recommendations, it must disclose its decision and reasons in the Annual Report.

2.3 Specification of communications with the external auditor regarding relationships

The charter must stipulate that the audit committee is responsible for ensuring that the external auditor makes required disclosures to the audit committee in a timely fashion and at least annually. These disclosures include a formal written statement covering matters including:

- an account of all relationships between the external auditor and the company; and
- confirmation by the auditor that it is, in its professional judgment, independent of the company.

In addition, the audit committee must engage in active discussions with the external auditor in relation to these disclosed relationships, and their potential impact on auditor independence. The

audit committee is also responsible for recommending that the Board of Directors take any appropriate action, arising as a result of the disclosures by the external auditor, required to satisfy itself of the external auditor's independence.

2.4 Obligation to review adequacy of the written charter

The written charter must specify that the audit committee must review and reassess the adequacy of the formal written charter at least annually.

3 COMPOSITION OF A QUALIFIED AUDIT COMMITTEE

3.1 Independence

The audit committee of a listed company, where market capitalisation of that company exceeds a specified threshold, must consist of at least three directors, and all of the members of the audit committee must meet the relevant definition of 'independent' set out below.

The chairperson of the Board of Directors should not be the chairperson of the audit committee

Listed companies with small capitalisation

A distinction in audit committee independence requirements between small capitalisation and large capitalisation companies exists in the listing rules of major United States stock exchanges. The distinction recognises that requirements for independent directors can be costly and that this cost may be higher for small capitalisation companies than for large capitalisation companies.

A threshold for market capitalisation will be established through negotiations between the Minister and Australian Stock Exchange Limited (ASX). These negotiations will further determine an objective and appropriate mechanism and timing rules for determining when a company crosses this threshold and becomes subject to the larger capitalisation requirements, or vice versa.

Where the market capitalisation of the listed company is below the specified threshold, the audit committee must contain at least one director meeting the independence criteria, instead of all directors of the audit committee being required to meet the independence criteria.

Definition of independent

An audit committee member will only be independent if he or she has no relationship with the company that may interfere with the exercise of independent judgment. The Investment and Financial Services Association (IFSA) has provided a definition of what constitutes an independent director in its Guidance Note No 2.00, *Corporate Governance: A Guide for Investment Managers and Corporations* (1999) as has the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors – Australia, in their publication *Audit Committees: Best Practice Guide* (2nd edition, 2001). The following is a modified version of the IFSA and *Audit Committees: Best Practice Guide* definitions which would be appropriate to apply to audit committee membership:

An independent director is a director who is not a member of management (a non-executive director and who:

- is not a substantial shareholder of the company or an officer of or otherwise associated directly or indirectly with a substantial shareholder of the company;

- has not within the last three years been employed in an executive capacity by the company or a related entity or been a director after ceasing to hold any such employment;
- is not a member of the immediate family of a person who, within the last three years, has been employed in an executive capacity by the company or a related entity or been a director after ceasing to hold any such employment;
- is not a principal of, or consultant to, a professional adviser to the company or a related entity where that professional adviser has provided significant services to the company or a related entity;
- is not a significant supplier or customer of the company or a related entity or an officer of or otherwise associated directly or indirectly with a significant supplier or customer;
- has no significant contractual relationship with the company or a related entity other than as a director of the company;
- is not employed in an executive capacity by another company where any of executives of the company the individual is a director of, are on the other company's remuneration committee; and
- is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.

Definition of immediate family

Immediate family in relation to an individual means a spouse (or equivalent) or dependent.

Definition of related entity

Where a company:

- (a) is controlled by another entity; or
- (b) controls another entity;

the entity is a related entity of the company.

Definition of control

Control has the meaning contained in section 50AA of the Corporations Act.

3.2 Financial literacy

Financial literacy is an important component of the general standards of care, skill and diligence required of company directors. Courts have imposed an objective standard of skill for all company directors in relation to financial literacy as outlined by Ford, Austin and Ramsay:

'[A] director is obliged to inform himself or herself as to the financial affairs of the company to the extent necessary to form each year the opinion of solvency required for the directors statement under s 295(4), and they cannot avoid liability by claiming that they had never learned to read financial statements: *Statewide Tobacco Services v Morley* (1990) 2 ACSR 405; 8 ACLC 827 affirmed [1993] 1 VR 423; (1992) 8 ACSR 305; 10 ACLC 1233; *Commonwealth Bank of Australia v Friedrich* [(1991) 5 ACSR 115; 9 ACLC 946]...at ACSR 125; at ACLC 955.

Thus it appears that Australian company directors are subject to an objective standard of skill, admittedly minimal, with respect to the financial statements and financial affairs of their companies.³³⁵

Each member of the audit committee should be financially literate, or made financially literate within a reasonable period of time of appointment. The Board of Directors in its business judgment will determine financial literacy. In making this determination, the Board of Directors will consider that financial literacy includes the ability to read and understand fundamental financial statements including a balance sheet, a profit and loss statement and a cash flow statement.

It is appropriate that members of the audit committee have a range of different backgrounds, skills and experiences. However, financial literacy is an essential skill for audit committee members.

3.3 Accounting expertise

At least one member of the audit committee must have accounting and/or related financial expertise. The Board of Directors in its business judgment will determine accounting and/or related financial expertise. Accounting and/or related financial expertise includes past employment, professional certification or other comparable experience or background.

4 GENERAL REQUIREMENTS

4.1 Meetings

The audit committee should have a regular schedule of meetings with pre-arranged dates. Additional unscheduled meetings from time to time may supplement these meetings, as matters require. The audit committee should put in place a process for arranging these supplementary meetings. In addition, the audit committee should ensure that an agenda for each meeting is prepared.

Structure and agenda for meetings

Meetings of the audit committee should be structured and follow a predetermined agenda. Contributions to this agenda should be sought from both the internal and the external auditors. The chair of the audit committee should review this agenda prior to issuance, and the agenda, along with briefing papers, should be circulated in a timely fashion prior to the meeting.

Attendance at meetings

As far as is reasonable, meetings should be scheduled so that all committee members can attend. Ample time for discussion should be allowed. The audit committee should establish a quorum for meetings, and ensure that this quorum has been met prior to commencing the meeting. In addition to audit committee members, the following persons may attend meetings as provided:

- internal and external auditors, except where a conflict of interest may be perceived; and
- management, only on express invitation by the audit committee requiring their presence.

³³⁵ H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (10th ed, 2001), para [8.340].

Records of meetings

Minutes should be taken at all audit committee meetings, and these should be signed by the chair of the committee.

4.2 Systems of Reporting***Reporting to the Board of Directors***

Following each audit committee meeting, the chair should furnish a formal report at the next meeting of the Board of Directors. This report should cover issues including but not limited to:

- the minutes of the committee and any formal resolutions;
- information about the audit process including the results of internal and external audits;
- any determination by the audit committee relating to the independence of the external auditor;
- any other matters that in the opinion of the audit committee should be brought to the attention of the board, and any recommendations requiring board approval and/or action; and
- at least annually, a review of the formal written charter and its continuing adequacy, and an evaluation of the extent to which the committee has met the requirements of the charter;

Reporting in the external reports

Membership of the audit committee must be disclosed in the Annual Report. In addition, the Board of Directors must disclose whether or not the company complies with the ASX Guidance Note on audit committees, and if not, why not.

The audit committee must ensure there is disclosed in the Annual Report a statement regarding non-audit service (NAS) provision by the external auditor. In this statement, the audit committee must outline whether or not it believes the level of NAS provision by the external auditor is compatible with maintaining auditor independence, and should include reasons where appropriate.

Where the Board of Directors disagrees with a recommendation by the audit committee relating to the external auditor, it must disclose its decision and reasons in writing in the Annual Report.

The audit committee must include further information about its activities in the Annual Report, and, where appropriate, in any interim report. This information must include:

- a summary of the audit committee's main rights, responsibilities and duties;
- biographical details of audit committee members, including expertise, appointment, dates and terms of appointment;
- member and related party dealings with the company;
- details of meetings, including the number of meetings held during the relevant period, and the number of meetings attended by each member;
- details of any change to the independent status of each member during the relevant period, if applicable; and
- details of any determination by the audit committee regarding the external auditor's independence.

5 DUTIES AND RESPONSIBILITIES OF A QUALIFIED AUDIT COMMITTEE³³⁶

To the extent that the following functions exist, an audit committee should follow the guidance outlined below in relation to performing its duties and responsibilities.

5.1 External reporting

The audit committee should review and assess the external reporting of the company. In particular the audit committee should:

- Review and assess the appropriateness of the company's accounting policies and principles. Any significant changes to the company's policies and principles should also be reviewed and assessed by the audit committee. To ensure that the audit committee can carry out this duty effectively, management should inform the audit committee of:
 - Any changes in accounting policies or their application during the reporting period;
 - Whether the methods chosen by management are consistent with Accounting Standards, Accounting Concepts and Urgent Issues Group (UIG) Consensus views; and
 - The methods used to account for unusual transactions for which there may be no specific accounting standard, including management's reasoning in determining that method.
- Review and assess any significant estimates and judgments in financial reports. To ensure that the audit committee can carry out this duty effectively, management should inform the audit committee of:
 - The method and process used in making material estimates and judgments, including management's reasoning in determining that method.
- Upon receipt of information from management relating to accounting policy choice or method for making significant estimates and judgments, seek the opinion and views of both internal and external auditors in relation to that choice or method. This opinion should include the appropriateness, and not just the acceptability of that choice or method.
- Review and assess the processes used by management to monitor and ensure compliance with laws, regulations and other requirements relating to external reporting by the company of financial and non-financial information. These include, but are not limited to:
 - Australian Accounting Standards;
 - Corporations Act;
 - Listing Rules of ASX, including but not limited to:
 - : The existence of an appropriate procedure for meeting the company's continuous disclosure obligations;
 - : Reviewing for completeness and accuracy the disclosure of the company's main corporate governance practices; and
 - Where applicable, requirements of other countries.
- Review and assess information from internal and external auditors that may affect the quality of financial reports.

³³⁶ These principles have been developed from international reports, best practice guides and standards. Particular reliance has been placed upon the Blue Ribbon Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (1999); the New York Stock Exchange, *NYSE Listed Company Manual: 303.01 Audit Committee*; and the Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, the Australian Institute of Company Directors and the Institute of Internal Auditors - Australia, *Audit Committees: Best Practice Guide* (2nd edition, 2001).

- Review and assess documents and reports to regulators and make recommendations to the Board of Directors on their approval or amendment.
- Based on the assessment by the audit committee, recommend to the Board of Directors whether the financial and non-financial statements should be signed.
- Where management does not offer information required to make any of the reviews or assessments required under this section, ensure that the audit committee acquires that information from management.

5.2 Related party transactions

The audit committee should review and monitor related party transactions and assess their propriety.

5.3 Internal control and risk management

The audit committee should review and assess internal processes for determining, monitoring and assessing key risk areas. In particular, the audit committee should consider:

- non-compliance with laws, regulations, standards and best practice guidelines;
- important judgments and accounting estimates;
- litigation and claims;
- fraud and theft; and
- any other business risks that are not dealt with by a specific board committee.

In relation to these risk areas, the audit committee should ensure:

- that the company has an effective risk management system in place, including for macro risks, and that the committee assesses this system;
- that the company has an effective internal control system in place, and that the committee assesses this system;
- that the company has a system in place for unusual and/or high risk transactions and that the committee assesses this system;
- that the company has a clear policy and procedure for reporting, actioning and documenting breaches of laws, including fraud and theft;
- that it receives from management reports on all actual and suspected breaches of laws, including fraud and theft; and
- that it meets periodically with management, and external and internal auditors to discuss the company's control environment, including the processes for improvement in place.

5.4 External audit

The audit committee should review and assess key areas relating to the external audit of the company. In particular the audit committee should:

- make recommendations to the board on the appointment, reappointment or replacement, remuneration, monitoring of the effectiveness, and independence of the external auditor;
 - as outlined in section 4.2, if the Board of Directors disagrees with any of these recommendations, it must disclose its decision and reasons in the Annual Report;
- review and assess the independence of the external auditor, including but not limited to any relationships with the company or any other entity that may impair or appear to impair the external auditor's judgment or independence in respect of the company;

- review and assess any prospect of auditor replacement and/or tender suggested by management. Before any decision is made, the audit committee should report the results of its investigation to the Board of Directors and make recommendations;
 - where the decision for replacement or a new tender is made, this tender should then be conducted by the audit committee;
 - as outlined in section 4.2, if the Board of Directors disagrees with any of these recommendations, it must disclose its decision and reasons in the Annual Report;
- review and agree on the terms of engagement for the external auditor at the start of each audit;
- review the scope of the external audit with the external auditor including identified risk areas and any additional agreed-upon procedures;
- review and assess non-audit service (NAS) provision by the external auditor, with particular consideration given to the potential for the provision of these services to impair or appear to impair the external auditor's judgment or independence in respect of the company;
 - as outlined in section 4.2, the audit committee must disclose in the Annual Report whether or not it believes the level of NAS provision by the external auditor is compatible with maintaining auditor independence, and should include reasons where appropriate;
- review the external auditor's audit fee, and be satisfied that an effective, comprehensive and complete audit can be conducted for that fee;
 - in addition to reviewing the audit fee, the audit committee should review and assess total fees paid to the external auditor, considering in particular fees paid for NAS provision, and these fees as a proportion of total fees;
- review and monitor management's responsiveness to the external auditor's findings and recommendations;
- review with the external auditor any significant disagreements between the external auditor and management, irrespective of whether they have been resolved;
- review all representation letters signed by management, and be satisfied that the information provided is complete and appropriate;
- monitor the number of former employees of the external auditor currently employed in senior positions in the company and assess whether this impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether taken as a whole, the various relationships between the company and the external auditor impairs or appears to impair the auditor's judgment or independence in respect of the company;
- consider whether the compensation of the individuals employed by the external auditor who are performing the audit of the company is tied to the provision of non-audit services and, if so, consider whether this impairs or appears to impair the external auditor's judgment or independence in respect of the company;
- review the economic importance of the company (in terms of fees paid to the external auditor for the audit as well as fees paid to the external auditor for the provision of non-audit services) to the external auditor and assess whether the economic importance of the company to the external auditor impairs or appears to impair the external auditor's judgment or independence in respect of the company; and
- at least annually, meet with the external auditor without the presence of management.

5.5 Internal audit

The audit committee should review and assess key areas relating to the internal audit of the company. In particular the audit committee should:

- review the internal auditor's mission, charter and resources;

- communicate the audit committee's expectations to the internal auditor in writing;
- review and assess the scope of the internal audit and the internal auditor's audit plan and work program, as well as the systems in place to monitor and evaluate the effectiveness of the internal auditor;
- monitor and assess the progress of the internal audit and any implications that may arise for the control environment;
- review and monitor management's responsiveness to the internal auditor's findings and recommendations;
- oversee the co-ordination of the internal and external auditors;
- ensure that the internal auditor reports directly to the managing director and the audit committee; and
- at least annually, meet with the internal auditor without the presence of management.

APPENDIX E

PROFESSIONAL STATEMENT F1 - PROFESSIONAL INDEPENDENCE

Principles

1. Professional independence is a concept fundamental to the accounting profession requiring a member to observe integrity in and an objective approach to professional work.
2. In each professional assignment undertaken, a member in public practice must 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 reporting function but also applies to all other professional work. In determining whether a member in public practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should be whether a reasonable person, having knowledge of the relevant facts and taking into account the conduct of the member and the member's behaviour under the circumstances, could conclude that the member has placed himself or herself in a position where his or her objectivity would or could be impaired.
3. A member not in public practice has a duty to be objective in carrying out his or her professional work whether or not the appearance of professional independence is attainable. Thus a member performing professional work in commerce, industry or the public service must recognise the problems created by personal relationships or financial involvements which by reason of their nature or degree might threaten his or her objectivity.
4. This Statement is confined to the professional aspect of independence as distinct from any requirements which may be imposed by law.

Definitions

5. The following expressions, when used in this Statement, have the meanings assigned to them in this paragraph:
 - (a) "Company" includes the parent company and all subsidiaries of that parent.
 - (b) "Near relative" includes spouse or minor child or any other close relative, or person in loco parentis who is financially dependent upon the person in the practice or upon the spouse of that person.
 - (c) "Practice" is a firm or other organisation (incorporated or otherwise) which offers accountancy services to the public and "person in a practice" includes -
 - (i) a sole practitioner;
 - (ii) each partner or other principal in a practice;
 - (iii) any consultant or retired principal having a continuing relationship within a practice in that he or she is under an obligation to earn his or her consulting fee by rendering services to the practice when called upon to do so;
 - (iv) each employee engaged in the professional work of a practice;
 - (v) each sub-contractor to a practice in relation to work sub-contracted to him or her;
 - (vi) any person engaged in any of the above capacities with any related practice.

A practice is "related" to another practice if the practices have:

 - one or more principals in common, or
 - a continuing financial or commercial relationship or arrangement with each other which might impair the professional independence of the practice in relation to a client.
 - (d) "Report" or "reporting function" means an opinion on financial information by a person in a practice.
 - (e) References to beneficial ownership of or interest in shares include rights to acquire such ownership or interest.
6. It is not possible to give a definition of "material" which would cover all circumstances where materiality is referred to herein. In such circumstances regard will be had to the effect which an interest might have or be seen to have on the objectivity of a person in a practice.

Reporting

7. A member must present or report on information objectively. That duty is the essence of professionalism and is appropriate to all accountants in public practice, in commerce, in industry and in the public service.

8. No person in a practice shall personally take part in the exercise of the reporting function in respect of a client if, during the period in respect of which the report is to be made or at any time in the twelve months prior to the first day of the period in respect of which the report is to be made, the person or a near relative has been an officer (other than an auditor), partner or employee of the client or had any financial or commercial relationship with the client which might impair the person's professional independence.

Audits (see also the prohibition in paragraph 22(a)(ii) below)

9. Notwithstanding the absence of any legal prohibition on such an appointment, a practice must not act as auditor of a company if any person in the practice is an employee, director or other officer of that company.

Material Beneficial Interest in Audit Clients

10. A practice must not have as an audit client a company in which any person in the practice, or a near relative of any person in the practice, is the beneficial owner of shares forming a material part of the equity share capital of the company, or forming a material part of the assets of that person.
11. A material beneficial interest in an audit client may be involuntarily acquired, for example where a person in a practice inherits such shares or marries a shareholder or acquires shares as a result of a take-over or when a new employee engaged in professional work owns such shares when joining the practice. If the audit appointment is to be retained, immediate steps must be taken to reduce such beneficial interest to a level which is not material.

Material Beneficial Interest in Non-Audit Clients

12. Where a practice is asked to report on a company otherwise than as auditor, no person in the practice who has a material beneficial interest in, or is a near relative of a person who has a material beneficial interest in, the company shall personally take part in that assignment.
13. Paragraphs 10, 11 and 12 are not intended to prevent any person in a practice from having a material beneficial interest in a public unit trust or listed company which holds shares in a client company, provided that such unit trust or company is not an audit client of the practice nor has a material beneficial interest in the client company.

Independent Valuation

14. No person in a practice may provide valuation services to a reporting entity in respect of the assets and/or liabilities of that reporting entity, its subsidiaries or entities which it significantly influences if:
- (a) the valuation is to be referred to as an "independent" valuation in an audited financial report of that reporting entity; and
 - (b) any person in the practice is acting as an auditor or an officer of that reporting entity.

Trustee Shareholders in Audit Clients

15. A practice must not have a company as an audit client if any person in the practice, or a near relative of any person in the practice, is a trustee of a trust having a material interest in that company. Where the practice is asked to report other than as auditor, the person concerned must not personally take part in that assignment.

Corporate Trustee

16. Prohibitions similar to those set out in paragraph 15 apply where any person in a practice is a director or employee of a company which acts as trustee of a trust having a material interest in the client company.
Nominee Shareholdings
17. A material interest in an audit client company held by any person in a practice as nominee may not, in fact, be a threat to professional independence but may well impair the appearance of professional independence and, if the audit appointment is to be retained, immediate steps must be taken to procure the appointment of a nominee unconnected with the practice.

Loans to or from Clients

18. No person in a practice, or near relative of any person in the practice, shall accept or make or guarantee a loan from or to a client except for a loan negotiated at arm's length in the ordinary course of the client's business. A transaction so negotiated must not be entered into without full consideration of its effects on actual and apparent professional independence. In the case of an audit client company, the restrictions under the Corporations Law must be observed.

Commission

19. Acceptance of commission by a practice or by any person in a practice could impair the professional independence required of members. Members are referred to paragraph D.2 in the Code of Professional Conduct. Goods and Services from Clients
20. No person in a practice, or near relative of any person in the practice, shall accept from a client goods or services on terms more favourable than those generally available to others. Hospitality or gifts on a scale which is not commensurate with normal courtesies of social life must not be accepted.

Conflicts

21. It is recognised that from time to time unavoidable conflicts of interest or of duty will occur. Conflicts are generally of two types. On the one hand, there may be an actual or apparent conflict between the duty owed by the practice or a person in the practice to a client and the personal interest of the practice or a person in the practice. On the other hand, there may be an actual or apparent conflict between the respective interests of two or more clients of a practice. In all such cases, a practice and each principal of the practice must ensure that a full and frank explanation and disclosure of the conflict is made to the client(s). Additionally, in severe cases of conflict of duty, such as where two clients are, or are about to become, in dispute on a matter, the practice must not advise both clients on the matter. The practice may elect to continue to advise one client on the matter provided that the interests of the other client would not be materially prejudiced thereby. The practice may, however, if asked by both clients, put forward proposals for settling the dispute.

Insolvency

22. (a) Except in the case of a member's voluntary winding up:
 - (i) No person in a practice shall accept appointment as liquidator, provisional liquidator, controller, scheme manager or administrator of a company if any person in the practice has, or during the previous two years has had, a continuing professional relationship with the company.
 - (ii) No practice or person in a practice shall accept appointment as auditor of a company if any person in the practice has been a liquidator, provisional liquidator, controller, scheme manager, official manager or administrator of the company within the previous two years.
- (b) For the purpose of (a)(i) above, a "continuing professional relationship" shall not arise:
 - (i) by reason only of the appointment of a practice or person in a practice to investigate, monitor or advise on the affairs of a company on behalf of a third party so long as the professional obligation is to a party other than the company being investigated, or
 - (ii) if the professional relationship existed for less than two months, or
 - (iii) by reason only of the appointment of a person as liquidator of a company in which that person or any other person in the practice has been liquidator, provisional liquidator or administrator, or
 - (iv) by reason only of the appointment of a person as scheme manager or administrator of a company in which that person or any other person in the practice has been official manager, liquidator, controller, provisional liquidator or administrator, or
 - (v) by reason only of the appointment of a person as controller of a company in which that person or any other person in the practice has been controller under a prior ranking debenture or where their appointment has been made by the Court.
- (c) The above principles apply to all insolvency appointments, including appointments under the Bankruptcy Act.

Directorships

23. No person in a practice shall accept or retain a directorship of a company which, through ownership of shares or otherwise, exerts significant influence over another company of which the practice or any person in the practice is auditor.

Management Consulting Services

24. 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.

Appointments Generally

25. Whenever a practice or any person in a practice is asked to accept an appointment, consideration must be given to whether acceptance might give rise to a situation in which the professional independence of the practice or of the individual may be, or may appear to be, compromised. In the case of an existing appointment, should a situation arise in which professional independence is threatened, immediate steps must be taken to resolve the conflict.

Preparation of Books

26. (a) A practice should not participate in the preparation of 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 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 books of an audit client, particular care must be paid to the need for 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.

Fees

27. When the receipt of recurring fees from a client or group of connected clients represents a large proportion of the total gross fees of a practice, the extent of dependence on that client or group of connected clients will inevitably come under scrutiny and raise doubts as to objectivity. It is not possible to give precise guidance on the proportion of fees which should not come from one client or a group of connected clients. However, if such fees are the only income or a substantial part of the gross income the practice should carefully consider its position.

Personal and Business Relationships

28. Personal and business relationships can affect objectivity. There is a particular need, therefore, for a practice to ensure that its objective approach to any assignment is not endangered as a consequence of any such relationship. By way of example, objectivity may be impaired where a person in a practice has a mutual business interest with an officer or employee of a client or has an interest in a joint venture with a client.

Enterprises other than Companies

29. All of the foregoing rules applicable in the case of a company apply in the case of other enterprises. For this purpose, "other enterprise" means any business organisation incorporated or otherwise other than a company and includes a partnership or trust.

APPENDIX F

STATEMENT OF AUDITING PRACTICE AUP 32 - AUDIT INDEPENDENCE

Citation

- 1 This Statement may be cited as Statement of Auditing Practice AUP 32 "Audit Independence".

Application and Operative Date

- 2 This Statement applies to external audits of financial reports in relation to the first financial reporting period that ends on or after 1 January 1993 and later reporting periods. The Statement is reissued in February 1999 to incorporate changes in the Corporations Law.

Introduction

- 3 Statement of Auditing Standards AUS 1 requires auditors to be:

"... straightforward, honest and sincere in their approach to their professional work. They must be fair and must not allow prejudice or bias to override their objectivity. They shall maintain an impartial attitude and both be, and appear to be, free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity."

- 4 The purpose of this Statement is to provide guidance to auditors when considering their independence, and to assist in the application of the auditing standard in AUS 1, the profession's ethical requirements and other relevant provisions affecting audit independence, for example requirements in the Corporations Law. This Statement, however, cannot cover all circumstances which might affect independence, and it will be for auditors to use judgment when applying the spirit of the Statement and other professional pronouncements to circumstances in which they find themselves at any given time. The use of the term auditor in this Statement refers to both individual auditors and audit firms.

- 5 While this Statement is directed towards external auditors in the private and public sectors undertaking an audit of a financial report, subject to statutory provisions that may affect audit engagements, it may also provide useful guidance for engagements involving non-financial information, and for internal auditors.

Audit Independence

- 6 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. The value of the independent audit lies both in the fact that the auditor is, and is seen to be, independent of the audited entity, and hence is able to carry out the audit free of any externally imposed constraints.

- 7 The professional ethical pronouncements of the Australian Society of Certified Practising Accountants (the Society) and The Institute of Chartered Accountants in Australia (the Institute) define independence as a freedom from any interest incompatible with integrity and objectivity.

- 8 Independence requires a freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure, any of which could lead to a belief that the audit opinion was determined other than by reference to the facts of the audit alone.

- 9 Statement of Auditing Standards AUS 1 requires an auditor not only to be independent, but also to appear to be independent. The perception of audit independence is fundamental to the credibility of the profession. For the purpose of this Statement:

- (a) *actual independence* is the achievement of actual freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure; and
- (b) *perceived independence* is the belief of financial report users that actual independence has been achieved.

References to independence throughout this Statement refer to both actual and perceived independence.

- 10 Whatever the cause of a lack of actual independence or a perceived lack of independence, it can be damaging to the role of the auditor and ultimately to the credibility of the financial report on which the auditor is expressing an opinion. Perceived independence may not be achieved, even though actual independence has been maintained, due to various factors, such as confusion over the facts of a particular situation or a lack of public appreciation of the role of auditing.

- 11 The auditor should be able to clearly demonstrate independence and should not act in a manner which may cast doubt on independence.
- 12 In order to achieve actual independence, professional ethics stress the importance of the auditor's attitude of mind. Furthermore, the auditor's belief in the importance of actual and perceived independence is integral to the successful application of the various forms of regulations, such as auditing standards, professional ethics, and legislative requirements concerned with audit independence.

Attitude of Mind

- 13 The independence of the auditor is heavily reliant upon the personal attributes of the individual. Without believing in and supporting the need to remain independent of any bias, personal interest, susceptibility to undue influence or pressure, the auditor is unlikely to achieve the appropriate attitude of mind. Personal attributes essential to the maintenance of an independent frame of mind include:
- (a) *integrity* — the staunch observance of accepted standards of honesty which must underlie all professional decisions and actions. An auditor who has integrity has a straightforward, honest and sincere approach to professional work;
 - (b) *objectivity* — an unwillingness to allow prejudice or bias to influence judgment and the maintenance of a fair and impartial attitude; and
 - (c) *strength of character* — the ability to maintain integrity and objectivity in the face of pressure from others. The opinion of the auditor is vital to the credibility of financial reports, and the governing body, recognising this, may seek to influence the auditor. Without the strength of character to withstand such pressure, the auditor will not be able to express an independent opinion.
- 14 The personal qualities of the auditor are integral to the maintenance of audit independence, but they cannot be maintained by rules or regulations and it is incumbent upon the auditor to ensure that integrity, objectivity and strength of character have been maintained. However, support for audit independence can be derived from external sources such as legislation and through the self-regulatory procedures of the Society and the Institute.

Regulation

Legislation

- 15 Legislation governs the audit of many entities and frequently incorporates protection of the auditor's independence. For example, the Westminster system establishes the independence of an Auditor-General and the various Audit Acts generally provide for unrestricted access to documents, information and entity personnel. Similar rights of access are provided for audits which are conducted under the Corporations Law. It is incumbent upon the auditor to become familiar with relevant legislation and to use judgment as to its application in particular circumstances. Before accepting any engagement the relevant legislation should be reviewed and its implications considered.

Professional Ethics and Auditing Standards

- 16 Statements on professional ethics, issued by the Society and the Institute, and Statements of Auditing Standards and Practice issued by the Australian Accounting Research Foundation on behalf of the Society and the Institute, identify the appropriate professional conduct expected of members. The concept of an auditor's independence and the importance of the perception of that independence form an integral part of the ethical rules and standards. These self-regulatory measures are important in increasing public awareness of auditors as being responsible for their own conduct.

General Considerations

- 17 It is an objective of this Statement to assist the auditor in the application of existing legislation and professional requirements. The guidance given below, whilst not exhaustive, aims to illustrate the application of such requirements at key stages both prior to and during the audit.

Scope

- 18 Fundamental to the independence of the auditor is freedom to plan and conduct the audit, report findings, and express an opinion free from external influence. Such influence can manifest itself in a number of ways and these are considered in turn.

Accepting Engagements

- 19 The auditor should consider any legislation which might be relevant to the acceptance of the audit engagement. For example, for engagements which are governed by the Corporations Law there are legal restrictions regarding those allowed to become the auditor of a company. These provisions are designed to help ensure the appointment of an independent and professionally competent auditor who has the freedom to plan, conduct and

report without undue influence or bias. Whilst reference should be made to the Corporations Law itself for full details and definitions, specific measures to ensure that independence is protected include:

- (a) no member of the firm shall be a partner or employee of an employee of an officer of the company to be audited*;
- (b) at least one member of the firm shall be a registered company auditor, ordinarily resident in Australia (and hence bound by the ethical requirements and standards of a professional accountancy body);
- (c) no member of the firm, or corporation in which any member is a substantial shareholder, shall owe an amount exceeding \$5,000 to the company to be audited;
- (d) no member of the firm shall be an officer of the company to be audited or a partner, employer or employee of an officer of the company to be audited*; and
- (e) no officer of the company to be audited shall receive any remuneration from the firm for acting in an advisory capacity to it on accounting or auditing matters.*

(*unless a proprietary company - however, refer to paragraph 20.)

- 20 The auditor must also consider the requirements of the Society and the Institute which may, notwithstanding the absence of any legal prohibition, preclude a person from accepting an engagement as auditor of an entity if that person or a near relative has been an officer (other than an auditor) or employee of the entity or had any financial or commercial relationship with the entity which might impair the auditor's professional independence.
- 21 Professional ethics also contain a number of factors which the auditor should consider before accepting an engagement, for example auditors should not accept engagements if they, or any other person in the practice:
- (a) hold the position of a trustee of a trust having a material interest in the client company;
 - (b) are a director or employee of a company which acts as a trustee of a trust having a material interest in the client company;
 - (c) hold a material interest in an audit client company as nominee;
 - (d) hold a material beneficial interest in audit clients;
 - (e) hold the office of director in audit clients (through such an involvement the auditor would be committed to the objectives of the entity, and hence could neither be objective, nor independent);
 - (f) have been an officer of the entity during the period specified in the ethical requirements; and
 - (g) hold close personal or professional relationships with clients which could result in a favourable bias.
- 22 When the auditor is involved in providing "other services" for the prospective client there are particular independence issues which must be resolved before the audit engagement is accepted. In such circumstances the guidance provided in paragraphs 36 to 45 should be followed.
- 23 The auditor should also be aware of the professional ethical requirement for communication with the preceding auditor prior to the acceptance of an audit engagement. Communication should occur in order to ascertain any reasons why the appointment should not be accepted, and may serve to protect both auditors from potential manipulation by the governing body.

Charging for Services

- 24 The auditor determines the scope of an audit of financial information in accordance with Statements of Auditing Standards and Practice, the requirements of relevant legislation and the terms of the engagement. If the freedom to determine the scope of the audit is denied, the auditor cannot be independent. When competing for an audit engagement through a tendering process, the auditor is under pressure to provide a competitive service, but this must not be done at the expense of conducting enough work to gain sufficient appropriate audit evidence on which to base the opinion to be given. The governing body may seek to influence the scope of the audit through restricting the amount of the auditor's remuneration. All such attempts to restrict scope must be rebuffed and it is incumbent upon the auditor to clearly demonstrate that independence has been maintained.
- 25 The auditor should not enter into fee arrangements where independence might be, or be seen to be, compromised. The auditor should ensure that the fee for an audit is commensurate with the service provided (except where an honorary audit is performed), and reflects the time needed and quality of staff necessary to complete the audit in accordance with Australian Auditing Standards. 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.

Fee Dependence

- 26 The auditor should ensure that professional independence is not put at risk by economic factors. The auditor should avoid undue economic dependence on the revenues derived from any one client so that the public perception of a member's objectivity is not likely to be in jeopardy, and to avoid the risk that such a dependence could result in the auditor being influenced by the entity's governing body to report favourably for fear of losing the appointment.
- 27 An auditor can demonstrate that undue economic dependence does not place independence at risk by ensuring that the fees from one audit client or group of audit clients do not exceed an appropriate limit. Because the risk of undue economic dependence will vary according to individual circumstances, it is not practicable to set a general limit at which the risk of undue economic dependence will be significant. An audit practice should establish an appropriate limit at which it is satisfied that it will not place independence at risk in respect of any audit engagement, and should periodically assess fees received from individual audit clients, or a group of connected audit clients, against this limit. 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 connected audit clients exceed fifteen percent of the gross fees of the practice.
- 28 In circumstances where the remuneration of an auditor depends on the profits of any one office within a practice, and that office regularly depends on one audit client or a group of connected audit clients for a significant proportion of its total fees, or where one client may be significant to a partner's position within a firm, freedom from undue economic influence should be demonstrated by ensuring that adequate quality control procedures are in place, such as the involvement of a review partner, or equivalent, from another office of the practice or from another firm.
- 29 A small, newly-formed practice or a declining or down-sizing practice may have a tendency towards a client portfolio in which one or more clients are dominant in terms of the fee revenues generated from them. Such a situation could be viewed as unavoidable in the short term. However it is particularly important that in such circumstances the auditor is able to demonstrate independence despite the apparent reliance on fees from a dominant client or group of connected clients, for example through a commitment to procedures within the firm that serve to protect independence, such as those outlined in paragraphs 49 to 53.
- 30 Where significant fees remain unpaid for previous work undertaken by the auditor, outstanding fees may assume the characteristics of a loan after the expiration of the normal receivables period. In such circumstances the auditor should consider whether audit independence has been compromised and, if this is believed to be the case, should take all possible steps to resign from the audit engagement.

Operational Independence

- 31 Auditors should ensure that they are able to conduct the audit free from intervention or control by the governing body. Care should be taken to identify instances where the governing body seeks to restrict the nature, timing and extent of audit procedures, for example by claiming that tests are:
- (a) too expensive to be undertaken;
 - (b) too disruptive to the entity; and/or
 - (c) unnecessary, and will not meet the auditor's objectives;
- or by:
- (d) restricting the auditor's access to members of staff; and/or
 - (e) restricting the auditor's access to records.
- 32 The auditor must ensure that the right of access to all records and to all members of staff is accepted by the client entity, for example by specific mention of this right in the audit engagement letter. This serves to consolidate the auditor's independent position with free access to the means by which to make an independent assessment. In the case of an audit under the Corporations Law, the rights to such access are contained in section 310 and 312. Should the auditor be unable to obtain sufficient appropriate audit evidence on which to base the audit opinion, the audit report should be qualified.
- 33 It is important that the auditor is able to access and communicate effectively with levels of management having sufficient authority to take appropriate action. Access to audit committees, for example, enables the auditor to report to an influential and authoritative body which is independent of management. Therefore, if an audit committee has been formed, the auditor should ensure that free and unrestricted access to it exists. Where no audit committee exists, the auditor may indicate to the governing body the benefits to be derived therefrom, and may encourage the formation of an audit committee.

Financial Involvement

- 34 The auditor can protect independence by ensuring that there is no direct or indirect financial involvement in a client entity. The auditor should ensure that, for example, for all members of the practice:
- (a) no investments are held in a client entity except if required by the legislation under which the audit is mandated. The auditor should take immediate steps to dispose of any investments held in a client entity following the acceptance of an audit engagement;
 - (b) no loans are made to or borrowings accepted from a client entity except as allowed by the legislation under which the engagement is mandated;
 - (c) no gifts or hospitality are accepted from a client entity, other than that which might be perceived as commensurate with normal social and professional courtesies;
 - (d) no goods or services are accepted from a client entity, except in the normal course of business on terms and conditions applicable to members of the general public;
 - (e) no commissions are accepted in any form other than in accordance with the professional ethical pronouncements of the Society and the Institute; and
 - (f) no action is knowingly undertaken which would cause disqualification from acting as auditor during the course of an audit.
- 35 The auditor should also consider the effect on independence of a dispute with an audit client, for example, if the client has initiated significant litigation against the auditor or practice, or vice versa. Such a situation would not be conducive to a good auditor/client relationship, and could represent a breakdown in the relationship of trust that should exist. As the auditor and client may be placed in adversarial positions, the auditor's ability to remain objective could be seen to be impaired. If the auditor believes that independence has been compromised as a result of a significant dispute, the auditor should take all possible steps to resign from the audit engagement. If, taking into account the specific circumstances of the dispute, the auditor does not believe that actual independence has been impaired, but that there may be a perception that the auditor's objectivity is likely to be at risk, the auditor should consider resigning, and document the basis of the decision made.

Other Services

- 36 An auditor might be asked to conduct a range of "other" services for past, present, or potential audit clients. 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.
- 37 Fees obtained from "other" services suggest that an entity may be able to exert undue pressure on the auditor through the threat of removal from other engagements. While the earning of fees by an audit firm from "other" services provided to an audit client does not necessarily impair the auditor's independence, the auditor should consider the effect on independence of the level of fees derived from "other" services.
- 38 There are likely to be important differences between the auditor's responsibilities for conducting "other" service engagements and financial report audits. The auditor should ensure that management is aware of the different objectives and reporting requirements of each engagement. This may be achieved through the issue of separate engagement letters for each "other" service engagement accepted. The auditor should also be satisfied that the perception of financial report users of the auditor's independent status will not be impaired.
- 39 Professional ethics require that auditors should not:
- (a) undertake management consulting services if this would involve them in the executive function of a client (for example, auditors providing executive search and recruitment services should not make any final decisions regarding the appointment of candidates); or
 - (b) act as a liquidator, receiver, receiver and manager, scheme manager or official manager if the auditor has had involvement with the client during the period specified in the ethical requirements (professional ethics provide an exemption in the case of a member's voluntary winding-up).
- 40 Professional ethics also state that a business activity is inconsistent with the provision of audit services if it:

- (a) creates a conflict of interest with existing clients;
- (b) impairs independence, objectivity, and integrity;
- (c) impairs the ability to provide professional services to the general public; and
- (d) impairs the professional reputation of auditors.

41 These provisions, and those which follow, do not preclude the auditor from informing management of findings arising during the course of an audit, and from discussing them with management in accordance with the requirements of Statement of Auditing Practice AUP 12 "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit".

42 Owing to the range of circumstances under which "other" service engagements might be undertaken, each potential engagement should be viewed individually. Before undertaking any "other" service, the auditor should specifically consider factors which may affect independence or the perception of independence. These include:

(a) Decision Making

The auditor responsible for the audit of the financial report should not make decisions which should be made by management, and must not be perceived to be acting for or closely aligned with management. Such involvement is incompatible with an independent audit.

(b) Objectivity

The auditor should not be in the position of both performing and auditing the same work, or be perceived to be doing so. Where "other" services have been provided which affect the information subject to audit, for example the auditor or the auditor's firm has provided a valuation service for an item appearing in the financial report, or estimates are provided for inclusion in the financial report, the auditor should ensure that the information has been adopted by the entity, and that no undue reliance is placed upon work undertaken by colleagues. Appropriate audit procedures should be applied to that information when gathering sufficient appropriate audit evidence on which to form the audit opinion. Where the partner responsible for forming an opinion on the financial report has any direct responsibility for the provision of "other" services, a second partner or other independent and authoritative individual should review the audit to ensure that independence has been maintained.

(c) Fee Dependence

The auditor should consider whether the fees derived from "other" services might compromise independence through an actual or perceived undue economic dependence on the receipt of those fees.

43 Each potential engagement should be considered individually when assessing its potential effect on audit independence. However, certain types of "other" service engagement can carry particularly high risks of a perceived loss of independence. In order to assist the auditor when considering the application of the guidance given in paragraph 42, specific examples of accounting services and internal audit services are considered below.

Accounting Services

44 Auditors are frequently requested by their audit clients to undertake work of an accounting nature, particularly in emergency situations such as the unforeseen loss of key personnel. Professional ethics state that such services may only be provided for public company clients in exceptional circumstances, although a more extensive service may be provided to a proprietary company. In either case, in order to protect independence, the auditor should ensure that:

(a) Decision Making

- (i) the client accepts responsibility for the records produced and for directing personnel undertaking the service; and
- (ii) the role of management is not assumed when providing the service; and

(b) Objectivity

- (i) sufficient appropriate audit evidence is gathered through the conduct of appropriate audit procedures when forming an opinion on the financial report and undue reliance is not placed on work undertaken by colleagues.

Internal Audit Services

45 Internal audit is an integral part of an entity's organisation and functions under the policies established by the governing body with the objective of assisting that body in the effective discharge of its responsibilities. The

provision of internal audit services by the external auditor of the same entity may, therefore, place at risk the perception of the independence of the external auditor from the perspective of financial report users and other interested parties. The scope and nature of the role of an internal audit function varies between organisations and may entail aspects of systems evaluation and review, examination of financial and operating information and examination of the economy, efficiency and effectiveness of operations, including non-financial controls. In order for the external auditor to demonstrate independence, the principles outlined in paragraphs 36 and 42 should be applied to each engagement as follows:

- (a) Decision Making
 - (i) the external auditor should not assume the role of management when undertaking internal audit services; and
 - (ii) any recommendations made by auditors are for implementation by management rather than the auditor; and
- (b) Objectivity
 - (i) the external auditor should not accept any internal audit engagement which involves the auditor becoming part of the entity's internal control structure relating to the preparation of financial report information; and
 - (ii) the external auditor should gather sufficient appropriate audit evidence through the conduct of appropriate audit procedures when forming an opinion on the financial report and should not place any more reliance on work undertaken by colleagues than that undertaken by any other internal auditor.

Independence of Reporting

- 46 Auditors must be able to report audit findings free from pressure or influence from others, but they can be vulnerable to the threat of removal from office if the governing body wishes to coerce favourable responses. If the audit engagement is conducted under the Corporations Law there are specific provisions regarding the auditor's resignation or removal from office. These provisions are designed to protect the shareholder from the auditor who wishes to resign rather than undertake an audit which might prove difficult or controversial and to protect the auditor from manipulation by the governing body threatening removal from office to coerce a favourable audit opinion.
- 47 In the case of an audit of a company (other than a proprietary company) or registered scheme under the Corporations Law, the auditor is required to apply to the Australian Securities & Investments Commission (ASIC) and obtain its consent in order to resign. Details of reasons for the resignation and of any disagreements with the governing body must be furnished before permission is granted. Furthermore, the auditor has the right to make verbal representations at any general meeting, and to make written representations to all members should the governing body of an entity, or others, wish to remove the auditor from office. Thus, fear of removal from office should never cause an auditor to revise or withdraw the audit opinion in the face of pressure from the governing body. ASIC Policy Statement 26 sets out the Australian Securities & Investments Commission's policy on applications for its consent to the resignation of an auditor. The legislation is designed to protect the auditor's independence, and hence the interests of members.
- 48 The auditor may be required by the terms of the audit engagement, or the legislation by which it is regulated, to report to external bodies, for example the Australian Securities & Investments Commission in respect of corporate audits, or a professional regulatory body. Should the auditor consider that the ability to report independently is being hampered or denied by the client, this fact should be communicated to the regulatory or governing body. In such circumstances the auditor should have due regard both to the confidentiality of information obtained during the conduct of the audit and to any protection afforded the auditor by legislation pertinent to the engagement.

Quality Control Procedures

Quality Control

- 49 Rigorous and effective quality control procedures will assist in the maintenance of audit independence. Miscellaneous Professional Statements APS 4 "Statement of Quality Control Standard" and APS 5 "Quality Control Policies and Procedures _ General Guidelines" state that members have a mandatory professional obligation to implement and monitor a system of quality control.
- 50 The auditor should be able to demonstrate that internal procedures have been designed, implemented and monitored in such a way as to promote and protect independence through the control of the quality of audit work. Statement of Auditing Practice AUP 13 "Control of the Quality of Audit Work" sets out certain minimum requirements concerning how this might be achieved.

51 There are many ways in which quality control procedures might be developed to protect independence, and auditors should assess those areas in which the risk of loss of independence is significant. Procedures should be designed to ensure that the risk of loss of independence is minimised. Procedures could, for example, include:

- (a) the periodic review of audit working papers to identify instances where the independence of the auditor's judgment might be questioned;
- (b) appropriate consultation processes within the audit firm, including, in appropriate circumstances, the independent review of audit decisions;
- (c) the periodic positive declaration of personal interests in clients by all staff and their close relatives;
- (d) policies for the immediate disposal of staff members' interests in new (and existing) audit clients;
- (e) the periodic rotation of audit staff between audit engagements;
- (f) policies to review the relationship of the auditor and the entity to monitor any potential impact on objectivity and to ensure that excessive familiarity does not exist with long-standing clients, such as the periodic rotation of audit partners after a suitable period of time; ensuring that the fees received from an audit client or group of connected clients do not exceed an appropriate level; and the review of all significant decisions of the engagement partner by a review partner; and
- (g) adequate training of all members of staff in the professional, business and legal requirements relative to their clients.

Quality Control Review

52 The auditor should ensure that all quality control procedures are regularly reviewed. Small practices and sole practitioners should also consider reciprocal external consultation arrangements with other firms when designing, implementing and reviewing quality control procedures.

53 The auditor's review process should include an annual review to be satisfied that each engagement should continue having regard to the guidance in this Statement, and to identify situations where independence may be at risk. Where the review process indicates that an audit engagement should be continued only with additional safeguards against loss of independence, the range of safeguards should be subject to independent review by a partner unconnected with the engagement or as part of any reciprocal external arrangements.

Opinion Shopping

54 "Opinion shopping" is the term commonly given to the practice of searching for an auditor willing to support a proposed accounting policy. This policy may have been designed to help an entity achieve its reporting objectives even though that treatment might frustrate reliable reporting. Opinion shopping may also occur where conflicting opinions are obtained in situations requiring judgment with regard to the accounting policy. Such practices have clear implications for the independence of the auditor as the governing body could use any response to seek to influence existing auditors, or even to remove them from office and appoint an auditor with an opinion more "favourable" to itself. Such practices would leave both auditors open to a lack of perceived independence.

55 When applying the profession's ethical requirements in relation to professional appointments and opinion requests, an auditor, faced with a request from an entity for an opinion on an actual or hypothetical accounting issue, should consider the potential effect on independence of the circumstances under which the request is being made, the purpose of the request and the requester's intended use of any response. In addition the following procedures should be adopted:

- (a) the auditor whose opinion is requested should communicate with the incumbent auditor as to the facts surrounding the request and provide a copy of the opinion to the incumbent auditor, who should have the right to comment to the governing body and/or audit committee;
- (b) opinions should be limited by a statement to the effect that the opinion is solely for use by the client and cannot be issued to third parties without written approval; and
- (c) opinions should be issued under the name of a partner to permit ready identification of the author.

APPENDIX G

IFAC EXPOSURE DRAFT

This re-exposure draft has been drafted by the Ethics Committee of the International Federation of Accountants and was approved for publication in April 2001. The exposure draft may be modified in the light of comments received before being issued in its final form.

Comments should be submitted in writing so as to be received by June 30, 2001 preferably by e-mail, or on a computer disk or in writing. Unless respondents to the exposure draft specifically request confidentiality, their comments are considered a matter of public record. Comments should be addressed to:

Technical Director

International Federation of Accountants

535 Fifth Avenue, 26th Floor

New York, New York 10017 USA

E-mail responses should be sent to: EDComments@ifac.org

The approved text of this Exposure Draft of the Ethics Committee is published in the English language.

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PREFACE

INTRODUCTION

In June 2000, the IFAC Council (now the IFAC Board) approved, for publication, the exposure draft *Independence – Proposed Changes to the Code of Ethics for Professional Accountants*. The Ethics Committee has considered the comments received on exposure and has released this re-exposure draft. Although there have been no significant changes in principle, the document has been substantially re-written in response to comments received. In particular, the re-exposure draft clarifies certain points and describes additional specific circumstances that may create threats to independence and safeguards that may be appropriate to reduce the threats to an acceptable level in each circumstance. Therefore, this document is being re-exposed to provide interested parties with the opportunity to comment on the changes made.

HIGHLIGHTS OF RE-EXPOSURE DRAFT

The June 2000 exposure draft proposed a move to a conceptual framework approach that would require the identification and evaluation of threats to independence and the application of safeguards to reduce any threats created to an acceptable level. Respondents to the exposure draft were strongly supportive of this approach and suggested that additional examples be added. Therefore, the re-exposure draft provides details of additional circumstances that may create threats to independence. As with the exposure draft, in certain circumstances the only possible course of action is to resign or not accept the assurance engagement.

The June 2000 exposure draft was predicated on the assumption of the issuance of the new International Standard on Assurance Engagements and, therefore, used the term “reporting accountant”. The new assurance standard has now been issued but it does not use the term “reporting accountant”. The re-exposure draft, therefore, uses the term “assurance team”.

In response to comments received on exposure, the re-exposure draft expands the class of people that may create threats to independence. As with the exposure draft, immediate and close family members may create threats to independence; however, the re-exposure draft also discusses threats to independence that may be created by individuals who are not part of the assurance team such as other partners and professional staff within the firm, and the firm itself.

Many respondents indicated the importance of consistency between jurisdictions. In considering revisions to the exposure draft, the Ethics Committee carefully considered this matter, and, where appropriate took steps to achieve greater consistency.

REQUESTS FOR COMMENTS

While comments are sought on all matters addressed in this re-exposure draft, the Ethics Committee would particularly welcome comments on an appropriate effective date for this section.

The Ethics Committee looks forward to receiving comments on this re-exposure draft from all interested parties. Respondents are invited to provide detailed comments indicating specific paragraph numbers, or groups of paragraphs to which they relate, clearly explaining the issue and suggesting alternative wording, with supporting reasoning, where appropriate. These comments should be submitted in time to be received by **June 30, 2001**. Unless respondents request confidentiality, their comments will be a matter of public record.

MEMBERS OF THE IFAC ETHICS COMMITTEE

Marilyn Pendergast, Chair, United States

Jean-Francois Cats, Belgium

Francisco Papellás Filho, Brazil

Donald G. Wray, Canada

Pekka Luoma, Finland

Jean-Jacques De Dutoit, France

S.P. Chhajed, India

Pierce H. Kent, Ireland

Francesco Serao, Italy

Jesús Peregrina, Spain

Chen-Chang Lai, Taiwan

Michael Foulds, United Kingdom

Extract from definitions section of code of ethics:

Audit client	An entity in respect of which a firm conducts an audit engagement. When the audit client is a listed entity, audit client includes its related entities.
Audit engagement	An assurance engagement to provide a high level of assurance that financial statements are free of material misstatement, such as an engagement in accordance with International Standards on Auditing. This includes a Statutory Audit which is an audit required by national legislation or other regulation.
Assurance client	An entity in respect of which a firm conducts an assurance engagement.
Assurance engagement	An engagement conducted to provide a high or a moderate level of assurance that the subject matter conforms in all material respects with identified suitable criteria. This would include an engagement in accordance with the “International Standard on Assurance Engagements” issued by the International Auditing Practices Committee or in accordance with specific standards for assurance engagements issued by the International Auditing Practices Committee such as an audit or review of financial statements in accordance with International Standards on Auditing.
Assurance team	<p>(a) All professionals participating in the assurance engagement; and</p> <p>(b) All others within a firm who can directly influence the outcome of the assurance engagement, including:</p> <ul style="list-style-type: none"> • those who supervise or have direct management responsibility for the assurance engagement, for the purposes of an audit engagement this includes those at all successively senior levels through the firm’s chief executive; • those who provide consultation regarding technical or industry specific issues, transactions or events for the assurance engagement; • those who provide quality control for the assurance engagement; and • those who provide direct supervisory, management, compensation or other oversight of the assurance engagement partner.
Close family	A parent, non-dependent child or sibling.
Direct financial interest	A financial interest beneficially owned directly by and under the control of an individual (including those managed on a discretionary basis by others).
Directors and officers	Persons charged with the governance of an entity, regardless of their title, which will vary from country to country.
Financial interest	An interest in equity or other security, debenture, loan or other debt instrument of an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.
Firm	<p>(a) A sole practitioner, partnership or corporation of professional accountants that performs an assurance engagement;</p> <p>(b) An entity that controls such parties; and</p> <p>(c) An entity controlled by such parties or otherwise under common control, ownership or management, or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm.</p>
Immediate family	A spouse (or equivalent) or dependent.
Indirect financial interest	A financial interest beneficially owned through a collective investment vehicle, estate, trust or other intermediary over which the individual has no control.
Independence	<p>Independence is:</p> <p>(a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that impair professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and</p>

- (b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional skepticism had been unacceptably impaired.

Lead engagement partner	In connection with an audit, the partner responsible for signing the report on the consolidated financial statements of the audit client, and, where relevant, the partner responsible for signing the report in respect of any entity whose financial statements form part of the consolidated financial statements, and on which a separate stand-alone report is issued. When no consolidated financial statements are prepared, the lead engagement partner would be the partner responsible for signing the report on the financial statements.
Listed entity	An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.
Other client service personnel	Partners and managerial employees who provide non-assurance services to an audit client, except those whose time involvement is clearly insignificant.
Office	A distinct sub-group, whether organized on geographical or practice lines, in which the lead engagement partner practices in connection with the audit.
Related entity	<p>(a) An entity that has direct or indirect control over the assurance client provided the assurance client is material to such entity;</p> <p>(b) An entity with a direct financial interest in the assurance client provided that such entity has significant influence over the assurance client and the interest in the assurance client is material to such entity;</p> <p>(c) An entity over which the assurance client has direct or indirect control;</p> <p>(d) An entity in which the assurance client has a direct financial interest, provided the assurance client has significant influence over such entity and the interest is material to the assurance client; and</p> <p>(e) An entity which is under common control with the assurance client (hereinafter a “sister entity”) provided the sister entity and the assurance client are both material to the entity that controls both the assurance client and sister entity.</p>

Draft Revision to Section 8 of the IFAC Code of Ethics

INDEPENDENCE

- 8.1 It is in the public interest and, therefore, required by this Code of Ethics, that the firm and the assurance team be independent of the assurance client.
- 8.2 Assurance engagements are intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria, thereby improving the likelihood that the information will meet the needs of an intended user. “The International Standard on Assurance Engagements” issued by the International Auditing Practices Committee describes the objectives and elements of assurance engagements to provide either a high or a moderate level of assurance. The International Auditing Practice Committee has also issued specific standards for certain assurance engagements. For example, International Standards on Auditing provide specific standards for audit (high level assurance) and review (moderate level assurance) of financial statements.

Paragraphs 8.3-8.6 are taken from the “International Standard on Assurance Engagements” and describe the nature of an assurance engagement.

- 8.3 Whether a particular engagement is an assurance engagement will depend upon whether it exhibits all the following elements:
- (a) a three party relationship involving:
 - (i) a professional accountant;
 - (ii) a responsible party; and
 - (iii) an intended user;
 - (b) a subject matter;
 - (c) suitable criteria;
 - (d) an engagement process; and
 - (e) a conclusion.
- The responsible party and the intended user will often be from separate organizations but need not be. A responsible party and an intended user may both be within the same organization, for example, a governing body may seek assurance about information provided by a component of that organization. The relationship between the responsible party and the intended user needs to be viewed within the context of a specific engagement.
- 8.4 There is a broad range of engagements to provide a high or moderate level of assurance. Such engagements may include:
- Engagements to report on a broad range of subject matters covering financial and non-financial information;
 - Attest and direct reporting engagements;
 - Engagements to report internally and externally; and
 - Engagements in the private and public sector.
- 8.5 The subject matter of an assurance engagement may take many forms, such as the following:
- Data (for example, historical or prospective financial information, statistical information, performance indicators);
 - Systems and processes (for example, internal controls);
 - Behavior (for example, corporate governance, compliance with regulation, human resource practices).
- 8.6 Not all engagements performed by professional accountants are assurance engagements. Other engagements frequently performed by professional accountants that are not assurance engagements include the following:
- Agreed-upon procedures;
 - Compilation of financial or other information;
 - Preparation of tax returns where no conclusion is expressed, and tax consulting;
 - Management consulting; and
 - Other advisory services.

- 8.7 This section of the Code of Ethics (this section) provides a framework, built on principles, for identifying, evaluating and responding to threats to independence. The framework establishes principles that the firm and

the assurance team should use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. This section is not a set of fixed rules and does not seek to identify all circumstances that may create threats to independence. This section requires the firm and the assurance team to apply the principles to the particular circumstances under consideration. Consequently, it is not sufficient for a firm or an assurance team merely to comply with the examples presented.

A Conceptual Approach to Independence

8.8 Independence requires:

(a) Independence of mind:

The state of mind that permits the provision of an opinion without being affected by influences that impair professional judgment; allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

(b) Independence in appearance:

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been unacceptably impaired.

- 8.9 Use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has some dependency on, and relationships with, others. Therefore, the significance of economic and financial relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be acceptable.
- 8.10 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules, which may be arbitrary, is, therefore, in the public interest.
- 8.11 This section is based on such a conceptual approach, one that takes into account threats to independence, accepted safeguards and the public interest. Under this approach, firms and members of assurance teams have an obligation to identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate these threats or to reduce them to an acceptable level by the application of safeguards. In addition to identifying and evaluating relationships between the firm, members of the assurance team and the assurance client, consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client may create threats to independence.
- 8.12 This section applies to all assurance engagements. However, the nature of the threats and the applicable safeguards necessary to reduce the threats to an acceptable level may differ depending on whether the report is an audit report or an other type of assurance report, and the purpose, subject matter and intended users of the report. A firm should, therefore, evaluate the relevant circumstances and the nature of the assurance engagement in deciding whether it is appropriate to accept or continue an engagement, the nature of the safeguards required and whether a particular individual should be a member of the assurance team.
- 8.13 The threats and safeguards identified in this section are generally discussed in the context of interests or relationships between the firm, a member of the assurance team and the assurance client. Where relevant to the evaluation, consideration should be given to threats created by such interests and relationships that may exist between the firm, a member of the assurance team and related entities.
- 8.14 The evaluation of threats to independence and subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed. The obligation to make such an evaluation and take action arises when a firm or a member of the assurance team knows, or could reasonably be expected to know, of circumstances or relationships that might compromise independence. An inadvertent violation of independence principles would not impair the independence of a firm or an assurance team provided the firm has policies and procedures in place and, once discovered, the violations are corrected promptly.
- 8.15 Throughout this section, reference is made to significant and clearly insignificant in the evaluation of threats to independence. In considering the significance of any particular matter, qualitative and well as quantitative factors should be taken into account. A matter should be considered clearly insignificant only if it is deemed to be both trivial and inconsequential.

Objective and Structure of this Section

- 8.16 The objective of this section is to assist firms and assurance teams in:
- (a) identifying threats to independence;
 - (b) evaluating whether these threats are clearly insignificant; and
 - (c) in cases, when the threats are not clearly insignificant, identifying and applying appropriate safeguards to reduce the threats to an acceptable level.

In situations where no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.

- 8.17 This section outlines the threats to independence (paragraphs 8.25 – 8.30). It then analyzes safeguards capable of eliminating these threats or reducing them to an acceptable level (paragraphs 8.31 – 8.39). It concludes with some examples of how this conceptual approach to independence is to be applied to specific circumstances and relationships. The examples discuss threats to independence that may be created by specific circumstances and relationships and the safeguards that may be appropriate to eliminate these threats or reduce them to an acceptable level (paragraphs 8.100 onwards). The examples are not intended to be all-inclusive.
- 8.18 When a firm identifies threats to independence, that are not clearly insignificant, and decides to accept or continue the assurance engagement, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to reduce the threats to an acceptable level.
- 8.19 Certain paragraphs in this section deal with additional matters that are relevant to the audit of listed entities. The financial arrangements of such entities are frequently complex and they have a large number of shareholders for whom the audit report represents an important part of the information used to assess the entity's financial performance and position. Furthermore, most of the larger companies whose performance can have a perceptible effect on national economies are listed entities. There is, therefore, a strong public interest in the financial statements of listed entities. This interest is reflected in their governance structures, which are sophisticated and enable a wide range of safeguards to be applied. In determining appropriate safeguards to be applied, due attention should be paid to threats to the appearance of independence. Accordingly, it is appropriate that more specific guidance be given in relation to the audit of listed entities, where relevant.
- 8.20 In some cases, there may also be significant public interest in entities which are not listed entities and consideration should be given to the application of the principles set out in this section in relation to the audit of listed entities to such other audit clients.

National Perspectives

- 8.21 This section establishes a conceptual framework for independence requirements for assurance engagements that is the international standard on which national standards should be based. Accordingly, no member body or firm is allowed to apply less stringent standards than those stated in this section.
- 8.22 Certain examples in this section indicate how the principles are to be applied to listed entity audit engagements. When a member body chooses not to differentiate between listed entity audit engagements and other audit engagements, the examples that relate to listed entity audit engagements should be considered to apply to all audit engagements. Member bodies and firms should apply this section unless they are prohibited from complying with certain parts of it by law or regulation. In such cases, they should comply with all other parts of this section.
- 8.23 When an assurance team conducts an assurance engagement, in accordance with the "International Standard on Assurance Engagements" or with specific standards for assurance engagements issued by the International Auditing Practices Committee such as an audit or review of financial statements in accordance with International Standards on Auditing, the assurance team and the firm should comply with this section unless they are prohibited from complying with certain parts of this section by law or regulation. In such cases, the assurance team and the firm should comply with all other parts of this section.
- 8.24 Some countries and cultures may have set out, either by legislation or common practice, more specific definitions of relationships than those used in this section. For example, some national legislators or regulators may have prescribed lists of individuals who should be regarded as close family.

Threats to Independence

- 8.25 Independence is potentially affected by self-interest, self-review, advocacy, familiarity and intimidation threats.
- 8.26 "Self-Interest Threat" occurs when a firm or a member of the assurance team could benefit from a financial interest in or other self-interest conflict with an assurance client.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) a direct financial interest or material indirect financial interest in an assurance client or a related entity;
- (b) a loan to or from an assurance client or any director, officer or controlling owner of an assurance client;
- (c) fear of losing the engagement;
- (d) undue dependence on total fees from an assurance client;
- (e) having a close business relationship with an assurance client;
- (f) potential employment with an assurance client; and
- (g) contingent fees relating to assurance engagements.

8.27 “Self-Review Threat” occurs when (1) any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement or (2) when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to affect the subject matter of the assurance engagement.

Examples of circumstances that may create a self-review threat include, but are not limited to:

- (a) a member of the assurance team being, or having recently been, a director or officer of the assurance client;
- (b) a member of the assurance team being, or having recently been, an employee of the assurance client in a position to affect the subject matter of an assurance engagement;
- (c) performing services for an assurance client that directly affect the subject matter of an assurance engagement; and
- (d) preparation of original data used to generate financial statements or preparation of other records that are the subject matter of an assurance engagement.

A self-review threat may arise in relation to non-assurance services provided by a firm that are subsequently reviewed as part of a non-audit assurance engagement. Consideration should be given to the significance of the firm’s involvement with the subject matter and whether any identified threats to independence could be reduced to an acceptable level by the application of safeguards, or whether the engagement should be declined. When the non-assurance services are not related to the subject matter of the non-audit assurance engagement, the threats to independence will generally be insignificant.

8.28 “Advocacy Threat” occurs when a firm, or a member of the assurance team, becomes an advocate for or against an assurance client’s position or opinion to the point that objectivity is, or is perceived to be, impaired.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) dealing in, or being a promoter of, shares or other securities in an assurance client; and
- (b) acting as an advocate on behalf of an assurance client in litigation or in resolving disputes with third parties.

8.29 “Familiarity Threat” occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client’s interests.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) a member of the assurance team having an immediate family member or close family member who is a director or officer of an assurance client;
- (b) a member of the assurance team having an immediate family member or close family member who, as an employee of an assurance client, is in a position to affect the subject matter of an assurance engagement;
- (c) a former partner of the firm occupying a policy making position with an assurance client;
- (d) long association of a senior member of the assurance team with the assurance client; and
- (e) acceptance of gifts or hospitality, unless the value is clearly insignificant, from an assurance client, its directors, officers or employees.

- 8.30 “Intimidation Threat” occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

Examples of circumstances that may create this threat include, but are not limited to:

- (a) threat of replacement over a disagreement with the application of an accounting principle; and
- (b) pressure to reduce the extent of work performed in order to reduce fees.

Safeguards

- 8.31 The firm and the assurance team have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to reduce the threats to an acceptable level.

- 8.32 When threats are identified, other than those that are clearly insignificant, appropriate safeguards should be identified and applied to reduce the threats to an acceptable level. This decision should be documented. The nature of the safeguards to be applied will vary depending upon the circumstances. Consideration should always be given to what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be acceptable. The consideration will be affected by matters such as the significance of the threat, the nature of the assurance engagement, the intended users of the assurance report and the structure of a firm.

- 8.33 Safeguards fall into three broad categories:

- (a) safeguards created by the profession, legislation or regulation;
- (b) safeguards within the assurance client; and
- (c) safeguards within the firm’s own systems and procedures.

The firm and the assurance team should select appropriate safeguards to reduce threats to independence, other than those that are clearly insignificant, to an acceptable level. The first two categories of safeguards are not within a firm’s control. Therefore, when such safeguards are not strong the firm should implement effective safeguards within the firm itself.

- 8.34 Safeguards created by the profession, legislation or regulation, include the following:

- (a) educational, training and experience requirements for entry into the profession;
- (b) continuing education requirements;
- (c) professional standards and monitoring and disciplinary processes;
- (d) external review of a firm’s quality control system; and
- (e) legislation governing the independence requirements of the firm.

- 8.35 Safeguards within the assurance client, include the following:

- (a) when the entity’s management appoints the firm, persons other than management ratify or approve the appointment;
- (b) the employment of high-quality staff in sufficient numbers to ensure that a member of the assurance team would not be requested to make managerial decisions for the entity;
- (c) internal procedures ensuring objective choice in commissioning non-assurance engagements; and
- (d) a corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm’s services.

- 8.36 Audit committees have an important corporate governance role in that they are independent of client management and can assist the Board of Directors in satisfying themselves that a firm is independent in carrying out its audit role. There should be regular communications between the firm and the audit committee (or other governance body if there is no audit committee) of listed entities regarding relationships that might, in the firm’s opinion, reasonably be thought to bear on independence.

- 8.37 Firms should establish policies and procedures relating to independence communications with audit committees. In the case of the audit of listed entities, the firm should communicate orally, and in writing at least annually, all relationships between the firm and the audit client that in the firm’s professional judgement may reasonably be thought to bear on independence. Matters to be communicated will vary in each circumstance and should be decided by the firm, but should generally address the relevant matters set out in this section.

8.38 Safeguards within the firm's own systems and procedures include the following:

Firm-wide safeguards:

- (a) firm leadership that stresses the importance of independence and the expectation that members of assurance teams will act in the public interest;
- (b) policies and procedures to monitor and implement quality control of assurance engagements;
- (c) documented independence policies regarding the identification of threats to independence, the evaluation of the significance of these threats and the identification and application of safeguards to reduce the threats, other than those that are clearly insignificant, to an acceptable level;
- (d) internal policies and procedures to monitor compliance with firm policies and procedures as they relate to independence and quality control;
- (e) policies and procedures that will enable the identification of interests or relationships between the firm or members of the assurance team and assurance clients;
- (f) policies and procedures to prohibit individuals who are not part of the assurance team from influencing the outcome of the assurance engagement;
- (g) timely communication of a firm's policies and procedures, and any changes thereto, to all partners and professional staff, including regular training and education thereon;
- (h) means of advising partners and professional staff of those assurance clients and related entities from which they must be independent; and
- (i) policies and procedures to empower staff to communicate, to senior levels within the firm, any issue of independence and objectivity that concerns them; this includes informing staff of the procedures open to them.

Engagement specific safeguards:

- (a) involving an additional professional accountant to carry out reviews of the work done or otherwise advise as necessary. This individual could be someone from outside the firm, or someone within the firm who is not a member of the assurance team;
- (b) consulting a third party, such as a committee of independent directors, a professional regulatory body or another professional accountant;
- (c) rotation of senior personnel;
- (d) discussing independence issues with the audit committee or others charged with governance;
- (e) disclosing to the audit committee, or others charged with governance, the nature of services provided and extent of fees charged;
- (f) policies and procedures to monitor, and if necessary restrict, the magnitude of revenue received from a single assurance client;
- (g) policies and procedures to ensure members of the assurance team do not make, or assume responsibility for, management decisions for the assurance client; and
- (h) removing an individual from the assurance team, where that individual's financial interests or relationships create a threat to independence.

8.39 When the safeguards available, such as those described above, are insufficient to reduce the threats to independence to an acceptable level, or when a firm chooses not to eliminate the activities or interests creating the threat, the only course of action available will be the refusal to perform, or withdrawal from the assurance engagement.

8.40 This section is applicable to assurance engagements for periods commencing on or after _____, earlier application is encouraged.

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Introduction

- 8.100 The following examples describe specific circumstances and relationships that may create threats to independence. The examples describe the potential threats created and the safeguards that may be appropriate to reduce the threats to an acceptable level in each circumstance. The examples are not all-inclusive. In practice a firm and the assurance team will be required to assess the implications of similar, but different, circumstances and relationships and to determine whether safeguards can be applied to satisfactorily address the threats to independence.

Financial Interests

Financial Interests in an Assurance Client

- 8.101 A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).
- 8.102 When evaluating the type of financial interest, consideration should be given to the fact that financial interests range from those where the individual has no control over the investment vehicle or the financial interest held (e.g. a mutual fund or unit trust) to those where the individual has control over the financial interest (e.g. as a trustee) or is able to influence investment decisions. In evaluating the significance of any threat to independence, it is important to consider the degree of control or influence that can be exercised over the intermediary, the financial interest held, or its investment strategy. When control exists, the financial interest should be considered direct. Conversely, when the holder of the financial interest has no ability to exercise such control the financial interest should be considered indirect.
- 8.103 If a firm has a direct financial interest, or material indirect financial interest, in an assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Similarly, if a firm has a material financial interest in an entity that has a controlling interest in an assurance client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, the only appropriate action would be for the firm to dispose of the financial interest or to refuse to perform the assurance engagement.
- 8.104 If a firm's pension plan has an investment in an audit client, the self-interest created would be so significant no safeguard could reduce the threat to an acceptable level. If a firm's pension plan has an investment in an assurance client that is not an audit client, a self-interest threat may be created. Accordingly, such an interest should not be held unless:
- the trustees are legally independent; and
 - the investment is immaterial to the firm and the client.
- 8.105 If a member of the assurance team, or their immediate family member, has a direct financial interest, or a material indirect financial interest, in the assurance client, the self-interest threat created would be so significant the only safeguard available to reduce the threat to an acceptable level would be to remove the member of the assurance team from the assurance engagement.
- 8.106 If a member of the assurance team, or their immediate family member receives, by way of, for example, an inheritance, gift or as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards should be applied to reduce the threat to an acceptable level:
- disposing of the financial interest at the earliest practical date; or
 - removing the member of the assurance team from the assurance engagement.
- During the period prior to disposal of the financial interest or the removal of the individual from the assurance team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:
- discussing the matter with those charged with governance, such as the audit committee; and
 - involving an additional professional accountant to carry out reviews of the work done, or otherwise advise as necessary.
- 8.107 When a member of the assurance team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. In evaluating the significance of any threat, consideration should be given to the nature of the relationship between the member of the assurance team and the close family member and the materiality of the financial

interest. Once the significance of the threat has been evaluated, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- disposing of the financial interest at the earliest practical date;
- discussing the matter with those charged with governance, such as the audit committee;
- involving an additional professional accountant who did not take part in the assurance engagement to carry out reviews of the work done or otherwise advise as necessary; and
- removing the individual from the assurance engagement.

8.108 When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest should not be held unless:

- the member of the assurance team, an immediate family member of the member of the assurance team, and the firm are not beneficiaries of the trust;
- the interest held by the trust in the assurance client is not material to the trust;
- the trust is not able to exercise significant influence over the assurance client; and
- the member of the assurance team or the firm does not have significant influence over any investment decision involving a financial interest in the assurance client.

8.109 Consideration should be given to whether a self-interest threat may be created by the financial interests of individuals outside of the assurance team and their immediate and close family members. Such individuals would include:

- partners, and their immediate family members, who are not members of the assurance team;
- partners and professional staff who provide non-assurance services to the assurance client; and
- individuals who have a close personal relationship with a member of the assurance team.

Whether the interests held by such individuals may create a self-interest threat will depend upon factors such as:

- the firm's organizational, operating and reporting structure; and
- the nature of the relationship between the individual and the member of the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- where appropriate, policies to restrict people from holding such interests;
- discussing the matter with those charged with governance, such as the audit committee; and
- involving an additional professional accountant who did not take part in the assurance engagement to carry out reviews of the work done or otherwise advise as necessary.

8.110 If other partners, or their immediate family, in the office in which the lead engagement partner practices in connection with the audit hold a direct financial interest or a material indirect financial interest in that audit client, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such partners or their immediate family should not hold any such financial interests in such an audit client.

8.111 If other client service personnel, or their immediate family, hold a direct financial interest or a material indirect financial interests in the audit client the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. Accordingly, such personnel or their immediate family should not hold any such financial interests in such an audit client.

8.112 A self-interest threat may be created if the firm or its professional personnel have an interest in an entity and an audit client, or a director, officer or controlling owner thereof also has an investment in that entity. Whether such an interest creates a threat will depend upon the materiality of the investment in the entity held by the firm or any member of the assurance team and the audit client or any director, officer or controlling owner thereof. Independence is not impaired with respect to the audit client if the respective interests of the firm or member of the assurance team, and the audit client, or director, officer or controlling owner thereof are both immaterial and the audit client cannot exercise significant influence over the entity. If an interest is material, to either the firm or the audit client, and the audit client can exercise significant influence over the entity, no

safeguards are available to reduce the threat to an acceptable level and the firm should either dispose of the interest or decline the audit engagement. Any member of the assurance team with such a material interest should either dispose of the interest or withdraw from the audit.

- 8.113 An inadvertent violation of independence principles as they relate to financial interests in an assurance client would not impair the independence of the firm or the assurance team when:
- (a) the firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client;
 - (b) the firm promptly notifies the professional that the financial interest should be disposed of; and
 - (c) the disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.

Loans and Guarantees

- 8.114 A loan from an assurance client, that is a bank or a similar institution, to the firm would not create a threat to independence provided the loan is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client. If the loan is material to the assurance client or the firm it may be possible, through the application of safeguards, to reduce the self-interest threat created to an acceptable level. Such safeguards might include involving an additional professional accountant from outside the firm to carry out a review of the work done.
- 8.115 A loan from an assurance client, that is a bank or a similar institution, to a member of the assurance team would not create a threat to independence provided the loan is made under normal lending procedures, terms and requirements. Examples of such loans include home mortgages, bank accounts, car loans and credit card balances.
- 8.116 Similarly, deposits made by a firm or a member of the assurance team with an assurance client that is a bank or similar institution would not create a threat to independence provide the deposit is made under normal deposit terms.
- 8.117 If the firm, or a member of the assurance team, makes a loan to an assurance client, that is not a bank or similar institution, or guarantees such an assurance client's borrowing, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.
- 8.118 Similarly if the firm or a member of the assurance team accepts a loan from, or has borrowing guaranteed by, an assurance client that is not a bank or similar institution, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the assurance team and the assurance client.

Close Business Relationships with an Assurance Client

- 8.119 A close business relationship between a firm or a member of the assurance team and the assurance client or its management may involve a commercial or common financial interest and may create self-interest and intimidation threats. The following are examples of such relationships:
- (a) having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client;
 - (b) arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties; and
 - (c) distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.

Unless the relationship is clearly insignificant to the firm and the assurance client, no safeguards will reduce the threat to an acceptable level. Consequently, the only course of action is to terminate the business relationship or to refuse to perform the assurance engagement. Unless any such relationship is clearly insignificant to the member of the assurance team the only appropriate safeguard would be to remove the individual from the assurance team.

- 8.120 Business relationships involving an interest held by the firm or a member of the assurance team or their immediate family in a closely held entity when an audit client or a director or officer of an audit client, or any group thereof, also has an interest in that entity do not create threats to independence provided the interest held

is immaterial to the investor, or group of investors, and does not give the investor, or group of investors, the ability to exercise significant influence over the closely held entity.

- 8.121 The purchase of goods and services from an assurance client by the firm or a member of the assurance team would not generally create a threat to independence providing the transaction is in the normal course of business and on an arm's length basis. However, such transactions may be of a nature or magnitude so as to create a self-interest threat. If the threat created is other than clearly insignificant, safeguards should be applied to reduce the threat to an acceptable level. Such safeguards might include:
- eliminating or reducing the magnitude of the transaction;
 - removing the individual from the assurance team; and
 - discussing the issue with those charged with governance, such as the audit committee.

Family and Personal Relationships

- 8.122 Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, or related entity, may create self-interest, familiarity or intimidation threats. It is impracticable to attempt to describe in detail the significance of the threats that such relationships may create. The significance will depend upon a number of factors including the individual's responsibilities on the assurance engagement, the closeness of the relationship and the role of the family member or other individual within the assurance client. Consequently, there is a wide spectrum of circumstances that will need to be evaluated and safeguards to be applied to reduce the threat to an acceptable level.
- 8.123 When an immediate family member of a member of the assurance team is a director, an officer or an employee of the assurance client in a position to affect the subject matter of the assurance engagement, the threats to independence can only be reduced to an acceptable level by removing the individual from the assurance team. The closeness of the relationship is such that no other safeguard could reduce the threat to independence to an acceptable level. If application of this safeguard is not possible, the only course of action is to withdraw from the assurance engagement. For example, in the case of an audit of financial statements, if a member of the assurance team's spouse is an employee in a position to exert direct influence on the preparation of the audit client's accounting records or financial statements, the threat to independence could only be reduced to an acceptable level by removing the individual from the assurance team.
- 8.124 When a close family member of a member of the assurance team is a director, an officer, or an employee of the assurance client in a position to affect the subject matter of the assurance engagement, threats to independence may be created. The significance of the threats will depend on factors such as:
- the position the close family member holds with the client; and
 - the role of the professional on the assurance team.
- The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:
- removing the individual from the assurance team;
 - where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the close family member; and
 - policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.
- 8.125 Self-interest, familiarity or intimidation threats may also be created when a person who has a close relationship with a member of the assurance team is a director, an officer or an employee of the assurance client who is in a position to affect the subject matter of the assurance engagement. In this context, members of the assurance team will bear the responsibility for identifying any such persons. The evaluation of the significance of any threat created and the safeguards appropriate to reduce the threat to an acceptable level will include considering matters such as the closeness of the relationship and the role of the individual within the assurance client.
- 8.126 Consideration should be given to whether self-interest, familiarity or intimidation threats may be created by a personal or family relationship between an individual outside the assurance team and a director, an officer or an employee of the assurance client who is in a position to affect the subject matter of the assurance engagement.

- 8.127 An inadvertent violation of independence principles, as they relate to family and personal relationships, would not impair the independence of a firm or the assurance team when:
- (a) the firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence;
 - (b) either, the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement; and
 - (c) additional care is given to reviewing the work of the professional.

Employment with an Assurance Client

8.128 A firm or assurance team's independence may be threatened if an assurance client's director, officer or member of management has been a member of the assurance team or partner of the firm. Such circumstances may create self-interest, familiarity and intimidation threats particularly when significant connections remain between the individual and his or her former firm. Similarly, an assurance team's independence may be threatened when an individual participates in the assurance engagement knowing that he or she is to join the client some time in the future.

8.129 If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created will depend upon the following factors:

- the position the individual has taken at the assurance client;
- the amount of any involvement the individual will have with the assurance team;
- the length of time that has passed since the individual was a member of the assurance team or firm; and
- the former position of the individual within the assurance team or firm.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;
- involving an additional professional accountant who was not part of the assurance team to carry out reviews of the work done or otherwise advise as necessary; and
- quality control review of the assurance engagement.

In all cases the following safeguards are necessary to reduce the threat to an acceptable level:

- the individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence; and
- the individual does not continue to participate or appear to participate in the firm's business or professional activities.

A self-interest threat is created when a member of the assurance team participates in the assurance engagement while knowing that he or she is to join the assurance client. This threat can be reduced to an acceptable level by the application of safeguards such as:

- policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client;
- removal of the individual from the assurance engagement; and
- an independent review of any significant judgments made by that individual while on the engagement.

Recent Service with an Assurance Client

8.130 To have a former officer, director or employee of the assurance client serve as a member of the assurance team may create self-review and self-interest threats. This would be particularly true when a member of the

assurance team has to report on, for example, subject matter he or she had prepared or elements of the financial statements he or she had valued.

- 8.131 If, during the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to influence the subject matter of the assurance engagement, the self-review and self-interest threats created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, such individuals should not be assigned to the assurance team.
- 8.132 If, prior to the period covered by the assurance report, a member of the assurance team had served as an officer or director of the assurance client, or had been an employee in a position to influence the subject matter of the assurance engagement, this may create self-review and self-interest threats. The significance of the threats will depend upon factors such as:
- the position the individual held with the assurance client;
 - the length of time that has passed since the individual left the assurance client; and
 - the role the individual plays on the assurance team.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- involving an additional professional accountant to carry out reviews of the work done or otherwise advice as necessary; and
- discussing the issue with those charged with governance, such as the audit committee.

Serving as an Officer or as a Director on the Board of an Assurance Client

- 8.133 If a partner or employee of the firm serves as an officer or as a director on the board of an assurance client, or its related entities, the self-review and self-interest threats created would be so significant no safeguard could reduce the threat to an acceptable level. Consequently, if such an individual were to accept a position as officer or director on the board of an assurance client, the only course of action is to refuse to perform, or to withdraw from the assurance engagement.
- 8.134 The position of Company Secretary has different implications in different jurisdictions. The duties may range from administrative duties such as personnel management and the maintenance of company records and registers, to duties as diverse as ensuring that the company complies with regulations or providing advice on corporate governance matters. Generally this position is seen to imply a close degree of association with the entity and may create self-review and advocacy threats.
- 8.135 If a partner or employee of the firm serves as Company Secretary for an audit client, unless such a practice is specifically permitted under local law, professional rules and practice, the self-review and advocacy threats created would generally be so significant, no safeguard could reduce the threat to an acceptable level. Even when the practice is permitted, executive duties and management functions undertaken should be limited to those of a formal administrative nature such as the preparation of minutes and maintenance of statutory returns.
- 8.136 Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

Long Association of Senior Personnel with an Assurance Client

- 8.137 Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend upon factors such as:
- the length of time that the individual has been part of the assurance team;
 - the role of the individual on the assurance team;
 - the structure of the firm; and
 - the nature of the assurance engagement.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- considering whether such individuals should be rotated off the assurance team;

- involving an additional professional accountant who was not part of the assurance team to carry out reviews of the work done or otherwise advise as necessary; and
- independent internal quality reviews.

8.138 Using the same lead audit engagement partner on an audit over a prolonged period may create a familiarity threat. This threat is particularly relevant in the context of the audit of listed entities and safeguards could be applied in such situations to reduce such threat to an acceptable level. Accordingly for the audit of listed entities:

- (a) the lead audit engagement partner should be rotated after a pre-defined period, normally seven years; and
- (b) a partner rotating after a pre-defined period should not resume the lead audit engagement partner role until a further period of time, normally two years, has elapsed.

Provision of Non-Assurance Services to an Assurance Client

8.139 Firms have traditionally provided to their assurance clients a range of non-assurance services that are consistent with their skills and expertise. Assurance clients value the benefits that derive from having these firms, who have a good understanding of the business, bring their knowledge and skill to bear in other areas. Furthermore, the provision of such non-assurance services will often result in the assurance team obtaining information regarding the assurance client's business and operations that is helpful in relation to the assurance engagement. The greater the knowledge of the assurance client's business, the better the assurance team will understand the assurance client's procedures and controls, and the business and financial risks that it faces.

8.140 The provision of non-assurance services may, however, create threats to a firm or the assurance team's independence. The following activities would generally create self-review or self-interest threats that are so significant that only avoidance of the activity or refusal to perform the assurance engagement would reduce the threat to an acceptable level:

- authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so;
- preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders);
- determining which recommendation of the firm should be implemented; and
- reporting, in a management role, to those charged with governance.

8.141 The examples set out in paragraphs 8.148-8.186 are addressed in the context of the provision of non-assurance services to an assurance client. The potential threats to independence will likely be greatest when a non-assurance service is provided to an audit client. The financial statements of an entity provide financial information about a broad range of transactions and events that have affected the entity. The subject matter of other assurance services, however, may be limited in nature. Threats to independence, however, may, also arise when a firm provides a non-assurance service related to the subject matter of a non-audit assurance engagement. In such cases, consideration should be given to the significance of the firm's involvement with the subject matter of the non-audit assurance engagement, whether any self-review threats are created and whether any threats to independence could be reduced to an acceptable level by application of safeguards, or whether the non-assurance engagement should be declined. When the non-assurance service is not related to the subject matter of the assurance engagement, the threats to independence will generally be insignificant.

8.142 The following activities may also create self-review or self-interest threats:

- having custody of an assurance client's assets; and
- supervising assurance client employees in the performance of their normal recurring activities.

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- making arrangements so that personnel providing such services do not participate in the assurance engagement;
- involving an additional professional accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team; and
- other relevant safeguards set out in national regulations.

8.143 New developments in business, the evolution of financial markets, rapid changes in information technology, and the consequences for management and control, make it impossible to draw up an all-inclusive list of all

situations when providing non-assurance services to an assurance client might create threats to independence and of the different safeguards that might reduce these threats to an acceptable level. In general, however, a firm may provide services beyond the assurance engagement provided any threats to independence have been reduced to an acceptable level.

- 8.144 The following safeguards may be particularly relevant in reducing, to an acceptable level, threats created by the provision of non-assurance services:
- policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions;
 - discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee;
 - policies within the assurance client regarding the provision of non-assurance services by the firm;
 - involving an additional professional accountant to advise on the potential impact of the non-assurance engagement on the independence of the assurance team and the firm;
 - involving an additional professional accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement;
 - obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm;
 - disclosing to those charged with governance, such as the audit committee, the nature and extent of fees charged; and
 - making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.
- 8.145 Before the firm accepts an engagement to provide a non-assurance service, consideration should be given to whether the provision of such a service would create a threat to independence. In situations where a threat created is other than clearly insignificant, the non-assurance engagement should be declined unless appropriate safeguards can be applied to reduce the threat to an acceptable level.
- 8.146 The provision of certain non-assurance services to audit clients may create threats to independence so significant that no safeguard can reduce the threat to an acceptable level. However, the provision of such services to an immaterial related entity, division or discrete financial statement item of such clients may be permissible where any threats to the firm's independence have been reduced to an acceptable level by arrangements for that immaterial related entity, division or discrete financial statement item to be audited by another firm. This safeguard may also be applied to reducing other potential threats to independence.

Preparing Accounting Records and Financial Statements

- 8.147 Assisting an audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.
- 8.148 It is the responsibility of client management to ensure that accounting records are kept and financial statements are prepared, although they may request the firm to provide assistance. If firm personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include the following:
- determining or changing journal entries, or the classifications for accounts or transaction or other accounting records without obtaining the approval of the audit client;
 - authorizing or approving transactions; and
 - preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.
- 8.149 The audit process involves extensive dialogue between the firm and management of the audit client. During this process, management requests and receives significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for audit clients are an appropriate means to ensure the fair presentation of the financial statements. The provision of such advice does not, under normal circumstances, threaten the firm's independence. Similarly, the audit process may involve assisting an audit client in resolving account reconciliation problems, analyzing and accumulating information for regulatory reporting, assisting in the preparation of consolidated financial statements (including the translation of local statutory accounts to comply

with group accounting policies and the transition to a different reporting framework such as International Accounting Standards), drafting disclosure items, proposing adjusting journal entries and providing assistance and advice in the preparation of local statutory accounts of subsidiary entities. These are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence.

8.150 The firm may provide an audit client with accounting and bookkeeping services of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services include:

- recording transactions for which the audit client has determined or approved the appropriate account classification;
- posting coded transactions to the audit client's general ledger;
- preparing financial statements based on information in the trial balance; and
- posting audit client approved entries to the trial balance.

The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- making arrangements so such services are not performed by a member of the assurance team;
- policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client;
- requiring the source data for the accounting entries to be originated by the audit client;
- requiring the underlying assumptions to be originated and approved by the audit client; and
- obtaining audit client approval for any proposed journal entries or other changes effecting the financial statements.

8.151 The provision of other bookkeeping services to audit clients in emergency or other unusual situations, where it is impracticable for the audit client to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:

- the firm does not assume any managerial role or make any managerial decisions;
- the audit client accepts responsibility for the results of the work; and
- personnel providing the services are not part of the assurance team.

8.152 The examples in paragraphs 8.148-8.152 indicate that self-review threats may be created if the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter of an audit engagement. This notion may be equally applicable in situations when the subject matter of the assurance engagement is not financial statements. For example, a self-review threat would be created if the firm developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information. Consequently, the firm should evaluate the significance of any self-review threat created by the provision of such services. If the self-review threat is other than clearly insignificant safeguards should be considered and applied to reduce the threat to an acceptable level.

8.153 The provision of accounting and bookkeeping services, including payroll services and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided, on behalf of listed audit clients, may impair the independence of the firm, or at least give the appearance of impairing independence. Accordingly, no safeguard other than the prohibition of such services (other than those related services falling within the statutory audit mandate, where applicable) could reduce the threat created to an acceptable level and firms should not, with the limited exceptions below, provide such services to listed entities which are audit clients.

8.154 The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of listed audit clients would not be seen as impairing independence with respect to the audit client provided that the following conditions are met:

- the services do not involve the exercise of judgement;
- the divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client, or the services provided are collectively immaterial to the division or subsidiary; and
- fees to the firm from such services are collectively clearly insignificant.

If such services are provided, the following safeguards should be applied:

- the firm should not assume any managerial role nor make any managerial decisions;
- the listed audit client should accept responsibility for the results of the work; and
- personnel providing the services should not participate in the audit.

8.155 The prohibitions on the provision of certain activities as detailed in 8.141 would also apply.

Valuation Services

8.156 A self-review threat may be created when a firm performs a valuation service that directly affects the subject matter of the assurance engagement.

8.157 If the valuation service provided involved the valuation of matters that were material to the subject matter of the assurance engagement and the valuation involved a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the assurance engagement.

8.158 Performing valuation services that are neither separately nor in the aggregate material to the subject matter of the assurance engagement, or that do not involve a significant degree of subjectivity, may create a self-review threat that could be reduced to an acceptable level by the application of safeguards. Such safeguards might include:

- involving an additional professional accountant who was not part of the assurance team to carry out reviews of the work done or otherwise advise as necessary;
- confirming with the assurance client their understanding, the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
- obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm; and
- making arrangements so that personnel providing such services do not participate in the assurance engagement.

In determining whether the above safeguards would be effective, consideration should be given to the following matters:

- the extent of the assurance client's knowledge, experience and ability to evaluate the issues concerned, and the extent of their involvement in determining and approving significant matters of judgement;
- the degree to which established methodologies and professional guidelines are applied when performing a particular valuation service;
- for valuations involving standard or established methodologies, the degree of subjectivity inherent in the item concerned;
- the reliability and extent of the underlying base data;
- the degree of dependence on future events of a nature which could create significant volatility inherent in the amounts involved; and
- the extent and clarity of the disclosures in the statements.

8.159 When a firm performs a valuation service for the assurance client for the purposes of making a filing or return to a tax authority, computing an amount of tax due by the assurance client or for the purpose of tax planning this would not create a significant threat to independence because such valuations are generally subject to external review, for example by the tax authority.

Internal Audit Services

8.160 A self-review threat may be created when a firm provides internal audit services to an audit client. Internal audit services may comprise an extension of the firm's audit service beyond requirements of generally accepted auditing standards, assistance in the performance of a client's internal audit activities or outsourcing of the activities. In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.

- 8.161 Services involving an extension of normal audit services would not be considered to impair independence with respect to an audit client provided that the firm's personnel do not act or appear to act in a capacity equivalent to a member of audit client management.
- 8.162 When the firm provides assistance in the performance of a client's internal audit activities or undertakes the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by audit client management and the internal audit activities themselves.
- 8.163 Performing a significant portion of the audit client's internal audit activities may create a self-review threat and a firm should consider the threats and proceed with caution before taking on such activities. Appropriate safeguards should be put in place and the firm should, in particular, ensure that the audit client acknowledges its responsibilities for establishing, maintaining and monitoring the system of internal controls.
- 8.164 Safeguards that should be applied in all circumstances to reduce any threats created to an acceptable level include ensuring that:
- (a) the audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;
 - (b) the audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;
 - (c) the audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;
 - (d) the audit client is responsible for determining which recommendations of the firm should be implemented;
 - (e) the audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and
 - (f) the findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.

IT Systems Services

- 8.165 The provision of services by a firm to an audit client which involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may create a self-review threat.
- 8.166 The significance of any self-review threat is likely to be too high to allow the provision of such services to an audit client unless appropriate safeguards are put in place ensuring that:
- (a) audit client management acknowledges its responsibility for establishing and monitoring a system of internal controls;
 - (b) audit client management designates a competent employee, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
 - (c) audit client management makes all management decisions with respect to the design and implementation process;
 - (d) audit client management evaluates the adequacy and results of the design and implementation of the system; and
 - (e) audit client management is responsible for the operation of the system (hardware or software) and the data used or generated by the system.
- 8.167 Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the audit engagement and with different reporting lines within the firm.
- 8.168 The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to pose a threat to independence provided that firm personnel do not perform management functions.

Temporary Staff Assignments

- 8.169 The lending of staff by a firm to an audit client may create a self-review threat when the individual is in a position to influence the preparation of a client's accounts or financial statements. Each situation should be carefully analyzed to identify whether any threats are created and whether appropriate safeguards (such as

those below) need to be implemented. In practice, such assistance may be given (particularly in emergency situations) but only on the understanding that the firm's personnel will not be involved in:

- (a) making management decisions;
- (b) approving or signing agreements or other similar documents; or
- (c) exercising discretionary authority to commit the client.

In addition, the audit client should acknowledge its responsibility for directing and supervising the activities of firm personnel.

Acting for or Assisting An Assurance Client in The Resolution of a Dispute or Litigation

- 8.170 An advocacy threat may be created when a firm acts for an assurance client in the resolution of a dispute or litigation. In addition, a self-review threat may be created when the assignment includes the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements. The significance of any threat created will depend upon factors such as:
- the materiality of the amounts involved;
 - the degree of subjectivity inherent in the matter concerned; and
 - the role undertaken by the firm.
- 8.171 Acting for an assurance client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the subject matter of the assurance engagement and the degree of subjectivity inherent in the case concerned is high, would create advocacy and self-review threats so significant no safeguard could reduce the threat to an acceptable level. Therefore, the firm should not perform this type of service for an assurance client.
- 8.172 When a firm is asked to act for an assurance client in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the subject matter of the assurance engagement or the degree of subjectivity inherent in the case concerned is not high, the firm should evaluate the significance of any advocacy and self-review threats created and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:
- policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
 - using professionals who are not part of the assurance team to perform the service; and
 - the involvement of others, such as independent lawyers.
- 8.173 If the role undertaken by the firm involved making managerial decisions on behalf of the assurance client, the advocacy and self-review threats created could not be reduced to an acceptable level by the application of any safeguard. Therefore, the firm should not perform this type of service for an assurance client.
- 8.174 The provision of assistance to an assurance client in the resolution of a dispute or litigation does not in general create an advocacy threat. However, a firm should consider whether any self-review threat is created taking account of the nature of the role being undertaken. If any threat created is other than clearly insignificant appropriate safeguards should be applied to reduce the threat to an acceptable level.
- 8.175 In many jurisdictions, the firm may be asked to represent or assist an assurance client in the resolution of a dispute or litigation in relation to a tax matter before a court or tax administration. These assignments are an integral part of the overall tax services traditionally offered to audit clients and are not generally seen to create threats to independence.

Legal Services

- 8.176 Legal services encompass a wide and diversified range of areas including both corporate and commercial services to clients, such as contract support, mergers and acquisition advice and support and the provision of assistance to clients' internal legal departments. The provision of legal services by a firm to an entity that is an audit client may create both self-review and advocacy threats.
- 8.177 Threats to independence need to be considered depending on the nature of the service to be provided, whether the service provider is separate from the assurance team and the materiality of any matter in relation to the entities' financial statements. The safeguards set out in paragraph 8.144 may be appropriate in reducing any threats to independence to an acceptable level. In circumstances where the threat to independence is considered other than clearly insignificant, and safeguards cannot satisfactorily be put in place, the only available action is to decline to provide such services or withdraw from the audit engagement.

- 8.178 In general, legal services which involve matters that, either separately or in the aggregate, would not be expected to have a material effect on the financial statements are not considered to create an unacceptable threat to independence.
- 8.179 The provision of legal services to support an audit client in the execution of a transaction (e.g. contract support; legal advice) would not generally be perceived to impair independence, provided that members of the assurance team are not involved in providing the service, the service involves the execution of what has been agreed by the audit client and the assurance team will not encounter an unacceptable self-review threat as a result of the provision of legal services.
- 8.180 There is a distinction between advocacy and advice. Services comprising advice are generally not seen as impairing independence provided the audit client makes the ultimate decision. Legal services that involve, or may be seen to involve, acting as an advocate for an audit client need to be carefully considered in respect of their impact on independence. For example, acting as an advocate for an audit client in the conduct of significant litigation is likely to create a threat to independence which could not be reduced to an acceptable level by safeguards and accordingly such services should not be provided.
- 8.181 Any assessment of whether services of an advocacy nature impair independence should also take account of the body before which the firm is representing the client. For example, the more senior the Court, the more likely the greater public interest and an increased perception of an advocacy threat. Acting for an audit client before administrative bodies (e.g. in relation to financial and tax matters) would not generally be seen as creating a threat to independence.
- 8.182 The appointment as general counsel for legal affairs to an audit client would create self-review and advocacy threats that are so significant no safeguards could reduce the threats to an acceptable level. The position of general counsel is generally a senior management position with broad responsibility for the legal affairs of a company and consequently, a firm should not perform such services for an audit client.

Recruiting Senior Management for an Assurance Client

- 8.183 The recruitment of senior management for an assurance client, such as those in a position to affect the subject of the assurance engagement, may create current or future self-interest, familiarity and intimidation threats. These threats can be reduced to an acceptable level with safeguards to prohibit the firm from making management decisions on behalf of the assurance client. Therefore, the firm can advertise for and interview prospective staff and produce a list of potential candidates. Nevertheless, in every case, the decision as to whom to hire should be left to the client.

Corporate Finance and Similar Activities

- 8.184 The provision of corporate finance services, advice or assistance to an assurance client may create advocacy and self-review threats. In the case of certain corporate finance services, the independence threats created would be so significant no safeguards could be applied to reduce the threats to an acceptable level. For example, promoting, dealing in, or underwriting of an assurance client's shares is not compatible with providing assurance services. Moreover, committing the assurance client to the terms of a transaction or consummating a transaction on behalf of the client would create a threat to independence so significant no safeguard could reduce the threat to an acceptable level.
- 8.185 Other corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include assisting a client in developing corporate strategies, assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria, and providing structuring advice and assisting a client in analyzing the accounting effects of proposed transactions. Safeguards that should be considered include:
- policies and procedures to prohibit individuals assisting the assurance client from making managerial decisions on behalf of the client;
 - using professionals who are not part of the assurance team to provide the services; and
 - ensuring the firm does not commit the assurance client to the terms of any transaction or consummate a transaction on behalf of the client.

Fees and Pricing

Fees – Relative Size

- 8.186 When the total fees generated by an assurance client or related entity represent a large proportion of a firm's total fees, the dependence on that client or client group may create a self-interest threat. The significance of the threat will depend upon factors such as:
- the structure of the firm; and

- whether the firm is well established or newly created.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- discussing the extent and nature of fees charged with the audit committee, or others charged with governance;
- taking steps to reduce dependency on the client;
- external quality control reviews; and
- consulting a third party, such as a professional regulatory body or another professional accountant.

8.187 A self-interest threat may also be created when the fees generated by the assurance client represent a large proportion of the revenue of an individual partner. The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- policies and procedures to monitor and implement quality control of assurance engagements; and
- involving an additional professional accountant who was not part of the assurance team to carry out reviews of the work done or otherwise advise as necessary.

Fees – Overdue

8.188 A self-interest threat may be created if fees due from an assurance client for professional services remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. The following safeguards may be applicable:

- discussing the level of outstanding fees with the audit committee, or others charged with governance; and
- disclosure in the financial statements or the assurance report.

Pricing

8.189 A self-interest threat may be created when the assurance engagement is won because the fee involved is significantly lower than that charged by other firms. When a firm obtains an assurance engagement at a much lower fee level than that charged by the predecessor firm, or quoted by other firms, the self-interest threat created will not be reduced to an acceptable level unless the firm is able to demonstrate that appropriate time and qualified staff are assigned to the task, all assurance standards, guidelines and quality control procedures are being complied with.

Contingent Fees

8.190 Contingent fees are calculated based on the outcome or result of a transaction or the result of the work performed. For the purposes of this section, fees are not regarded as being contingent if a court or other public authority has established them.

8.191 A contingent fee charged by a firm in respect of an assurance engagement creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a firm should not enter into any fee arrangement for an assurance engagement under which the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement.

8.192 A contingent fee charged by a firm in respect of a non-assurance service provided to an assurance client may also create self-interest and advocacy threats. When the fee is contingent on a matter that forms, or will form, part of the assurance engagement, the threats cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, the only acceptable action is not to accept such engagements. In other circumstances, the significance of the threats created will depend on factors such as:

- the range of possible fee amounts;
- the degree of variability;
- the basis on which the fee is to be determined; and
- the effect of the event or transaction on the assurance engagement.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level. Such safeguards might include:

- disclosing to the audit committee, or others charged with governance, the extent of nature and extent of fees charged;
- review or determination of the final fee by an unrelated third party; and
- quality and control policies and procedures.

Gifts and Hospitality

8.193 Accepting gifts or hospitality from the assurance client creates self-interest and familiarity threats. When a firm or a member of the assurance team accepts gifts or hospitality, unless the value is clearly insignificant, the threats to independence cannot be reduced to an acceptable level by the application of any safeguard. Consequently, a firm or a member of the assurance team should not accept such gifts or hospitality.

Actual or Threatened Litigation

8.194 When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest threat may be created. The relationship between client management and the assurance team must be characterized by complete candor and full disclosure regarding all aspects of a client's business operations. The firm and the client's management may be placed in adversarial positions by litigation, affecting management's willingness to make complete disclosures and the firm may face a self-interest threat. The significance of the threat created will depend upon such factors as:

- the materiality of the litigation;
- the nature of the assurance engagement; and
- whether the litigation relates to a prior assurance engagement.

Once the significance of the threat has been evaluated the following safeguards should applied, if necessary, to reduce the threats to an acceptable level:

- disclosing to the audit committee, or others charged with governance, the extent and nature of the litigation;
- if the litigation involves a member of the assurance team, removing that individual from the assurance team; or
- involving an additional professional accountant in the firm who was not part of the assurance team to carry out reviews of the work done or otherwise advise as necessary.

If such safeguards do not reduce the threat to an appropriate level, the only appropriate action is to withdraw from, or refuse to accept, the assurance engagement.

APPENDIX H

EUROPEAN COMMISSION CONSULTATIVE PAPER ON AUDIT INDEPENDENCE

INTRODUCTION

Statutory auditors' independence is fundamental to the reliability of statutory auditors' reports. Independence of EU statutory auditors implies adding credibility to published financial information and adding value and protection to European and non European investors, creditors and other stakeholders in EU companies, particularly in such companies which are public interest entities (e.g., listed companies, credit institutions, insurance companies, investment firms, UCITS, pension funds). Independence is also the profession's main means of demonstrating to the public and regulators that statutory auditors and audit firms are performing their task at a level that meets established ethical principles, in particular those of integrity and objectivity.

In order to enhance the efficient functioning of EU capital markets, a common European approach to statutory auditors' independence is needed, which provides statutory auditors, regulators and the interested public with a common understanding of what is meant by the independence requirement, and which ensures that facts and circumstances threatening a statutory auditor's independence will be interpreted and addressed consistently throughout the EU.

This issue has been extensively discussed between the Commission and representatives of the Member States and the European audit profession in the EU Committee on Auditing. Based on these discussions, the Commission intends to issue a Recommendation on statutory auditors' independence in the EU which will recommend to Member States that their independence rules should at least meet the fundamental set of principles provided therein.

Objectives

The objectives of a Commission's Recommendation on statutory auditors' independence are to provide a fundamental set of principles that

- (1) contributes to provide EU capital markets with the assurance that statutory audits of financial information provided by European companies are carried out at uniformly high levels of audit quality;
- (2) ensures that facts and circumstances threatening statutory auditors' independence will be interpreted and addressed consistently throughout the EU;
- (3) helps to provide a level playing field for the provision of statutory audit services within the single market; and
- (4) contributes to the ongoing development of international ethical standards in order to achieve that published financial information is audited at an equivalent level throughout the world.

The European Commission and the members of the EU Committee on Auditing considered a Recommendation to be the fastest way to achieve these objectives without preparing new legislation. However, if the Recommendation does not bring about the desired harmonisation on independence rules within the EU, the Commission might have to reconsider the need for legislation.

Current Situation

The requirement for statutory auditors to be independent is provided in Council Directive 84/253/EEC 1 (Eighth Directive) "on the approval of persons responsible for carrying out the statutory audits of accounting documents" which lays down the minimum conditions for the qualification of the persons who are allowed to carry out statutory audits. Articles 24 and 25 of this Directive require Member States to prescribe that statutory auditors do not carry out statutory audits, neither on their own nor on behalf of an audit firm, if they are not independent in accordance with the law of the Member State which requires the audit. According to Article 26 of the Directive, Member States are also required to ensure that statutory auditors are liable to appropriate sanctions when they do not carry out a statutory audit in an independent manner. Furthermore, Article 27 of the Eighth Directive provides for Member States to ensure at least that the members and shareholders of an audit firm, and those members of the administrative, management and supervisory body of the audit firm who are not personally approved as statutory auditors, do not intervene in the conduct of statutory audits in any way which jeopardises the independence of the natural persons performing the statutory audit on behalf of that audit firm.

At the time of adoption of the Eighth Directive, it was impossible to agree on a common definition of statutory auditors' independence and, as a consequence, this issue has been dealt with differently in Member States, based on different traditions and experiences. Current national rules on statutory auditors' independence differ in several aspects such as the scope of persons, within and outside an audit firm, to whom independence rules should apply, the kind of financial, business or other relationships with an audit client, the type of non-audit services to audit clients that are permitted or prohibited, and the safeguards which need to be put in place.

This situation makes it difficult to provide investors and other stakeholders in EU companies with a uniform high level of assurance that statutory auditors perform their audit work independently throughout the EU.

This issue was already addressed by the 1996 Commission's Green Paper 2 on "The Role, Position and Liability of the Statutory Auditor in the EU", which was supported by the Council, the Economic and Social Committee and the European Parliament. Following from the 1998 Commission's Communication "The Statutory Audit in the European Union, the way forward"³ the EU Committee on Auditing was established which decided to put statutory auditors' independence as one of the priorities on its agenda. Finally, the Commission's Communication "EU Financial Reporting Strategy: the way forward"⁴ underlines the importance of a statutory audit carried out to uniformly high levels across the EU which includes a common approach to professional ethics standards.

As far as international developments are concerned, the Commission has recognised that there is at present no internationally accepted standard for statutory auditors' independence which could be used as a benchmark for national independence rules throughout the EU. The International Federation of Accountants (IFAC) has recently issued an Exposure Draft to modify the independence section of its Code of Ethics proposing a framework approach to address auditor independence, but at present this Code is lacking a world-wide endorsement by public authorities. The U.S. stock market regulator, the Securities and Exchange Commission (SEC) recently issued its new rules governing auditors' independence, but these rules are only designed for the statutory auditors of SEC registrants, and generally do not apply to statutory auditors of non-listed companies, and in particular not to those of SME's.

The Approach

To order to address statutory auditors' independence, the Commission proposes to issue a Recommendation providing a principles-based approach which requires auditors and audit firms to consider the expectations of those directly affected by their work, the public interest, the threats to independence which may arise in practice and the safeguards which are available to eliminate those threats or to reduce them to an acceptable level. This framework is then complemented by specific requirements which provide guidance on the application of the general principles to specific situations, including prohibitions where no other safeguard would be acceptable. Such a principles-based approach to statutory auditors' independence is preferred to detailed rules because it provides greater flexibility to react promptly and effectively to new developments in business and the audit environment than is possible with a rigid, regulation-based regime, and will therefore better serve the needs of European capital markets, as well as those of SMEs.

The proposed principles are considered to be comprehensive, rigorous, robust, enforceable and reasonable. They should be consistently interpreted and applied in letter and in spirit by professional bodies, supervisors and regulators, as well as by statutory auditors, their clients and other interested parties. To promote public confidence in the audit process, continuous monitoring is necessary in order to check whether the principles are properly applied by statutory auditors. In this regard the Commission Recommendation on "Quality Assurance for the Statutory Auditor in the EU"¹ provides for quality reviews on statutory auditors to include a review of compliance with independence rules.

The Commission Recommendation on statutory auditors' independence will provide a framework which outlines the general issues of statutory auditors' independence. It includes overall requirements for statutory auditors and the scope of persons to which independence rules should apply (Section A) as well as a set of specific requirements which a statutory auditor should apply in relation to a particular statutory audit (Section B) and a definition of important terms in a glossary (Appendix). The basic principles and essential safeguards which are identified in the Recommendation by bold type lettering are to be interpreted and implemented in the context of the explanatory and other material that provides related guidance.

PROPOSED SET OF FUNDAMENTAL PRINCIPLES ON STATUTORY AUDITORS' INDEPENDENCE

A. Framework

The basic test for the effectiveness of the approach adopted by a statutory auditor to mitigate threats and risks to his independence in respect of a particular audit engagement will be whether a reasonable and informed third party, knowing all the relevant facts and circumstances about a particular audit engagement, will conclude that the statutory auditor has neither mutual nor conflicting interests with the audit client, and is exercising objective and impartial judgement on all issues brought to his attention. The statutory auditor should have a precise understanding of what is meant by objectivity and independence, as matters both of fact and of appearance, and the approach he adopts should consider (a) the variety of persons who, besides himself, may influence the result of the audit in question, (b) all existing and potential threats and risks which may impair his independence from a stakeholder's point of view, and (c) a system of safeguards which would eliminate or mitigate these threats and risks and demonstrate his independence by, for example, declining certain relationships with the audit client.

1. OBJECTIVITY, INTEGRITY & INDEPENDENCE

- (1) Objectivity and professional integrity should be the overriding principles behind a statutory auditor's audit opinion on financial statements. The main way in which the Statutory Auditor 1 can demonstrate to the public that a Statutory Audit 2 is performed in accordance with these principles is by acting, and being seen to act, independently.**

- (2) **Objectivity (as a state of mind) cannot be subjected to external verification, and integrity cannot be evaluated in advance.**
- (3) **Principles and rules on statutory auditors' independence should allow a reasonable and informed third party to evaluate the procedures and actions taken by a Statutory Auditor to avoid or resolve facts and circumstances that pose threats or risks to his objectivity.**

Public understanding of the ethical requirements which apply to statutory auditors, and of how compliance with such requirements can be monitored, is a prerequisite for the public confidence in the public interest role of statutory audits, the reliability of audited financial statements, and the ability of the audit profession to play its proper part in the audit process. It is therefore important that there should be a common understanding of what is meant by the "statutory auditor's independence requirement",³ how it relates to the ethical requirements of "objectivity" and "integrity"¹, and how, and to what extent, compliance with these requirements can be objectively assessed.

The ultimate goal of the Statutory Audit is to express an objective audit opinion. The main means by which the Statutory Auditor demonstrates that he can express such an opinion is by demonstrating that he performs the audit process in an objective manner – that is to say with fairness, with intellectual honesty and without any conflict of interest – and with integrity, which implies fair dealing and truthfulness too.

Neither objectivity nor integrity can easily be tested or subjected to external verification, but both Member States and the audit profession have accepted rules and guidance which uphold the pre-eminence of these principles and clarify the ethical responsibilities of statutory auditors, such as those provided in Section 1 of the IFAC Code of Ethics.

The requirement that a Statutory Auditor should be independent addresses both:

- Independence of mind, i.e. the state of mind which has regard to all considerations relevant to the task in hand, but no others; and
- Independence in appearance, i.e. the avoidance of facts and circumstances which are so significant that a reasonable and informed third party would question the Statutory Auditor's ability to act objectively.

The concept of statutory auditor independence requires a test which looks first at the relevant circumstances in which the Statutory Auditor finds himself, especially at any relationship or interest which has any relevance to his task.

Independence is not an absolute standard which Statutory Auditors must attain, free from all economic, financial and other relationships which could appear to entail dependence of any kind, since this state is manifestly impossible as every person has some dependency and relationship with another.

Nevertheless, it is possible objectively to test a Statutory Auditor's compliance with the concept of independence through a monitoring process: This would look first at the relevant circumstances in which the Statutory Auditor finds himself, and especially at any relationship or interest that he may have with respect to his task. Secondly, it would look at whether such an interest or relationship would cause a reasonable and informed third party, knowing all these circumstances, to conclude that the Statutory Auditor is independent, i.e. is capable of exercising objective and impartial judgement on all issues encompassed within the statutory audit engagement. In this sense, independence could be seen as a proxy for integrity and objectivity and be verified by a reasonable and informed third party.

2. RESPONSIBILITY AND SCOPE

- (1) **It is the responsibility of the Statutory Auditor to ensure that the requirement for statutory auditors' independence is complied with.**
- (2) **The independence requirement applies to**
 - (a) **the Statutory Auditor himself; and**
 - (b) **those who are in a position to influence the outcome of the Statutory Audit.**
- (3) **Those in a position to influence the outcome of the Statutory Audit are**
 - (a) **all persons who are directly involved in the Statutory Audit (the Engagement Team), including**
 - (i) **the Audit Partners, audit managers and audit staff (the Audit Team);**
 - (ii) **professional personnel from other disciplines involved in the audit engagement (e.g., lawyers, actuaries, taxation specialists, IT-specialists, treasury management specialists);**
 - (iii) **those who provide quality control or direct oversight of the audit engagement;**
 - (b) **all persons, who form part of the Chain of Command for the Statutory Audit within the Audit Firm or within a Network 6 of which the firm is a member;**
 - (c) **all persons within the Audit Firm or its Network who, due to any other circumstance, may be in a position to exert influence on the Statutory Audit.**

Responsibility

It is the responsibility of statutory auditors, whether natural or legal persons, generally to comply with national law and national professional rules in respect of Statutory Audits, including those on independence.

In the case of a particular Statutory Audit, it is the appointed Statutory Auditor who is responsible for ensuring that the requirement for statutory auditors' independence is complied with, not only by himself and – if it is not the same legal person as the Statutory Auditor – the organisational entity forming the Audit Firm, but also by any other person who is in a position to influence the outcome of the Statutory Audit.

A Statutory Auditor, or – if the Statutory Auditor is an individual – the Audit Firm which carries out the audit work, should have adequate systems (e.g., internal organisation, employment contracts, sanctions) to guarantee that individuals within the firm comply with its independence policies and procedures (see also A. 4.3).

If a Statutory Auditor is a member of a Network, he should ensure that, in as far as they are in a position to exert influence on the Statutory Audit, the entities within this Network, their owners, shareholders, partners, managers and employees all comply with the independence rules which are applicable in the jurisdiction where the audit opinion is to be issued. This could, for example, be achieved by:

- contractual agreements which allow the Statutory Auditor to impose independence rules on his Network member firms, their Partners 1, managers and employees with regard to his particular Audit Clients 2, including inter-firm quality review procedures, and external quality assurance access;
- providing his Network member firms with regular information on Audit Clients, and requiring these firms to provide regular information on their own business and financial relationships with such clients;
- obligatory intra-firm consultation procedures in any case where there are doubts as to whether his or his Audit Client's relationship with one of the Network member firms could impair his independence as Statutory Auditor.

These instruments may also be appropriate to safeguard independence in situations where subcontractors or agents of the Statutory Auditor or the Audit Firm other than its Network member firms are involved in the audit.

For any particular audit engagement of an Audit Firm which is the Statutory Auditor, the responsibility for determining the scope of persons to whom the independence requirement applies, and what instruments and rules it may be appropriate to apply to them, generally lies with the audit Engagement Partner 3, who will need to exercise adequate professional judgement in order to fulfil this task. Since it is his responsibility to assess whether or not the independence requirement is complied with, he also should be informed on any audit and non-audit relationship which the Statutory Auditor, the Audit Firm or the Network has with the client.

Determination of the Scope

A Statutory Auditor must recognise that threats to his independence may arise not only from his own relationships with the Audit Client but also from other direct or indirect relationships with other individuals and firms within his practice and in the audit environment. The Statutory Auditor has to assess actual and potential threats arising from relationships with the natural and legal persons within the Engagement Team, within the Audit Firm and any Network of which it is a member, and with other persons, such as sub-contractors or agents for the Audit Firm or the Audit Client, including those engaged on non-audit matters, with relationships to another. He therefore has to identify any person who is in a position to influence the outcome of the Statutory Audit.

When considering the range of persons to whom independence requirements should apply, the Statutory Auditor must be sensitive to a variety of factors, such as the size and legal and organisational structure of the Audit Client, the size, structure and internal organisation of the Audit Firm and of any of the Networks of which it is a member, and the volume and nature of services provided to the Audit Client by the Audit Firm or any of its Network member firms.

For example, for a small Audit Firm of four or five Partners which is the Statutory Auditor to a company with, say, three branches all in the same state, the independence rules would probably apply to:

- the Engagement Partner, the Audit Team, and any Partner in their Chain of Command;
- any Partner with responsibility for non-audit services to the same client; and
- any other person within the firm who is, or might be seen to be, in a position to influence the outcome of the Statutory Audit;

whereas when the Statutory Auditor of a medium-sized multinational company is one firm in a Network, the scope of the rules might extend to:

- the Engagement Partner and Audit Team in the Statutory Auditor;

- any Partner and Audit Team member in the same firm or in another firm in the Network who is responsible for audit of the client's overseas entities, including any in centralised services or specialist discipline units which contribute to such work;
- any Partner in the same firm or in another firm in the Network who is responsible for providing non-audit services to the client;
- any Partner in the Chain of Command, either in the jurisdiction where the audit opinion is to be delivered or in an overseas country where audit or non-audit work is done for the Audit Client; and
- any other person within the firm or another firm in the Network who is in a position to influence the outcome of the Statutory Audit.

In either case, the independence requirements which apply to everyone within the scope are the same, the difference lies in the number of people the Statutory Auditor may need to consider for inclusion within it.

Persons Other than Members of the Engagement Team or the Chain of Command

The Statutory Auditor should give further consideration to other persons who, even if they are not part of the Engagement Team or the Chain of Command, might influence the outcome of the Statutory Audit such as , for example,

- owners or shareholders of the Audit Firm with potential influence by virtue of the significance of their voting rights. Where, for example, there are only a few owners or shareholders of an Audit Firm, all owners/shareholders might be considered as being in a position to influence the outcome of the Statutory Audit;
- individuals who have supervisory or direct management responsibility for the audit function at successive levels in any location where members of the Audit Team are employed;
- other audit and non-audit Partners with potential influence by virtue of their working relationship with a member of the Audit Team (e.g., physical proximity, shared secretarial staff etc.). Depending on factors like the size and the internal organisation of an office, practice unit, Audit Firm, or even Network, all Partners of such an entity might be considered as being in a position to influence the outcome of the Statutory Audit.

The Statutory Auditor must also consider whether, there might be persons outside the Audit Firm or its Network who, due to their relationship with persons within the firm or group, have or appear to have an ability to influence the outcome of the Statutory Audit. Examples might include family members or other close personal contacts of members of the Engagement Team or Chain of Command who hold significant financial interests in the Audit Client or who hold a key position with the client or an entity with significant interests in it (see B. 6); individuals or entities with financially significant commercial relationships with either the Statutory Auditor and his firm or the Audit Client, such as major suppliers, customers or contractors. The Statutory Auditor will need to identify those individuals in the Audit Firm or the Network whose involvement in the audit engagement might be affected by such an external influence, either in fact or in appearance, taking into account the fact that he would not be able to impose his independence rules on persons outside the Audit Firm or its Network.

3. INDEPENDENCE THREATS AND RISK

- (1) Statutory auditors' independence can be affected by different types of threats, including self-interest, self-review, advocacy, familiarity or trust, and intimidation.**
- (2) The level of risk that a Statutory Auditor's independence might be impaired will be determined by the significance of any of these threats in specific circumstances.**

In order to avoid or resolve facts and circumstances which might impair a Statutory Auditor's independence it is essential to identify the threats to independence which arise in specific circumstances, to evaluate their significance, and to determine the level of risk that a Statutory Auditor's independence may be impaired.

The more clearly a Statutory Auditor is able to identify the nature of the threats, the more clearly he can judge the level of risk to his independence that they create. Based on their general nature the following types of threats to independence have been recognised:

- Self-interest threat: the Statutory Auditor's independence may be threatened by a financial or other self-interest conflict (e.g., direct or indirect financial interest in the client, dependence on the client's audit or non-audit fees, the desire to collect outstanding fees, fear of losing the client);
- Self-review threat: relates to the difficulty of maintaining objectivity in conducting self-review procedures (e.g., when taking decisions, or taking part in decisions, which should be taken wholly by the Audit Client's management; or when any product or judgement of a previous audit or non-audit assignment performed by the Statutory Auditor or his firm needs to be challenged or re-evaluated to reach a conclusion on the current audit);
- Advocacy threat: the Statutory Auditor's independence may be threatened if the Statutory Auditor becomes an advocate for, or against, his client's position in any adversarial proceedings or situations (e.g. dealing in or

promoting shares or securities in the client; acting as an advocate on behalf of the client in litigation; when the client litigates against the auditor);

- Familiarity or trust threat: a risk that the Statutory Auditor may be over-influenced by the client's personality and qualities, and consequently become too sympathetic to the client's interest through, for example, too long and too good knowledge of the client's issues, which may result in excessive trust in the client and insufficient objective testing of his representations.
- Intimidation threat: covers the possibility that the auditor may be deterred from acting objectively by threats or by fear of, for example, an influential or overbearing client.

The significance of a particular threat depends on a variety of (quantifiable and non-quantifiable) factors such as its force, the status of the person(s) involved, the nature of the matter causing the threat, and the overall audit environment. When evaluating the significance of a threat the Statutory Auditor also has to consider that different kinds of threats may arise in one set of circumstances. With regard to one certain set of circumstances a threat can be considered significant if, considering all of its quantitative and qualitative aspects, it increases the level of independence risk to an unacceptable high level.

4. SYSTEMS OF SAFEGUARDS

- (1) **Different types of safeguards – including prohibitions, restrictions, other policies and procedures, and disclosures – have to be established in order to mitigate or eliminate threats to statutory auditors' independence (see A. 3).**
- (2) **The existence and the effectiveness of various safeguards affect the level of independence risk.**

Where threats to statutory auditors' independence exist, the Statutory Auditor should always consider and document whether safeguards are appropriately applied to negate or reduce the significance of threats to acceptable levels. The safeguards to be recognised relate to different responsibilities in the audit environment, including the governance structure of the Audit Client (see A. 4.1), the entire system of self-regulation, public regulation and oversight of the audit profession (see A. 4.2), and the Statutory Auditor's system of internal quality control (see A. 4.3).

4.1 Audited Entities' Safeguards

4.1.1 Governance Structure's Impact on Independence Risk Assessment

The Statutory Auditor should consider whether the governance structure of the audited entity provides for safeguards to mitigate threats to his independence and how these safeguards are operated. Such safeguards include:

- (1) **the appointment of the Statutory Auditor by persons other than the audited entity's management; and**
- (2) **oversight and communications within the audited entity regarding the Statutory Audit and other services provided to it by the Audit Firm or its Network.**

When analysing governance responsibilities in the Audit Client which may help to safeguard its Statutory Auditor's independence, it is appropriate to differentiate between the governance structure of a public interest client (e.g., listed companies, credit institutions, insurance companies, investment firms, UCITS, pension funds) and that of an Audit Client with relative little public interest. This differentiation is relevant to the corporate governance task, which is to particularly protect actual and potential investors, and to the appearance of the Statutory Auditor's independence.

Audit Clients of Public Interest

Concerning the appearance aspect of independence in relation to a public interest client, the Statutory Auditor has to consider the whole variety of possible perceptions of the national, regional or even international public. In this respect corporate governance plays an important role in safeguarding statutory auditors' independence.

Statutory auditors are formally appointed by a majority vote of the shareholders at the Annual General Meeting. Shareholders often appoint the Statutory Auditors recommended to them by management, particularly if no additional approval by any Governance Body 1 of the Audit Client other than management (e.g. supervisory board, non-executive directors, audit committee) or by any regulatory body (e.g. regulatory authority of a certain industry) is required. This does not necessarily protect the interests of minority shareholders or potential investors, nor does it ensure statutory auditors' independence.

Governance structures within an entity being audited therefore should ensure that the appointment of the Statutory Auditor is made in the interests of its shareholders, and that during the engagement the Statutory Auditor performs his work in the same interests. If, for example, a supervisory board or an audit committee is effectively to accomplish its task of over-seeing the financial reporting process, it must rely in part on the work, guidance and judgment of the Statutory Auditor. Integral to this reliance is the requirement that the Statutory Auditor performs his service independently.

In order to determine the significance of a threat to statutory auditors' independence and to evaluate the level of the independence risk (see A. 3), the Statutory Auditor should carefully consider whether the audited entity's governance provides an appropriate infrastructure to generally safeguard its statutory auditor's independence. The analysis of such an infrastructure may include issues such as:

- the involvement of a Governance Body in the Statutory Auditor's appointment (e.g., formal approval of management's recommendation vs. active participation in negotiations with the potential Statutory Auditor);
- the duration of the Statutory Auditor's appointment (one audit vs. long-term contract);
- the involvement of a Governance Body in commissioning non-audit services from the Statutory Auditor, the Audit Firm or to any entity within the Network of which it is a member (e.g., no involvement vs. participation when negotiating significant engagements);
- the existence of oversight and communications regarding the Statutory Audit and other services provided to the audited entity by the Statutory Auditor, the Audit Firm or its Network, and the frequency of such communications with the Statutory Auditor.

Other Audit Clients

When auditing clients other than public interest entities, the Statutory Auditor should also analyse whether the governance infrastructure of the Audit Client provides general safeguards to his independence. However, when auditing an entity of relative little public interest (e.g., a small manager-owned production company) the Statutory Auditor may be able to identify certain groups of his Audit Client's stakeholders (e.g., employees, actual and potential creditors, local authorities), their specific expectations, and, as a result thereof, specific threats to his independence which can be appropriately addressed by particular safeguards within the audited entity, other than those generally provided by corporate governance. Such safeguards, for example, could include

- the Audit Client's employment of a sufficient quality and quantity of staff to ensure that the Statutory Auditor does not make managerial decisions; and
- appropriate internal procedures for objective choice in commissioning non-audit engagements.

4.1.2 Involvement of the Governance Body

- (1) **Where a public interest entity has a Governance Body (see A. 4.1.1), the Statutory Auditor should at least annually:**
 - (a) **disclose to the Governance Body, in writing:**
 - (i) **all relationships between himself, the Audit Firm and its Network member firms, and the Audit Client and its Affiliates 1 that may reasonably be thought to bear on the independence and the objectivity of the Statutory Auditor; and**
 - (ii) **the related safeguards that are in place;**
 - (b) **confirm in writing that, in his professional judgement, the Statutory Auditor is independent within the meaning of regulatory and professional requirements and the objectivity of the Statutory Auditor is not impaired; and**
 - (c) **discuss these matters with the Governance Body of the Audit Client.**
- (2) **Where Audit Clients other than public interest entities have a Governance Body, the Statutory Auditor should consider whether similar measures are appropriate.**

As stated under A. 4.1.1, to some extent it is the responsibility of the Audit Client to safeguard the independence of its Statutory Auditor. Discussions between the Statutory Auditor and the Governance Body of the client are the main means to establish a link between the Statutory Auditor's own safeguards and those of the Audit Client. To protect himself and to allow the quality assurance regime (see A. 4.2) to verify his compliance with this requirement, the Statutory Auditor should initiate the process by writing to the Audit Client to invite him to discuss these issues.

4.2 Quality Assurance

Quality assurance systems which meet the minimum requirements of the Commission Recommendation on "Quality Assurance for the Statutory Audit in the EU"¹ are required mechanisms contributing to safeguard statutory auditors' compliance with the independence requirement at a Member State level.

To ensure that professional standards, including the independence requirement, are complied with by Statutory Auditors, a control or enforcement system is needed. Safeguards and procedures to be considered include an overall control environment, starting with a professional approach towards matters of quality and ethics and taking into account the assurance provided by a regularly monitored and evidenced control system. One way to enforce independence requirements is the Member State system for quality assurance on Statutory Audits. The Commission Recommendation

on “Quality Assurance for the Statutory Audit in the EU” recommends that statutory auditors’ compliance with ethical principles and rules, including independence rules, should be subjected to quality review procedures. As the recommended systems of quality assurance include public oversight they are also able to address the public perception of independence issues.

4.3 The Statutory Auditor’s Overall Safeguards

4.3.1 Ownership of and Control over Audit Firms

- (1) If the Statutory Auditor is an Audit Firm, the majority of the firm’s voting rights (50% plus one vote) must be held by persons who are authorised to perform Statutory Audits within the European Union (statutory auditors 2). The Statutory Auditor’s legal statutes should contain provisions to ensure that a non-auditor owner could not gain control over the Audit Firm.**
- (2) Neither the Audit Firm nor any of its Network member firms should provide statutory audit services to a non-auditor owner or its Affiliates where the voting rights which the non-auditor owner holds in the Audit Firm exceed 5% of the total voting rights.**

Need to Safeguard Control over the Audit Firm

For an Audit Firm to be authorised to carry out Statutory Audits, Article 2.1 b) ii) of the 8 th Company Law Directive requires the majority of the Audit Firm’s voting rights to be held statutory auditors who have been approved by a competent authority of any of the EU Member States, i.e., natural persons or firms who satisfy at least the minimum conditions of that Directive.

Without any further restrictions, this would allow Audit Firms to raise capital on capital markets by either private or public offerings. Some Member States regard such funding as raising serious concerns about statutory auditor independence and have imposed more restrictive rules on the ownership of Audit Firms (e.g. allowing a maximum of 25% ownership by individuals who are not statutory auditors, or restricting minority ownership to members of certain regulated professions only).

There is a concern about whether holding majority voting rights is sufficient to ensure that statutory auditors control the firm. For example, if one non-auditor held 49% of voting rights and the other 51% were divided among a number of statutory auditors, the non-auditor owner could have effective control of the Audit Firm. In this respect, careful attention should be paid to the threats to statutory auditors’ independence which can result and consideration should be given to the safeguards needed to avoid such situations. These might include, for example, limiting the voting rights of a single non-auditor owner to 5% or 10% of the whole. Where only a few statutory auditors hold the majority of voting rights in an Audit Firm, it may be appropriate to allow certain individuals to hold a higher proportion than this, in particular if these individuals are members of a regulated profession (e.g., lawyers, notaries), or other persons (e.g., management or other professional consultants) whose professional activities rest with the Audit Firm or with one of its Network members.

The risks that relationships between the Statutory Auditor, the Audit Firm and a non-auditor owner of the Audit Firm and an Audit Client might impair the Statutory Auditor’s independence should be addressed by reference to A. 2, which sets out the scope of persons to which the independence requirement applies, and B. 1 and B. 2, which consider the financial and/or business links which may exist between them. The threat to independence is however considered too high, to permit a Statutory Auditor, an Audit Firm or any member of its Network to provide statutory audit services to a non-auditor owner who holds over 5% of the voting rights in the Audit Firm.

4.3.2 The Audit Firm’s Internal Safeguarding System

- (1) A Statutory Auditor should be required to set up and maintain a safeguarding system which is an integral part of his firm-wide management and internal control structure.**
- (2) The functioning of such a system should be properly documented so that it can be subject to quality assurance systems (see A. 4.2).**
- (3) Generally, the safeguarding system of an Audit Firm would include:**
 - (a) written independence policies which address current independence standards, threats to independence, and the safeguards related thereto;**
 - (b) active and timely communication of the policies, and any changes to them, to each Partner, manager and employee, including regular training and education thereon;**
 - (c) appropriate procedures to be applied by Partners, managers and employees in order to meet independence standards, both on a regular basis and in response to particular circumstances;**
 - (d) designation of top-level audit professionals (Partners) responsible for updating the policies, timely communication of those updates, and overseeing the adequate functioning of the safeguarding system;**

- (e) **documentation for each Audit Client to show whether or not there were circumstances and facts which might have threatened the Statutory Auditor's independence, how potential threats were evaluated, and, if significant threats were noted, what steps were taken to avoid, negate, or at least reduce the independence risk to an appropriate level; and**
- (f) **internal monitoring of compliance with safeguarding policies.**

As far as the Statutory Auditor is concerned, he has to comply with independence standards, regardless of whether those are imposed by law or regulators, or by professional bodies as part of a self-regulatory regime, or adopted voluntarily as part of the Audit Firm's own policy. In order to ensure his compliance the Statutory Auditor needs to set up a system of related safeguards, or – if the Statutory Auditor and the Audit Firm are not identical legal persons – at least require the Audit Firm to do so.

Audit Firm's Independence Policies

An Audit Firm should develop independence policies covering activities which are acceptable and not acceptable when performed for Audit Clients or their Affiliates.

Regardless of how detailed independence standards are developed, the objective is to enforce appropriate implementation and maintenance of Statutory Auditors' safeguards and to encourage their continuous improvement. This is why the Audit Firm's independence policies should be flexible enough to be regularly updated when either circumstances and facts or, even due to a change in public expectations, independence standards change.

The design and documentation of the Audit Firm's independence policies should reflect the immediate practice environment (e.g., size and organisational structure of the Audit Firm) and the audit environment (e.g., client and business portfolio of the Audit Firm, others outside the Audit Firm who are involved in Audit Firm's assignments) as well.

An Audit Firm must have in place appropriate policies and procedures to ensure that the relevant Engagement Partner is notified of any other relationship which exists between the firm and its group member firms, and the Audit Client and its Affiliates. This includes the requirement that the Engagement Partner has to be consulted prior to acceptance of any assignment from the Audit Client or its Affiliates. It is then the responsibility of the Engagement Partner to assess whether any such relationship may reasonably be thought to affect the independence of the Statutory Auditor. In cases where the Audit Client has a Governance Body (see A. 4.1), it might be appropriate to involve that body in this process.

Where persons others than the Audit Firm, its Partners, managers and employees are involved with the Audit Client or in the audit assignment (e.g.; subcontracted specialists, Network member firms), the Audit Firm's independence policies should also address requirements and consultation processes needed to prevent these persons from causing an unacceptable level of independence risk for the Statutory Auditor.

In order to ensure that its Partners, managers and employees comply with its independence policies the Audit Firm will need to communicate its policies appropriately, and to educate and train these individuals on a regular basis. This should also include informing them about sanctions for independence policy violations.

Procedures to be Applied

In accordance with the independence policies adopted by an Audit Firm and depending on its size, the procedures to be applied by Partners, managers and employees may vary. While for a small Audit Firm it might be appropriate to consider its independence only on a case by case basis, and then to decide on certain procedures to mitigate the independence risk, a large Audit Firm might need to establish routine procedures in order to detect even hypothetical threats to the Statutory Auditor's independence. For example, to detect a self-interest threat resulting from financial or business relationships it might be necessary for such an Audit Firm to maintain a regularly updated database (e.g., restricted entity list) which provides all its Partners, managers and employees who are or are likely to be in a position to influence the outcome of any Statutory Audit the Audit Firm is performing or going to perform, with information on all Audit Clients which may give rise to a self-interest threat if they fulfil certain criteria. The operation of this safeguarding system will require these individuals to regularly provide the Audit Firm with certain personal and client information.

Depending on its size and structure, it might also be adequate for an Audit Firm or Network to establish internal procedures to ensure that there is appropriate consultation across the firm or Network about any client where the significance of an independence threat is unclear. This consultation would involve experienced Partners who are not involved in the Audit Client's affairs and who are not impacted by the independence threat in question.

Documentation of Independence Assessment

The main purpose of the Statutory Auditor's documentation of his independence assessment on a certain Audit Client is to provide evidence that he performed his assessment properly. It is considered appropriate that such documentation should be included in the audit files.

Internal Monitoring of Compliance

The monitoring of compliance with the Audit Firm's independence policies should be an integral function of the Audit Firm's quality review structure. Where large Audit Firms may designate this task to quality control specialists, or even independence specialists, small and medium sized Audit Firms, which generally assess their independence only on a case by case basis, should at least have their individuals' compliance reviewed by a Partner who is not a member of the particular Engagement Team. In the case of sole practitioners and of small partnerships where either all Partners are in the Engagement Team or the involvement of any other Partner outside the Engagement Team would increase the level of independence risk (e.g., when this Partner provides significant non-audit services to the Audit Client), the Statutory Auditor should either seek advice from his professional regulatory body or ask for a review by another statutory auditor.

B. Specific Requirements

1. FINANCIAL INVOLVEMENT

- (1) **An actual or impending, direct or indirect financial interest in the Audit Client or its Affiliates, including any derivative directly related thereto, may threaten the Statutory Auditor's independence, if it is held by the Statutory Auditor or any other person being in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2).**

The Statutory Auditor has to assess the significance of any such threat, identify whether any safeguards would mitigate the independence risk it presents, and take any action necessary, such as refusal of or resignation from the audit engagement or exclusion of the relevant person from the Audit Team. Where applicable, the Governance Body of a public interest client should be involved in this process.

- (2) **Financial involvement in the Audit Client or its Affiliates will be incompatible with the Statutory Auditor's independence, if**
- (a) **the Statutory Auditor, the Audit Firm, or any member of the Engagement Team or the Chain of Command, or any Partner of the firm or its Network who is working in an "Office"¹ which participates in a significant proportion of an audit engagement, holds**
- (i) **any direct financial interest in the Audit Client; or**
- (ii) **any indirect financial interest in the Audit Client which is significant to either party; or**
- (iii) **any (direct or indirect) financial interest in the client's Affiliates which is significant to either party;**
- (b) **any other person within the scope of A. 2, holds any (direct or indirect) financial interest in the Audit Client or its Affiliates which is significant to either party.**

The persons concerned should not therefore hold any of such financial interests. Where such an interest is acquired as a result of an external event (e.g. inheritance, gift, merger of firms or companies) it must be disposed of at the earliest practicable date. In the meantime, additional safeguards are needed to ensure the Statutory auditor's independence, such as secondary review of the relevant person's audit work or exclusion of the relevant person from any substantive decision making concerning the Statutory Audit of the client.

- (3) **The Statutory Auditor's independence may also be threatened by an apparently insignificant financial interest in an Audit Client or its Affiliates. The level of threat will be higher, and likely to be unacceptable, if the interest is acquired or held on other than standard commercial terms. It is the responsibility of the Statutory Auditor to assess the level of risk that such an interest presents and to ensure that any necessary mitigating action is taken.**

The term "financial interest" would comprise of, in a broad sense, the whole variety of financial interests which the Statutory Auditor himself, his Audit Firm or any other person within the scope of section A. 2 may have in an Audit Client or in any Affiliate of the client. It includes "direct" and "indirect" financial interests such as

- direct or indirect shareholding in the Audit Client or its Affiliates,
- holding or dealing in securities of the Audit Client or its Affiliates,
- accepting pension rights or other benefits from the Audit Client or its Affiliates.

Commitments to hold financial interests (e.g. contractual agreements to acquire a financial interest) and derivatives which are directly related to financial interests (e.g., stock options, futures, etc.) should be dealt with in the same way as would an already existing financial interest.

Direct Financial Interests

When the persons who are directly involved in the conduct of the statutory audit (the Statutory Auditor, the Audit Firm, an individual of the Engagement Team or within the Chain of Command) hold a direct financial interest in the Audit Client, such as shares, bonds, notes, options, or other securities, the significance of the self-interest threat is considered to be too high to enable any safeguards to reduce the Statutory Auditor's independence risk to an acceptable level.

In such a case the Statutory Auditor either has to withdraw from the engagement or, if an individual of the Audit Firm holds the direct financial interest, has to exclude this individual from the engagement.

Where Partners of the Audit Firm or its Network who are working in an office or operational unit which participates in a significant portion of an audit engagement ("Office"), have a direct financial interest in the Audit Client, the perception of self-interest is also considered as too high to allow this situation to be maintained.

Indirect Financial Interests

The term "indirect financial interest" refers to situations where, for example, a person within the scope of A. 2 has investments in non-client entities that have an investment in the Audit Client, or in companies in which an Audit Client also has invested.

A person within the scope of A. 2 should not hold such an indirect financial interest, where the self-interest threat resulting from this financial involvement is significant. This is particularly the case when an indirect shareholding in the Audit Client allows or appears to allow that person to influence management decisions of the Audit Client (e.g., by significant indirect voting rights), or when the direct shareholder due to any circumstance can or appears to be able to influence the outcome of the Statutory Audit. In addition, an unacceptable level of independence risk would also arise from situations where the Statutory Auditor or any other person within the scope of A. 2 serves as voting trustee of a trust or executor of an estate containing securities of an Audit Client, provided that no appropriate safeguards exist to mitigate this risk, such as supervision and control by beneficiaries, governmental authorities or courts.

On the other hand, the potential self-interest threat to the Statutory auditor's independence may be regarded as insignificant to the independence risk if, for example, when holding indirect financial interests in the Audit Client

- the financial interest is directly held by an investment fund, pension fund, UCITS or an equivalent investment vehicle, and
- the person holding the indirect interest is not directly involved in the audit of the fund manager, nor can influence the individual investment decisions of the fund manager.

External Events

If a financial interest that would create a significant threat to the Statutory Auditor's independence is acquired as a result of an external event (e.g. inheritance, gift, merger of firms or companies), it must be disposed of at the earliest practicable date. If the interest were shares in a listed company, for example, this would mean that the shares should be sold at the earliest opportunity in accordance with applicable stock exchange regulations that govern the disposal or sale of shares by those with insider knowledge.

Until the financial interest is disposed of, additional safeguards are needed to ensure the Statutory auditor's independence. For example, where a Statutory Auditor becomes aware that a member of the Engagement Team has acquired shares in a client as the result of inheritance, that individual should not continue to be a member of the Engagement Team until the shares have been sold, or, if this individual cannot be replaced by another individual of equal competence, a secondary review has to be carried out on the audit work of the individual concerned.

Inadvertent Violations

There will be occasions where the Statutory Auditor becomes aware that an individual in his Audit Firm inadvertently holds a financial interest in an Audit Client or in one of its Affiliates which, in general, would be regarded as a violation of independence requirements. Such inadvertent violations will not impair the Statutory Auditor's independence with respect to an Audit Client, provided that the Statutory Auditor

- has established procedures that require all professional personnel to report promptly to him any breaches of the independence rules resulting from the purchase, inheritance or other acquisition of a financial interest in an Audit Client by such individuals (see also A.4.3.2);
- promptly notifies the individual to dispose of the financial interest at the earliest opportunity after the inadvertent violation is identified; and
- takes particular care when reviewing the relevant audit work of this individual.

Where it proves impossible to compel the individual to dispose of the financial interest, the individual should be removed from the Engagement Team and/or excluded from any substantive decision making concerning the Statutory Audit of the client.

Whatever financial involvement exists, it is primarily the Statutory auditor's safeguarding system (see A. 4.3) which should provide evidence that the threats to independence have been identified and investigated, have been discussed with the client's Governance Body where appropriate, and that a decision has been taken about whether or not they are significant and the reasons behind that decision have been recorded.

2. BUSINESS RELATIONSHIPS

- (1) **Business relationships between the Statutory Auditor, the Audit Firm or any other person being in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2) on the one hand, and the Audit Client, its Affiliates, or its management on the other hand, may cause self-interest, advocacy or intimidation threats to the Statutory Auditor's independence.**
- (2) **Business relationships, or commitments to establish such relationships, should be prohibited unless the relationship is in the normal course of business and insignificant.**

With regard to public interest clients, and where applicable, any cases where doubt arises whether or not a business relationship is in the normal course of business and insignificant this should be discussed with the Governance Body of the Audit Client.

Business Relationships

Business relationships are considered to mean relationships which involve a commercial or financial common interest between the Statutory Auditor, the Audit Firm or any other person being in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2) on the one hand and the Audit Client, an Affiliate of the client, or the management thereof on the other. The following are examples of such relationships that may, if significant to the auditor or conducted outside the normal course of business, cause a self-interest, advocacy or intimidation threat:

- having a financial interest in a joint venture with the Audit Client, or with an owner, managing director or other individual who performs senior management functions of that client;
- having a financial interest in a non-audit client that has an investor or investee relationship with the Audit Client;
- giving a loan to the Audit Client or guarantees for the Audit Client's risks;
- accepting a loan from an Audit Client or having borrowings guaranteed by the Audit Client;
- providing services to a managing director or another individual performing a senior management function of the Audit Client in respect of the personal interest of such individual;
- receiving services from the Audit Client or its Affiliates which concern underwriting, offering, marketing or selling of securities issued by the audit firm or one of its group member firms.

Commitments to establish such relationships should be dealt with in the same way as would an already established relationship.

In the Normal Course of Business

In the normal course of its business, a Statutory Auditor might not only render audit or non-audit services to the Audit Client or to its Affiliates, but might also purchase goods or services provided by these entities (e.g. insurance and bank services, commercial loan agreements, purchase of office equipment, EDP software, or company cars). If these transactions are performed at arm's length (as between third parties), it is considered that they generally do not threaten the Statutory Auditor's independence (e.g. purchase of goods which are offered under normal wholesale discount terms, and are available to the whole of the client's other customers). However, the Statutory Auditor should carefully consider the risk that even an arm's length transaction could reach a magnitude which threatens his independence by creating financial dependencies, either in fact or at least in appearance.

Accepting any goods or services from an Audit Client on favourable terms is not considered as being within the normal course of business, unless the value of any benefit is insignificant.

Significance of Independence Risk

Whether a business relationship would be regarded as a significant threat to the Statutory Auditor's independence depends on whether a reasonable and informed third party would assume that such a relationship could have an influence on the outcome of the Statutory Audit. Objective criteria are therefore needed in order to evaluate the significance of a relationship to the Statutory Auditor, as well as to the Audit Client. With regard to the financial statements and the audit task, the relationship should neither enable the Statutory Auditor, the Audit Firm or one of its Network members to influence management decisions of the Audit Client nor allow the Audit Client, or one of its Affiliates to influence the outcome of the Statutory Audit, nor appear to enable such influences.

Whatever business relationship exists, it is primarily the task of the Statutory Auditor's safeguarding system (see A. 4.3) to provide evidence that the threats of such transactions have been identified and investigated, have been discussed

with the client's Governance Body, where appropriate, and that a decision has been taken about whether or not the risk to independence is significant and the reasons behind that decision have been recorded.

3. EMPLOYMENT WITH THE AUDIT CLIENT

- (1) **Dual employment of any individual who is in a position to influence the outcome of the Statutory Audit both in the Audit Firm (a person within the scope of A. 2) and in the Audit Client or its Affiliates should be prohibited. Loan staff assignments to an Audit Client or any of its Affiliates are also regarded as dual employment relationships. Where an Audit Firm's employee has worked with an Audit Client under a loan staff assignment and is to be assigned to the audit Engagement Team of that client's Statutory Audit, this individual should not be given audit responsibility for any function or activity that he was required to perform or supervise during the former loan staff assignment (see also B. 5 below).**
- (2) **Where a member of the Engagement Team is to leave the Audit Firm and join an Audit Client, policies and procedures of the Audit Firm (see A 4.3) should provide:**
 - (a) **a requirement that members of any Engagement Team immediately notify the Audit Firm of any situation involving their potential employment with the Audit Client;**
 - (b) **the immediate removal of any such Engagement Team member from the audit engagement; and**
 - (c) **an immediate review of the audit work performed by the resigning or former Engagement Team member in the current and/or (where appropriate) the most recent audit by an Audit Firm's audit professional at least one level higher. If the individual was an Audit Partner or the Engagement Partner, the review should be performed by an Audit Partner who was not involved in the audit engagement. (Where, due to its size, the Audit Firm does not have a Partner who was not involved in the audit engagement, it may seek either a review by another statutory auditor or advice from its professional regulatory body.)**
- (3) **Where a former Engagement Team member or an individual within the Chain of Command has joined an Audit Client, policies and procedures of the Audit Firm should ensure that there remain no significant connections between itself and the individual. This includes:**
 - (a) **regardless of whether the individual was previously involved in the audit engagement, that all capital balances and similar financial interests must be fully settled (including retirement benefits) unless these are made in accordance with pre-determined arrangements that cannot be influenced by any remaining connections between the individual and the Audit Firm;**
 - (b) **that the individual does not participate or appear to participate further in the Audit Firm's business or professional activities.**

Policies and procedures to be included in the overall safeguarding system of the Audit Firm (see A. 4.3) should recognise that different treatments may be required, depending on (a) the position of the departing individual at the Audit Firm (e.g. Partner vs. senior or other professional), (b) the circumstances which lead to the departure (e.g. retirement, termination, voluntary withdrawal), (c) the position the departing individual is taking at the client (e.g., managerial position vs. position with insignificant influence on the financial statements), (d) the length of time that has passed since the individual left the Audit Firm, and (e) the length of time that has elapsed since the departing individual performed services related to the audit engagement.

Where the individual leaving the Audit Firm was an Engagement or Audit Partner, the required secondary partner's review should also consider the risks that the former partner might be perceived as, for example, having been influenced by the client during the previous audit; or having established close relationships with other Audit Team members which might threaten the independence of those staying on the Audit Team; or using his knowledge of the current audit approach and testing strategy to circumvent the audit designs.

A small Audit Firm which is not able to perform a secondary partner's review might appropriately seek either a secondary review performed by another statutory auditor or, at least, advice from its professional regulatory authority.

4. MANAGERIAL OR SUPERVISORY ROLE IN AUDIT CLIENT

- (1) **An individual who is in a position to influence the outcome of the Statutory Audit (a person within the scope of A. 2) should not be a member of any management (e.g. board of directors) or supervisory body (e.g. audit committee or supervisory board) of an Audit Client. Also, he should not be a member of such a body in an entity which holds directly or indirectly more than 20% of the voting rights in the client, or in which the client holds directly or indirectly more than 20% of the voting rights.**
- (2) **When a person who was formerly a member of the Engagement Team takes a managerial or supervisory role in an Audit Client, B. 3(3) will apply.**

In addition to the risks in taking a managerial or supervisory role in an Audit Client, membership of a managerial or supervisory body of an entity which is not an Audit Client (non-client entity), but is in a position to influence the Audit

Client, or where the Audit Client is in a position to influence the non-client entity, creates an unacceptably high level of independence risk due to intimidation and self-review threats and should therefore be prohibited.

Where national law requires members of the audit profession to undertake supervisory roles in certain companies, safeguards must ensure that such professionals do not have any responsibility with regard to the Engagement Team.

B. 4 (2) recognises that a former member of an Engagement Team who leaves the Audit Firm, whether to retire or to take up a post with a non-client entity, might be invited to take a non-executive post on a management or supervisory body of the Audit Client. In such cases, the Audit Firm will need to ensure that requirements at B. 3 (3) are met.

5. ESTABLISHING EMPLOYMENT WITH AUDIT FIRM

Where a director or manager of the Audit Client has joined the Audit Firm, this person should neither become a member of the Engagement Team nor, as a member of the Chain of Command, take part in any substantive decisions concerning this client or its Affiliates at any time in the two year period after leaving the Audit Client. This requirement also applies to a any former employee of the Audit Client unless the responsibilities he held and the tasks he performed at the Audit Client were insignificant in relation to the statutory audit function.

When a director or manager of an Audit Client joins the Audit Firm, the self-review threat is considered as too high to be mitigated by any other safeguard than to prohibit such a person from becoming a member of the Engagement Team or from taking part in any substantive decisions concerning the client's audit for a two-years period of time. Where a former employee of the Audit Client joins the Audit Firm, the significance of the self-review threat will relate to the responsibilities and tasks this employee had at the Audit Client and those he is going to take at the Audit Firm. For example, if the former employee prepared accounts or valued elements of the financial statements, the same safeguards would apply as for a director or manager; on the other hand, when the former employee held, for example, a non-management position in a branch of the Audit Client, the self-review threat may be mitigated if his activities as a member of the Engagement Team do not relate to that branch.

6. FAMILY AND OTHER PERSONAL RELATIONSHIPS

- (1) An individual who is a Statutory Auditor should not accept an audit engagement if one of his close family members**
 - (a) holds a senior management position with the Audit Client;**
 - (b) is in a position to exert direct influence on the preparation of the Audit Client's accounting records or financial statements;**
 - (c) has a financial interest in the Audit Client (see B. 1) unless it is insignificant; or**
 - (d) has a business relationship with the Audit Client (see B. 2) unless it is in the normal course of business and insignificant.**
- (2) Within an Audit Firm or Network an individual should not be assigned to the Engagement Team if one of his close family members meets any of the criteria under (1) (a) to (d) above, nor should an Audit Partner who is working in an "Office" where any of the other Partners in it has a close family member who meets these criteria.**

Appropriate safeguards should ensure that a member of the Chain of Command does not participate in any substantive decisions concerning the audit engagement if one of his close family members meets any of the criteria under (1) (a) to (d) above, or if he is working in an "Office" where any of the Partners in it has a close family member who meets these criteria.

- (3) The Statutory Auditor should consider whether he or any other individual in the Engagement Team or Chain of Command, or any person working in an "Office" which includes himself or such an individual, has any other close non-family personal relationships where similar safeguards would be needed.**
- (4) Assessment of the facts of a relevant individual's close family or non-family personal relationship should be based upon the best knowledge of the Statutory Auditor and the individual concerned, and the individual should be responsible for disclosing to the Statutory Auditor any fact and circumstance which might require safeguards to mitigate an unacceptable level of independence risk.**

The Statutory Auditor must be able to assess the risk to his independence when he or any member of the audit Engagement Team or the Chain of Command, or anyone in an "Office" which includes himself or such an individual, has any close family member or a close non-family relationship with anyone who meets the criteria under 1(a) to (d). His consideration of the facts should be based on his best knowledge of the circumstances of all relevant individuals, and he should have policies and procedures in place which require such individuals to disclose any fact or circumstance which he should take into account. The Statutory Auditor should evaluate all such information, determine whether any of the criteria are met and take any necessary mitigating action within a reasonable period of time. Such action might include refusal of the engagement, or exclusion of an individual from the Engagement Team or the "Office".

Close family members

The term “close family members” normally refers to parents, siblings, spouses or cohabitants and children and other dependants. It may extend to other family members who may have less immediate but not necessarily less close relationships with the relevant individual, such as former spouses or cohabitants and the spouses and children of family members.

Close non-family relationships

Other close relationships are hard to define but would include those with any person other than a family member which entail frequent or regular social contact.

Inadvertent Violations

There will be occasions where the Statutory Auditor becomes aware that an individual in his Audit Firm inadvertently has not reported to the firm a family or other personal relationship with an Audit Client which, in general, would be regarded as a violation of independence requirements. Such inadvertent violations will not impair the Statutory Auditor’s independence with respect to an Audit Client, provided that the Statutory Auditor

- has established procedures that require all professional personnel to report promptly to him any breaches of the independence rules resulting from changes in their family or other personal relationships, the acceptance of an audit sensitive position by their close family members or other close persons, or the purchase, inheritance or other acquisition of a significant financial interest in an Audit Client by such family members or persons;
- promptly removes the individual from the Engagement Team and/or excludes the individual from substantive decisions concerning the Statutory Audit of the relevant client, or, in case of significant financial interests, notifies the individual to ensure that the financial interest is disposed of at the earliest opportunity after the inadvertent violation is identified; and
- takes particular care when reviewing the relevant audit work of this individual.

7. NON-AUDIT SERVICES**7.1 General**

- (1) **Where a Statutory Auditor, an Audit Firm or one of its Network member firms provides services other than statutory audit work (non-audit services) to an Audit Client, the overall safeguarding system (A 4.3) of the Statutory Auditor has to ensure that**
 - (a) **the individuals employed by either the Audit Firm or its Network member firm neither take any decision nor take part in any decision-making on behalf of the Audit Client, or its management, either in the course of the statutory audit assignment or while providing a non-audit service; and**
 - (b) **where, due to specific threats which may result from the nature of a non-audit service, an independence risk remains, this risk is reduced to an acceptable level.**
- (2) **Even if not involved in the Audit Client’s decision-making, the Statutory Auditor should consider, among others, which of the following safeguards in particular may mitigate a remaining independence threat:**
 - (a) **arrangements to reduce the risk of self-review by compartmentalising responsibilities and knowledge in specific non-audit engagements;**
 - (b) **routine notification of any audit and non-audit engagement to those in the Audit Firm or Network who are responsible for safeguarding independence, including oversight of ongoing activities;**
 - (c) **secondary reviews of the Statutory Audit by an Audit Partner who was not involved in the provision of any services to the Audit Client; or**
 - (d) **external review by another statutory auditor or advice by the professional regulatory body.**

Independence from Audit Client’s Decision-Making

The self-review threat is always considered too high to allow the provision of any services other than statutory audit work which would involve the Statutory Auditor in any decision-making of either the Audit Client or its management. Therefore, if the Statutory Auditor or a member within his Network intends to provide non-audit services to an Audit Client, the Statutory Auditor has to ensure that any individual acting for or on behalf of the Audit Firm or its Network member does not take any decision for, nor take part in any decision-making on behalf of, the Audit Client or its management. Any advice or assistance related to any service provided by the Statutory Auditor or the Audit Firm should give the Audit Client or its management the opportunity to decide between reasonable alternatives. If the Audit Client is seeking advice where, due to legal or regulatory provisions, only one solution is available, the Statutory Auditor should ensure that its documentation refers to the relevant provisions (e.g. quotes the relevant law, includes advice from external professionals).

7.2 Examples – Analysis of Specific Situations

Due to ongoing developments in business and financial markets and rapid changes in information technologies, and to the consequences for management and control, it is not possible to draw up a comprehensive list of all those situations where the provision of non-audit services to an Audit Client would create a significant threat to statutory auditors' independence, nor of the different safeguards which may exist to mitigate such threats. The examples which follow describe specific situations that could impair a Statutory Auditor's independence and discuss the safeguards which may be appropriate to reduce the independence risk to an acceptable level in each circumstance. In practice, the Statutory Auditor will need to assess the implications of similar, but different circumstances, and to consider what safeguards would satisfactorily address the independence risk in the judgement of an informed third party.

7.2.1 Preparing Accounting Records and Financial Statements

- (1) **A self-review threat exists whenever a Statutory Auditor, an Audit Firm, an entity within a Network of firms or a Partner, manager or employee thereof participates in the preparation of the Audit Client's accounting records or financial statements. The significance of the threat depends upon the spectrum of these persons' involvement in the preparation process and upon the level of public interest.**
- (2) **The significance of the self-review threat is always considered too high to allow a participation in the preparation process unless the assistance provided is solely of a technical or mechanical nature or the advice given is of an informative nature only.**
- (3) **However, where Statutory Audits of public interest clients are concerned, the provision of any such assistance other than that which is within the statutory audit mandate would cause an unacceptable high level of independence risk, and should therefore be prohibited.**

Spectrum of Involvement in the Preparation Process

There is a spectrum of involvement by the Statutory Auditor (including his Audit Firm, Network member firms, or any employees thereof) in the preparation of accounting records and financial statements. At one end of the spectrum, the Statutory Auditor may prepare prime accounting records, do the bookkeeping and prepare the financial statements, as well as performing the Statutory Audit of these financial statements. In other cases, the Statutory Auditor helps his Audit Client in the preparation of the financial statements on the basis of the trial balance, assisting his Audit Client in the calculation of the closing entries (calculation of accruals, bad debts, depreciation, etc.). At the other end of the spectrum, the Statutory Auditor does not participate in any part of the preparation process. Even in the latter case, the Statutory Auditor who detects shortcomings in the Audit Client's proposed disclosures will normally suggest and draft the amendments required. This is part of the Statutory Audit mandate and should not be considered as the provision of a non-audit service. While management always has responsibility for the presentation of the financial statements, the end result is that it is uncommon for a set of financial statements to appear where the Statutory Auditor has had no hand whatsoever in the presentation or drafting.

Nature of Assistance and Advice

The Audit Client and its management must be responsible for the financial statements and the maintenance of accounting records, and the Statutory Auditor's safeguards must at least ensure that in any assistance he gives towards preparing these, the accounting entries and any underlying assumptions (e.g. for valuation purposes) are originated by the client, and that he is not involved in the decision-making of the Audit Client or its management in respect of the entries or assumptions.

The Statutory Auditor's assistance should therefore be limited to carrying out technical or mechanical tasks and to providing advisory information on alternative standards and methodologies which the Audit Client might wish to apply.

Examples of assistance which impair independence include the following:

- determining or changing journal entries, or the classifications for accounts or transactions, or other accounting records without obtaining the client's approval;
- authorising or approving transactions; or
- preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

Examples of assistance which would not necessarily impair independence could include:

- performing mechanical tasks of bookkeeping, such as recording transactions for which the Audit Client's management has determined the appropriate account classification; posting coded transactions to a client's general ledger; posting client-approved entries to a client's trial balance; or providing certain data-processing services;
- informing the client about applicable accounting standards or valuation methodologies for the client to decide which should be adopted.

Level of Public Interest

Listed companies, credit institutions, insurance companies, investment firms, UCITS (Undertakings for Collective Investments in Transferable Securities) and pension funds are regarded, among others, as entities with such a high level of public interest that the perception of the Statutory Auditor's independence is considered to cause a self-review threat too high to be mitigated by safeguards other than the prohibition of any assistance in the preparation of accounting records and financial statements which goes beyond the statutory audit mandate (i.e., which exceeds the suggestion and drafting of amendments during the due course of the Statutory Audit, after having detected shortcomings in the Audit Client's proposed disclosures).

However, whenever the Statutory Auditor is asked to participate in the preparation of an Audit Client's accounting records or financial statements, he should carefully consider whether, taking into account the Audit Client's business environment, the public interest reaches a level where this would create public perception of a significant self-review threat if he accepted the engagement. This may depend on the size and structure of the Audit Client as well as on the local, regional or national environment in which this client operates.

Emergency Situations

In an emergency case, where, for example, due to external and unforeseeable events, the Statutory Auditor would be the only one who has the necessary knowledge of the Audit Client's systems and procedures, and can provide sufficient resources to assist the client in a timely preparation of accounts and financial statements, and where the Statutory Auditor's refusal to provide these services would result in a severe burden for the Audit Client (e.g., withdrawal of credit lines), or would even threaten its going concern status, a Statutory Auditor may participate in the preparation process to an extent which would not be acceptable under normal circumstances (see (2) and (3)). In such an emergency situation, however, the Statutory Auditor should take no part in any final decisions, seek client's approvals wherever possible, and consider any additional safeguard which would allow him to minimise the level of his independence risk. Where appropriate, he should also ensure that the services he provided and the reasons for this are disclosed in the financial statements.

7.2.2 Design and Implementation of Financial Information Systems

- (1) **The provision of services by the Statutory Auditor, the Audit Firm or an entity within its Network to an Audit Client that involve the design and implementation of financial information technology systems used to generate information forming part of the Audit Client's financial statements may give rise to a self-review threat.**
- (2) **The significance of the self-review threat is considered too high to allow the provision of such services a Statutory Auditor, an Audit Firm or one of its group member firms to provide such services unless**
 - (a) **any design services provided involve the design of information technology systems to specifications made by the Audit Client's management; and**
 - (b) **the services do not constitute a turn key project consisting of software design, hardware configuration and the implementation of both; and**
 - (c) **the Audit Client or its management takes responsibility for**
 - (i) **the design and implementation process, including any decision thereon; and**
 - (ii) **the operation of the system, including the data used or generated by the system.**
- (3) **In cases not prohibited under (2) the Statutory Auditor should consider whether additional safeguards are needed to mitigate a remaining self-review threat, in particular where services which involve the design and implementation of financial information technology systems should only be provided by an expert team with different personnel (including engagement partner) and different reporting lines to those of the audit Engagement Team.**

Financial Information

Statutory audit work includes the testing of those hardware and software systems which are used by the Audit Client to generate the financial information which is to be disclosed in its financial statements. Where a Statutory Auditor (including his Audit Firm, Network member firms, or any employees thereof) is involved in the design and implementation of such a financial information technology (FIT) system, a self-review threat may arise. In this respect, financial information does not only include those figures which are directly disclosed in the financial statements, but also comprises any other valuation or physical data to which the financial statements' disclosures relate. Such information is generated by either integrated IT-systems or a variety of stand-alone systems (e.g., systems for bookkeeping, cost-accounting, payroll, or cash management as well as those systems which may only provide physical numbers, such as some warehousing and production control systems, etc.).

Spectrum of Involvement

There is a spectrum of involvement by the Statutory Auditor in the design and implementation of FIT-systems:

At one end of the spectrum, there are engagements where the Statutory Auditor takes on a management role or responsibilities for the FIT-systems design and implementation project as a whole, or for the operation of the FIT-system and the data it uses or generates. Such an engagement would clearly result in an unacceptable level of independence risk.

In other cases, the Statutory Auditor must carefully assess the independence risk which his involvement in client's systems design and implementation might cause, and whether or not there are appropriate safeguards to reduce it to an acceptable level, for example, where the Statutory Auditor's role is to contribute advice to a consortium retained by the client to carry out the design and implementation project, or to tailor a standard (off-the-shelf) accounting system to meet the needs of the client's particular business. When assessing the independence risk in these kind of situations, the Statutory Auditor should also consider the level of public interest and the Audit Client's IT-resources. Since a public interest client or a large company is often expected to maintain sufficient in-house IT-resources to carry out certain tasks, the provision by the Statutory Auditor of IT-services other than advisory ones might result in an unacceptable independence threat. On the other hand, particularly in the case of smaller companies, the Statutory Auditor's understanding of his client's business may make him the person uniquely qualified to provide such services, without impairing his independence.

At the other end of the spectrum, the Statutory Auditor might be engaged to provide his Audit Client with a review of alternative systems based on which the client himself decides which to install. The provision of such a service would generally not impair the Statutory Auditor's independence, provided that cost and benefits of the systems reviewed are properly documented and discussed with the Audit Client, and that the Statutory Auditor neither has a significant financial interest (see B.1) nor a significant business relationship (see B.2) with any of the systems' suppliers.

7.2.3 Valuation Services

- (1) A self-review threat exists whenever a Statutory Auditor, an Audit Firm, an entity within a Network or a Partner, manager or employee thereof provides the Audit Client with valuation services that result in the preparation of a valuation that is to be incorporated into the client's financial statements.**
- (2) The significance of the self-review threat is considered too high to allow the provision of valuation services which lead to the valuation of amounts which are material in relation to the financial statements and where the valuation involves a significant degree of subjectivity inherent in the item concerned.**
- (3) In cases not prohibited under (2) the Statutory Auditor should consider whether additional safeguards are needed to mitigate a remaining self-review threat, in particular where a valuation service should only be provided by an expert team with different personnel (including engagement partner) and different reporting lines to those of the audit Engagement Team.**

Valuation Services

A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or a range of values, for an asset, a liability or for a business as a whole. The underlying assumptions of such a valuation may relate to interpretations of the present or expectations of the future, including both general developments and the consequences of certain actions taken or planned by the Audit Client or anybody within its close business environment.

Engagements to review or to issue an opinion on the valuation work performed by others (e.g. engagements under Articles 10 and 27 of the 2nd Company Law Directive [77/91/EEC], Articles 10 and 23 of the 3rd Company Law Directive [78/855/EEC], or under Article 8 of the 6th Company Law Directive [82/891/EEC]), or to collect and verify data to be used in a valuation performed by others (e.g., typical "due diligence" work in connection with the sale or purchase of a business), are not regarded as valuation services under this principle.

Materiality and Subjectivity

Valuation services leading to the valuation of amounts which neither separately nor in aggregate are material in relation to the financial statements are not considered to create a significant threat to independence.

The underlying assumptions of a valuation and the methodologies to be applied are always the responsibility of the Audit Client or its management. Therefore, as part of its decision-making process, the Audit Client or its management has generally to determine the underlying assumptions of the valuation, and to decide on the methodology to be applied for the computation of the value. This is of particular importance when the valuation to be performed requires a significant degree of subjectivity, either in relation to the underlying assumptions or regarding the differences in applicable methodologies.

However, with regard to certain routine valuations (e.g., depreciation of assets, calculation of pension schemes, certain valuation for tax purposes), the degree of subjectivity inherent in the item concerned may be insignificant: for example,

when the underlying assumptions are determined by law (e.g., tax rates, depreciation rates for tax purposes), other regulations (e.g., provision to use certain interest rates), or are widely accepted within the Audit Client's business sector, and when the techniques and methodologies to be used are based on general accepted standards, or even prescribed by laws and regulations. In such circumstances, the result of a valuation performed by an informed third party, even if not identical, is unlikely to be materially different. The provision of such valuation services might therefore not impair statutory auditor's independence, even if the value itself could be regarded as material to the financial statements, provided that the Audit Client or its management has at least approved all significant matters of judgement.

Additional Safeguards

When valuation services are provided where the degree of subjectivity is insignificant, such as the application of standard techniques or methodologies or where the service is a review of the valuation methods used by a third party, but where the resulting valuation is material in relation to the financial statements, the Statutory Auditor should consider whether there remains a self-review threat which should be mitigated by additional safeguards. It may be appropriate to address such a threat by setting up a valuation service team separate from the Engagement Team, with different reporting lines for both.

7.2.4 Participation in the Audit Client's Internal Audit

- (1) Self-review threats may arise in certain circumstances where a Statutory Auditor, an Audit Firm or an entity within a Network provides internal audit services to an Audit Client.**
- (2) To mitigate self-review threats when involved in an Audit Client's internal audit task, the Statutory Auditor should**
 - (a) satisfy himself that the Audit Client's management or Governance Body is at all times responsible for**
 - (i) the internal audit function (i.e., the establishment and maintenance of internal controls, including the day to day controls and processes in relation to the authorisation, execution and recording of accounting transactions);**
 - (ii) determining the scope, risk and frequency of the internal audit procedures to be performed; and**
 - (iii) considering and acting on the findings and recommendations provided by internal audit or during the course of a Statutory Audit.**

If the Statutory Auditor is not satisfied that this is the case, neither he, nor the Audit Firm nor any entity within its Network should participate in the Audit Client's internal audit.

- (b) not accept the outcomes of internal auditing processes for statutory audit purposes without adequate review, including a reassessment of the relevant statutory audit work by an Audit Partner who is involved neither in the Statutory Audit nor in the internal audit engagement.**

Internal Audit is an important element of an entity's internal control system. In companies, particularly small and medium sized ones, which cannot afford an internal audit department or where such a department lacks certain facilities (e.g. access to specialists in information technology or treasury management), participation by the Statutory Auditor in the internal audit may strengthen management control capacities.

However, self-review threats can arise if, for example, there is not a clear separation between the management and control of the internal audit and the internal audit activities themselves, or if the Statutory Auditor's evaluation of his Audit Client's internal control system determines the kind and volume of his subsequent statutory audit procedures. To avoid such threats, the Statutory Auditor, the Audit Firm or its Network member must be able to show that it is not involved in management and control of the internal audit, and that it has not relied on the results from the internal audit in which it has participated in its statutory audit work. To ensure that, in this respect, his statutory audit work is adequate in all circumstances, the Statutory Auditor should have it reassessed by an Audit Partner who is not involved in any of the statutory audit or internal audit engagements concerned.

In companies where the internal audit department reports to a Governance Body rather than to management itself, the internal audit function performs a role that is complementary to the statutory audit function and can therefore be seen as a separate element of the corporate governance framework. If the Statutory Auditor is asked to perform internal audit work in these circumstances, he must still be able to demonstrate that he has adequately assessed any threats to his independence, and has applied any necessary safeguards.

7.2.5 Acting for the Audit Client in the Resolution of Litigation

- (1) An advocacy threat exists whenever a Statutory Auditor, an Audit Firm, an entity within a Network or a Partner, manager or employee thereof acts for the Audit Client in the resolution of a dispute or litigation. A self-review threat may also arise where such a service includes the estimation of the Audit Client's**

chances in the resolution of litigation, and thereby affects the amounts to be reflected in the financial statements.

- (2) **The significance of both the advocacy and the self-review threat is considered too high to allow a Statutory Auditor, an Audit Firm, an entity within a Network or a partner, manager or employee thereof to act for an Audit Client in the resolution of litigation which involves matters that, in the aggregate, would reasonably be expected to have a material impact on the client's financial statements and a significant degree of subjectivity inherent to the case concerned.**
- (3) **In cases not prohibited under (2) the Statutory Auditor should consider whether additional safeguards are needed to mitigate a remaining advocacy threat. This could include using personnel (including engagement Partner) who are not connected with the audit Engagement Team and who have different reporting lines.**

In certain circumstances the Statutory Auditor, the Audit Firm, an entity within a Network or a Partner, manager or employee thereof assists the Audit Client in the resolution of a dispute or litigation. The representation of an Audit Client before the court or the tax administration for tax litigation is a typical example of such Statutory Auditor's assistance which is generally not seen to impair independence.

Advocacy and Self-review Threats

A Statutory Auditor acting for the Audit Client in resolution of a dispute or litigation is generally perceived to take on an advocacy role which is incompatible with the responsibility of a Statutory Auditor to give an objective opinion on the financial statements. This advocacy threat is accompanied by a self-review threat when the assistance in the resolution of litigation also requires the Statutory Auditor to estimate chances of his Audit Client succeeding in the action if this could affect amounts to be reflected in the financial statements. A Statutory Auditor who is involved in the resolution of litigation has therefore to consider the significance of both the advocacy threat and the self-review threat.

Materiality and Subjectivity

Legal services relating to actions for the Audit Client in a resolution of a dispute or litigation which involves matters that, either separately or in aggregate, would not be expected by a reasonable and informed third party to have any material impact on the financial statements are not considered to create a significant threat to independence.

In terms of the inherent subjectivity which arises when acting as an advocate of the Audit Client, the Statutory Auditor has to take into account that, while performing the audit, he usually has the choice either to evaluate the outcome of a legal proceeding himself, or to rely on a confirmation provided by an external lawyer engaged by the client. The degree of subjectivity in both cases relates to factors such as the competence of the lawyer, his compliance with ethical rules of the lawyers' profession, and the given evidence, rather than to whether or not the lawyer is an employee of the Audit Firm or of a third party law firm. With respect to legal situations where the outcome of legal proceedings can be reasonably estimated on given evidence, the estimation of amounts affected by litigation should not lead to material differences between services provided by the Audit Firm or a third party law firm (e.g. litigation regarding employment contracts with staff, or certain tax proceedings).

On the other hand, there might be situations which bear inherent subjectivity or which, due to the nature of the business relationship between the Statutory Auditor and the Audit Client, do not even allow the evaluation of evidence in an objective manner (e.g. personal involvement of former or present management, non-executive directors, or shareholders). In such cases, the Statutory Auditor should ensure that he is not involved in the Audit Client's actions in the resolution of litigation, except in minor cases where the matter concerned would not reasonably be expected to have a material impact on the financial statements.

Additional Safeguards

In circumstances not covered under (2), the Statutory Auditor should consider whether there remain threats to independence which have to be mitigated by additional safeguards. It might be appropriate to avoid the audit Engagement Team being involved in the litigation process by setting up different engagement teams with different reporting lines for the Statutory Audit and the legal services related to the litigation.

7.2.6 Recruiting Senior Management

- (1) **Where a Statutory Auditor, an Audit Firm, an entity within a Network or a Partner, manager or employee thereof is involved in the recruitment of senior or key staff for the Audit Client, different kind of threats to independence may arise, such as self-interest, trust or intimidation.**
- (2) **The Statutory Auditor should assess the current and future threats to his independence which may arise from any engagement to assist in the recruitment of senior or key staff before accepting the assignment, and consider appropriate safeguards to mitigate such threats.**

- (3) **When recruiting key financial and administrative staff, the significance of the threats to his independence increases, so the Statutory Auditor should consider whether there might be circumstances where even the provision of a list of potential candidates may cause an unacceptable level of independence risk.**
- (4) **In any case, the decision as to who should be engaged should always be taken by the Audit Client.**

A Statutory Auditor who is asked to assist an Audit Client to recruit senior or key staff should first assess the threats to his independence which might arise from, for example, the role of the person to be recruited and the nature of the assistance sought. The need for careful assessment is highest where the person recruited is likely to have a significant role in the client's financial management processes and hence to have regular contact with the Statutory Auditor, but threats such as self-interest and familiarity may arise from other appointments too.

With regard to the nature of the assistance sought, examples of acceptable services might include to review the professional qualifications of a number of applicants and give an objective opinion on their suitability for a post, or to provide a short-list of candidates for interview, provided that it has been drawn up using criteria specified by the client, rather than on the Statutory Auditor's own judgement. In either case, care would be needed to ensure that any opinion given about the candidates did not pre-empt the Audit Client's decision. If the Statutory Auditor concludes that he could not give the assistance requested without directly or indirectly participating in the Audit Client's decision as to who should be appointed, he should decline to provide it.

8. AUDIT AND NON-AUDIT FEES

8.1 Contingent Fees

- (1) **Fee arrangements for audit engagements in which the amount of the remuneration is contingent upon the results of the service provided raise self-interest and advocacy threats which are considered to bear an unacceptable level of independence risk. It is therefore required that**
- (a) **audit engagements should never be accepted on a contingent fee basis; and**
 - (b) **in order to avoid any appearance of contingency, that the basis for the calculation of audit fees must be agreed each year in advance, including scope for variation so as to take account of unexpected factors in the work.**
- (2) **Threats to independence may also arise from contingent fee arrangements for non-audit services which the Statutory Auditor, the Audit Firm or an entity within its Network provides to an Audit Client or to one of its Affiliates. The Statutory Auditor's safeguarding system (see A. 4.3.2) should therefore ensure that**
- (a) **such an arrangement is never concluded without first assessing the independence risk it might create and ensuring that appropriate safeguards are available to reduce this risk to an acceptable level; and**
 - (b) **unless the Statutory Auditor is satisfied that there are appropriate safeguards in place to overcome the independence threats, either the non-audit engagement must be refused or the Statutory Auditor must resign from the Statutory Audit to allow the acceptance of the non-audit work.**

Audit Fee Arrangements

Statutory audit work performed in the public interest is inherently unsuitable for fee arrangements where the Statutory Auditor's remuneration depends on either any performance figure of the Audit Client or the outcome of the audit itself. Audit fees that are fixed by any court or governmental body do not constitute contingent fees.

Non-audit Fee Arrangements

Fee arrangements in respect of non-audit engagements between the Statutory Auditor, the Audit Firm or an entity within its Network, and the Audit Client or any of its Affiliates in which the remuneration of the former similarly depends on a contingent event also present self-interest, self-review and advocacy threats to the Statutory Auditor's independence. By dependency on a contingent event is meant, for example, that the fee depends in some way on the progress or outcome of the project or the attainment of a particular performance figure by the Audit Client (or its Affiliate).

In assessing the extent to which contingent fee arrangements pose a threat to statutory auditor independence, and the availability of suitable safeguards, the Statutory Auditor should consider amongst other factors: the relationship between the activity, for which the contingent fee is to be paid, and the conduct of any current or future audit; the range of possible fee amounts; and the basis on which the fee is to be calculated.

In performing this assessment, the Statutory Auditor should consider, inter alia, whether the amount of the contingent fee is directly determined by reference to an asset or transaction value (e.g., percentage of acquisition price) or a financial condition (e.g., growth in market capitalisation) the measurement of which will be subsequently exposed to an audit examination and whether this increases the self-interest threat to unacceptable levels. On the other hand,

independence threats will generally not arise in situations where there is no direct link between the basis of the contingent fee (e.g., the starting salary of a new employee when a recruitment service is provided) and a significant aspect of the audit engagement.

8.2 Relationship Between Total Fees and Total Revenue

- (1) **The rendering of any (audit and non-audit) services of a Statutory Auditor, an Audit Firm or a Network to one Audit Client or its Affiliates should not be allowed to create a financial dependency on that Audit Client or client group, neither in fact nor in appearance.**
- (2) **A financial dependency is considered to exist when the total (audit and non-audit) fees which a Statutory Auditor, an Audit Firm, or a Network receives from one Audit Client and its Affiliates make up an unduly high percentage of the total revenues in each of the last 5 years.**
- (3) **The Statutory Auditor should also consider whether there are certain fee relationships with one Audit Client and its Affiliates which may appear to create a financial dependency in respect of a person who is in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2).**
- (4) **In any case, the Statutory Auditor, the Audit Firm or the Network should be able to demonstrate that no financial dependency exists in relation to a particular Audit Client or its Affiliates.**

Excessive dependence on audit and non-audit fees from one Audit Client or one client group clearly gives rise to a self-interest threat to the Statutory Auditor's independence. The Statutory Auditor or the Audit Firm has not only to avoid the existence of such a financial dependency, but also to consider carefully where there might be an appearance of such dependency which would create a significant threat to independence.

Appearance of Financial Dependency

From a public perspective, the Statutory Auditor, the Audit Firm or a Network might be perceived to be financially dependent on a single Audit Client or client group when the total sum it receives from that client or client group as audit and non-audit fees exceeds a critical percentage of its total income. Public perception of the critical point at which the percentage of total fees from one client or client group creates a significant self-interest threat depends upon different factors within the audit environment. For example, the level might be different depending on the size of the firm, whether it is well established or newly created, whether it operates locally, nationally or internationally, and on the general business situation in markets in which it is operating.

These circumstances have to be carefully considered by the Statutory Auditor when he assesses the significance of the self-interest threat to his appearance of independence. If an analysis of all fees received for audit and non-audit services from a particular client or client group compared to the firm's or Network's total income indicates a level of dependency and a need for safeguards, an Audit Partner who has not been engaged in any of the audit or non-audit work for the client should carry out a review of all of the work done for the client and advise as necessary. Where doubts remain, or where, because of the size of the firm, no such partner is available, the Statutory Auditor should seek advice of his professional regulatory body or a review by another statutory auditor.

Certain Other Fee Relationships

The Statutory Auditor should also consider whether there are or appear to be fee relationships other than the direct ones between a single Audit Client or client group and himself or the Audit Firm (as a legal entity) which may cause a self-interest threat. For example, an Audit Partner within an office or branch might be perceived to be dependent on fees from a certain Audit Client, if most of that office's services were provided to that Audit Client, or if the same individual was responsible for the acquisition of both audit and non-audit engagements with the Audit Client. To mitigate such self-interest threats, an Audit Firm may reconsider its organisational structures and the responsibilities of certain individuals, or, where applicable, discuss the way services are provided and charged with the Audit Client's Governance Body.

Independence may particularly be compromised when significant fees are generated from an Audit Client or its Affiliates for non-audit services. The Statutory Auditor should therefore assess this risk to his independence in terms of the nature of the non-audit services provided, the different fees generated from the statutory audit engagement and the non-audit engagements, and their respective relationship to the total fees received by the Audit Firm or Network. If the analysis indicates the need for safeguards, particularly when the non-audit fees exceed the audit fees, an Audit Partner who is not involved in any of the audit and non-audit engagements should carry out a review of the work done for the client under both or otherwise advise as necessary.

8.3 Overdue Fees

A Statutory Auditor should not accept reappointment or should resign from the current audit engagement if fees for audit or other work become overdue and the sum outstanding, or that sum together with fees for current assignments could be regarded as a significant loan (see also B. 2). The situation should be reviewed by a Partner not involved in the provision of any services to the client or, where such a review could not be performed, subjected to either external review by another statutory auditor or advice by a professional regulatory body.

Unpaid fees for audit or other work could appear to be in effect a loan from the Statutory Auditor to the Audit Client, and thus to create a mutual financial interest which could be a threat to the Statutory Auditor's independence. In such circumstances, a Statutory Auditor must assess the level of the threat and take any action that may be necessary such as, for example, disclosing the extent of the potential mutual interest to all relevant third parties.

Where the Statutory Auditor is an Audit Firm, the circumstances may be reviewed by another Audit Partner who has not been involved in the provision of any services to the Audit Client. In the case of a sole practitioner, or a small partnership where all Audit Partners have been involved with the Audit Client, the Statutory Auditor should either seek advice from his professional regulatory body or ask for a review by another statutory auditor.

8.4 Public Disclosure

- (1) **Where an Audit Client's audited financial statements have to be published in accordance with national law, Member States or their regulatory bodies should provide for the (audit and non-audit) fees which a Statutory Auditor or, if not being the Statutory Auditor, his Audit Firm has received from the Audit Client for the services provided to him during the reporting period, to be publicly and appropriately disclosed.**
- (2) **The total fee income should be broken down by statutory audit and non-audit services, and categories of non-audit services should be further broken down in so far as items in them differ substantially from one another. In respect of each category item, the figure relating to the corresponding category item for the preceding reporting period should be shown as well.**
- (3) **Where a Statutory Audit of consolidated accounts is concerned, the fees received by the Statutory Auditor and his Network members for the services they provided to the Audit Client and its consolidated entities should be disclosed accordingly.**

A Statutory Auditor should be able to demonstrate that his independence has not been compromised by providing non-audit services to an Audit Client for which the remuneration he received has been disproportionate to the fees he was paid for the Statutory Audit. Since this should also be in the interest of the relevant Audit Client in order to add credibility to its published financial information, public disclosure requirements imposed by Member States through national law or their relevant regulatory bodies will ensure that a reasonable and informed third party is able to take a view on the extent of any imbalance between statutory audit and other fees. To assist such assessment, non-audit fees should be broken down into broad categories (e.g., assurance, tax advisory and other non-audit services) reflecting the different kinds of services which may have been provided. It may also be appropriate to identify particular engagements which make up a significant proportion of a particular category.

8.5 Pricing

A Statutory Auditor must be able to demonstrate that the fee for an audit engagement is adequate to cover the assignment of appropriate time and qualified staff to the task and compliance with all auditing standards, guidelines and quality control procedures, and that the resources allocated are at least those which would be allocated to other work of a similar nature.

A Statutory Auditor must be able to demonstrate that the fee he charges for any audit engagement is reasonable, particularly if it is significantly lower than that charged by a predecessor or quoted by other firms bidding for the engagement. He must also be able to demonstrate that a quoted fee is not dependent on the expected provision of non-audit services, and that a client has not been misled as to the basis on which future fees would be charged. The Statutory Auditor should have policies and procedures in place to be able to demonstrate that his fees meet these requirements.

9. LITIGATION

- (1) **Both a self-interest and an advocacy threat may arise where litigation takes place, or appears likely to take place, between the Statutory Auditor, the Audit Firm or any other person being in a position to influence the outcome of the Statutory Audit (any person within the scope of A. 2) and an Audit Client or its Affiliates. All of the audit and non-audit services provided to the client have to be considered in order to assess these threats.**
- (2) **These threats may become significant in relation to the independence risk where there is a serious likelihood of litigation which is material to any of the parties being involved, or which challenges a prior Statutory Audit, or where material litigation is in progress, and the Statutory Auditor should cease to act as soon as such circumstances become evident. The Statutory Auditor's actions in these circumstances may include discussions with the Audit Client's Governance Body or with his professional regulatory body, or even resignation from the statutory audit engagement.**

Whilst it is not possible to specify precisely for all cases the point at which it would become improper for a statutory auditor to continue as Statutory Auditor of an Audit Client, the following criteria should be considered:

- if an Audit Client’s management alleges deficiencies in statutory audit work for the Audit Client, and the Statutory Auditor concludes that it is probable that a claim will be filed, the level of independence risk is too high to be mitigated by safeguards other than that the Statutory Auditor should discuss all aspects of the litigation with the Governance Body of the Audit Client, or where such body does not exist, with his professional regulatory body, or should resign;
- if the Statutory Auditor alleges fraud or deceit by current management of an Audit Client, the level of independence risk and the decision as to whether or not he should resign also depends on safeguards such as discussion of all relevant aspects with the Governance Body of the client, or, where such a body does not exist, with the Statutory Auditor’s professional regulatory body. (In some countries, however, the national law safeguards the independence of the Statutory Auditor in case of alleged fraud by requiring the Statutory Auditor to report the detected fraud to a national authority and to continue his audit work on behalf of that authority which represents the national public interest. In any case the Statutory Auditor should consider seeking legal advice, giving due consideration to his responsibility to the public interest.);
- threatened or actual litigation relating to non-audit services for an amount not material to the Statutory Auditor or to the Audit Client (for example, claims out of disputes over billing for services, results of consultancy services) would not impair the Statutory Auditor’s independence.

10. SENIOR PERSONNEL ACTING FOR A LONG PERIOD OF TIME

- (1) **Trust or familiarity threats may arise where certain members of the Engagement Team work regularly and for a long period of time on an Audit Client engagement, particularly where public interest Audit Clients are concerned.**
- (2) **To mitigate these threats, where the audit of a public interest client is concerned, the Statutory Auditor is required at least to replace the Audit Partners (including the Engagement Partner) within a reasonable period of time (5 to 7 years). The replaced Audit Partners should not be allowed to return to the Audit Client engagement until a two-year period of time has elapsed after the date of their replacement.**
- (3) **Where Audit Clients other than those of public interest are concerned, the Statutory Auditor should consider whether, besides internal rotation, there might be other safeguards which would reduce the threats to independence to an acceptable level.**

To mitigate a familiarity or trust threat to the independence of a Statutory Auditor who is engaged to audit an Audit Client of public interest, the requirement to replace the Engagement Partner and/or Audit Partners within a reasonable period of time cannot be replaced by other safeguards. In addition, the Statutory Auditor or Audit Firm should ensure that the replacement requirement is not circumvented by situations like, for example, that of an Audit Team member who worked on the audit engagement for six years as senior accountant before being promoted to Audit Partner of that engagement for one year. In this case, the team member should be replaced as having served seven years on the audit in total.

With regard to Audit Clients which are of relatively little public interest, the Statutory Auditor should assess the impact of trust or familiarity threats on his independence, having regard to the perceptions of his Audit Client’s stakeholders. Where such perceptions are that the level of independence risk is significantly high, the Statutory Auditor should also consider an internal rotation, or, if this would not be a possible or viable safeguard due to the size of the Audit Firm (e.g., the Audit Firm is a sole practitioner’s practice, or, the day to day relationship between a limited number of Audit Partners is too close for internal rotation to constitute an appropriate safeguard), he should ensure that other safeguards are put in place within a reasonable period of time, such as coverage of the relevant audit engagement by an external quality review which was performed in accordance with the Commission Recommendation on “Quality Assurance for the Statutory Audit in the EU”, a secondary review by another statutory auditor, or, at least, seeking advice by his professional regulatory body.

Glossary

Affiliate	an undertaking within the meaning of Article 41 (1),(2) and (3) of the 7 th Company Law Directive (83/349/EEC) which, in general and regardless of its legal form, is any entity connected to another by means of common ownership, control or management.
Audit Client	the company or firm whose annual accounts are subject to Statutory Audit, or the parent undertaking in the meaning of Article 1 of the 7 th Company Law Directive (83/349/EEC) whose consolidated accounts are subject to Statutory Audit.
Audit Firm	the organisational – generally legal – entity that performs a Statutory Audit (e.g., a sole practitioner’s practice, a partnership or a company of professional accountants). The Audit Firm and the Statutory Auditor who is appointed for the Statutory Audit might be identical legal persons, but need not be (e.g., where an individual who is a member of a partnership practice is appointed as the Statutory Auditor, the partnership as such forms the Audit Firm).

Audit Partner	an audit professional within an Audit Firm or Network who himself is an approved person in the meaning of Article 2 (1) of the 8 th Company Law Directive (= statutory auditor) and, as an individual, takes on ultimate responsibilities for the audit work performed during a Statutory Audit; he, generally, is authorised to sign audit reports on behalf of the Audit Firm which is the Statutory Auditor. He may also be a shareholder/owner or principal of the Audit Firm.
Audit Team	all audit professionals who, regardless of their legal relationship with the Statutory Auditor or Audit Firm, are assigned to a particular Statutory Audit engagement in order to perform the audit task, such as Audit Partner(s), audit manager(s) and audit staff.
Chain of Command	Comprises all those persons on office, country, regional or global levels, who have a supervisory, management, compensation or other oversight responsibility over either any Audit Partner of the Audit Team or over the conduct of the Statutory Audit. This includes all Partners, principals and shareholders who may prepare, review or directly influence the performance appraisal of any Audit Partner of the Audit Team or otherwise determine their compensation as a result of their involvement with the audit engagement.
Engagement Partner	the Audit Partner who has ultimate responsibilities for the of the Statutory Audit of a particular Audit Client, who co-ordinates the work of the Audit Team and that of professional personnel from other disciplines involved ensures that this work is subject to quality control, and, if applicable, co-ordinates all statutory audit activities of a Network which relate to a Statutory Audit, particularly on consolidated accounts where different Audit Partners have different responsibilities for the audits of the entities to be consolidated.
Engagement Team	All persons who, regardless of their legal relationship with the Statutory Auditor or Audit Firm, are directly involved in the acceptance and performance of a particular Statutory Audit. This includes the Audit Team, employed or subcontracted professional personnel from other disciplines involved in the audit engagement (e.g., lawyers, actuaries, taxation specialists, IT-specialists, treasury management specialists), and those who provide quality control or direct oversight of the audit engagement.
Governance Body	A body or a group of persons which is embedded in the Audit Client’s corporate governance structure to exercise oversight over management as a fiduciary for investors and, if required by national law, for other stakeholders such as employees, and which consists of or, at least, includes individuals other than management, such as a supervisory board, an audit committee, or a group of non-executive directors or external board members.
Network	Includes the Audit Firm which performs the Statutory Audit, together with its Affiliates and any other entity controlled by the Audit Firm or under common control, ownership or management or otherwise affiliated or associated with the Audit Firm through the use of a common name or through the sharing of significant common professional resources.
“Office”	<p>The term “Office” means a distinct sub-group of an Audit Firm or Network, whether distinguished along geographical or practice lines, which participates in a significant portion of the audit engagement.</p> <p>A main criteria for identifying this sub-group should be the close working relationship between its members (e.g. working on the same kind of subjects or clients). In particular, it should be taken into account, that, due to technical developments and the increasing multinational activities of Audit Clients, such working relationships are more and more evolving by means of a “virtual” office, and that physical co-location is not necessarily an essential factor in this definition.</p> <p>In the case of smaller partnerships, the “Office” may encompass the whole firm, in which case all of the Partners and employees will be subject to the relevant requirements.</p>
Partner	a professional within an Audit Firm or Network who, as an individual, takes on ultimate responsibilities for the work performed during an (audit or non-audit) engagement; he, generally, is authorised to sign on behalf of the Audit Firm, and may also be a shareholder/owner or principal of the Audit Firm.
Statutory Audit	<p>the audit service which is provided by an approved person in the meaning of Article 2 (1) of the 8 th Company Law Directive (= statutory auditor) when</p> <p>(a) carrying out an audit of the annual accounts of a company or firm and verifying that the annual report is consistent with those annual accounts in so far as such an audit and such a verification is required by Community law; or</p> <p>(b) carrying out an audit of the consolidated accounts of a body of undertakings and verifying</p>

	<p>that the consolidated annual report is consistent with those consolidated accounts in so far as such an audit and such a verification is required by Community law.</p> <p>For the purpose of this Recommendation, the term “statutory audit” would also include an attest service which, dependent on national law, is provided by a statutory auditor when companies are required to have financial reporting information other than the above (e.g. companies’ interim financial accounts and reports) reviewed by a Statutory Auditor who has to give an opinion on this information.</p>
Statutory Auditor	<p>the approved person in the meaning of Article 2 (1) of the 8 th Company Law Directive (= statutory auditor) who, either being a natural or a legal person, is appointed for a certain Statutory Audit engagement by means of national law and – as a consequence – in whose name the audit report is signed.</p>

APPENDIX I

UNITED STATES SECURITIES AND EXCHANGE COMMISSION RULES ON AUDIT INDEPENDENCE

Final rule - November 2000

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The heading for Part 210 is revised as set forth above.
2. The authority citation for Part 210 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), 80b-3, 80b-11 unless otherwise noted.

3. By amending § 210.2-01 by adding a Preliminary Note and paragraphs (d), (e) and (f) and revising paragraphs (b) and (c) to read as follows:

§ 210.2-01 Qualifications of accountants.

Preliminary Note to § 210.2-01

Rule 2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client.

Rule 2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) reflect the application of the general standard to particular circumstances. The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in paragraph 2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: (a) creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in a position of being an advocate for the audit client.

These factors are general guidance only and their application may depend on particular facts and circumstances. For that reason, Rule 2-01 provides that, in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the Rule.

(a) * * *

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

(c) This paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section.

(1) **Financial relationships**. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client, such as:

(i) **Investments in audit clients**. An accountant is not independent when:

(A) The accounting firm, any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities. The term direct investment includes an investment in an audit client through an intermediary if:

- (1) The accounting firm, covered person, or immediate family member, alone or together with other persons, supervises or participates in the intermediary's investment decisions or has control over the intermediary; or
 - (2) The intermediary is not a diversified management investment company, as defined by Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(b)(1), and has an investment in the audit client that amounts to 20% or more of the value of the intermediary's total investments.
- (B) Any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G (17 CFR 240.13d-101 or 240.13d-102) with the Commission indicating beneficial ownership of more than five percent of an audit client's equity securities or controls an audit client, or a close family member of a partner, principal, or shareholder of the accounting firm controls an audit client.
- (C) The accounting firm, any covered person in the firm, or any of his or her immediate family members, serves as voting trustee of a trust, or executor of an estate, containing the securities of an audit client, unless the accounting firm, covered person in the firm, or immediate family member has no authority to make investment decisions for the trust or estate.
- (D) The accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client. For purposes of this paragraph, the term material indirect investment does not include ownership by any covered person in the firm, any of his or her immediate family members, or any group of the above persons of 5% or less of the outstanding shares of a diversified management investment company, as defined by Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(b)(1), that invests in an audit client.
- (E) The accounting firm, any covered person in the firm, or any of his or her immediate family members:
- (1) Has any direct or material indirect investment in an entity where:
 - (i) An audit client has an investment in that entity that is material to the audit client and has the ability to exercise significant influence over that entity; or
 - (ii) The entity has an investment in an audit client that is material to that entity and has the ability to exercise significant influence over that audit client;
 - (2) Has any material investment in an entity over which an audit client has the ability to exercise significant influence; or
 - (3) Has the ability to exercise significant influence over an entity that has the ability to exercise significant influence over an audit client.
- (ii) Other financial interests in audit client. An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:
- (A) Loans/debtor-creditor relationship. Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:
 - (1) Automobile loans and leases collateralized by the automobile;
 - (2) Loans fully collateralized by the cash surrender value of an insurance policy;
 - (3) Loans fully collateralized by cash deposits at the same financial institution; and
 - (4) A mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.
 - (B) Savings and checking accounts. Any savings, checking, or similar account at a bank, savings and loan, or similar institution that is an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer, except that an accounting firm account may have an uninsured balance

provided that the likelihood of the bank, savings and loan, or similar institution experiencing financial difficulties is remote.

- (C) Broker-dealer accounts. Brokerage or similar accounts maintained with a broker-dealer that is an audit client, if:
 - (1) Any such account includes any asset other than cash or securities (within the meaning of "security" provided in the Securities Investor Protection Act of 1970 ("SIPA") (15 U.S.C. 78aaa et seq.));
 - (2) The value of assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation advance, for those accounts, under Section 9 of SIPA (15 U.S.C. 78fff-3); or
 - (3) With respect to non-U.S. accounts not subject to SIPA protection, the value of assets in the accounts exceeds the amount insured or protected by a program similar to SIPA.
 - (D) Futures commission merchant accounts. Any futures, commodity, or similar account maintained with a futures commission merchant that is an audit client.
 - (E) Credit cards. Any aggregate outstanding credit card balance owed to a lender that is an audit client that is not reduced to \$10,000 or less on a current basis taking into consideration the payment due date and any available grace period.
 - (F) Insurance products. Any individual policy issued by an insurer that is an audit client unless:
 - (1) The policy was obtained at a time when the covered person in the firm was not a covered person in the firm; and
 - (2) The likelihood of the insurer becoming insolvent is remote.
 - (G) Investment companies. Any financial interest in an entity that is part of an investment company complex that includes an audit client.
- (iii) **Exceptions.** Notwithstanding paragraphs (c)(1)(i) and (c)(1)(ii) of this section, an accountant will not be deemed not independent if:
- (A) Inheritance and gift. Any person acquires an unsolicited financial interest, such as through an unsolicited gift or inheritance, that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the financial interest is disposed of as soon as practicable, but no later than 30 days after the person has knowledge of and the right to dispose of the financial interest.
 - (B) New audit engagement. Any person has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and:
 - (1) The accountant did not audit the client's financial statements for the immediately preceding fiscal year; and
 - (2) The accountant is independent under paragraph (c)(1)(i) and (c)(1)(ii) of this section before the earlier of:
 - (i) Signing an initial engagement letter or other agreement to provide audit, review, or attest services to the audit client; or
 - (ii) Commencing any audit, review, or attest procedures (including planning the audit of the client's financial statements).
 - (C) Employee compensation and benefit plans. An immediate family member of a person who is a covered person in the firm only by virtue of paragraphs (f)(11)(iii) or (f)(11)(iv) of this section has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the acquisition of the financial interest was an unavoidable consequence of participation in his or her employer's employee compensation or benefits program, provided that the financial interest, other than unexercised employee stock options, is disposed of as soon as practicable, but no later than 30 days after the person has the right to dispose of the financial interest.
- (iv) **Audit clients' financial relationships.** An accountant is not independent when:
- (A) Investments by the audit client in the accounting firm. An audit client has, or has agreed to acquire, any direct investment in the accounting firm, such as stocks, bonds, notes, options,

or other securities, or the audit client's officers or directors are record or beneficial owners of more than 5% of the equity securities of the accounting firm.

- (B) Underwriting. An accounting firm engages an audit client to act as an underwriter, broker-dealer, market-maker, promoter, or analyst with respect to securities issued by the accounting firm.
- (2) **Employment relationships**. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client, such as:
- (i) Employment at audit client of accountant. A current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or serves as a member of the board of directors or similar management or governing body of the audit client.
 - (ii) Employment at audit client of certain relatives of accountant. A close family member of a covered person in the firm is in an accounting role or financial reporting oversight role at an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.
 - (iii) Employment at audit client of former employee of accounting firm. A former partner, principal, shareholder, or professional employee of an accounting firm is in an accounting role or financial reporting oversight role at an audit client, unless the individual:
 - (A) Does not influence the accounting firm's operations or financial policies;
 - (B) Has no capital balances in the accounting firm; and
 - (C) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the accounting firm):
 - (1) Pursuant to a fully funded retirement plan, rabbi trust, or, in jurisdictions in which a rabbi trust does not exist, a similar vehicle; or
 - (2) In the case of a former professional employee who was not a partner, principal, or shareholder of the accounting firm and who has been disassociated from the accounting firm for more than five years, that is immaterial to the former professional employee.
 - (iv) Employment at accounting firm of former employee of audit client. A former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client covering any period during which he or she was employed by or associated with that audit client.
- (3) **Business relationships**. An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.
- (4) **Non-audit services**. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:
- (i) Bookkeeping or other services related to the audit client's accounting records or financial statements.
 - (A) Any service involving:
 - (1) Maintaining or preparing the audit client's accounting records;
 - (2) Preparing the audit client's financial statements that are filed with the Commission or form the basis of financial statements filed with the Commission; or
 - (3) Preparing or originating source data underlying the audit client's financial statements.
 - (B) Notwithstanding paragraph (c)(4)(i)(A) of this section, the accountant's independence will not be impaired when the accountant provides these services:

- (1) In emergency or other unusual situations, provided the accountant does not undertake any managerial actions or make any managerial decisions; or
 - (2) For foreign divisions or subsidiaries of an audit client, provided that:
 - (i) The services are limited, routine, or ministerial;
 - (ii) It is impractical for the foreign division or subsidiary to make other arrangements;
 - (iii) The foreign division or subsidiary is not material to the consolidated financial statements;
 - (iv) The foreign division or subsidiary does not have employees capable or competent to perform the services;
 - (v) The services performed are consistent with local professional ethics rules; and
 - (vi) The fees for all such services collectively (for the entire group of companies) do not exceed the greater of 1% of the consolidated audit fee or \$10,000.
- (ii) Financial information systems design and implementation.
- (A) Directly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network.
 - (B) Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements taken as a whole, unless:
 - (1) The audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with Section 13(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(b)(2));
 - (2) The audit client's management designates a competent employee or employees, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
 - (3) The audit client's management makes all management decisions with respect to the design and implementation of the hardware or software system including, but not limited to, decisions concerning the systems to be evaluated and selected, the controls and system procedures to be implemented, the scope and timetable of system implementation, and the testing, training, and conversion plans;
 - (4) The audit client's management evaluates the adequacy and results of the design and implementation of the hardware or software system; and
 - (5) The audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls and financial reporting systems.
 - (C) Nothing in this paragraph (c)(4)(ii) shall limit services an accountant performs in connection with the assessment, design, and implementation of internal accounting controls and risk management controls, provided the auditor does not act as an employee or perform management functions.
- (iii) Appraisal or valuation services or fairness opinions.
- (A) Any appraisal service, valuation service, or any service involving a fairness opinion for an audit client, where it is reasonably likely that the results of these services, individually or in the aggregate, would be material to the financial statements, or where the results of these services will be audited by the accountant during an audit of the audit client's financial statements.
 - (B) Notwithstanding paragraph (c)(4)(iii)(A) of this section, the accountant's independence will not be impaired when:

- (1) The accounting firm's valuation expert reviews the work of the audit client or a specialist employed by the audit client, and the audit client or the specialist provides the primary support for the balances recorded in the client's financial statements;
 - (2) The accounting firm's actuaries value an audit client's pension, other post-employment benefit, or similar liabilities, provided that the audit client has determined and taken responsibility for all significant assumptions and data;
 - (3) The valuation is performed in the context of the planning and implementation of a tax-planning strategy or for tax compliance services; or
 - (4) The valuation is for non-financial purposes where the results of the valuation do not affect the financial statements.
- (iv) Actuarial services.
- (A) Any actuarially-oriented advisory service involving the determination of insurance company policy reserves and related accounts for the audit client, unless:
 - (1) The audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities;
 - (2) Management accepts responsibility for any significant actuarial methods and assumptions; and
 - (3) The accountant's involvement is not continuous.
 - (B) Subject to complying with paragraph (c)(4)(iv)(A)(1) - (3) of this section, the accountant's independence will not be impaired if the accountant:
 - (1) Assists management to develop appropriate methods, assumptions, and amounts for policy and loss reserves and other actuarial items presented in financial reports based on the audit client's historical experience, current practice, and future plans;
 - (2) Assists management in the conversion of financial statements from a statutory basis to one conforming with generally accepted accounting principles;
 - (3) Analyzes actuarial considerations and alternatives in federal income tax planning; or
 - (4) Assists management in the financial analysis of various matters, such as proposed new policies, new markets, business acquisitions, and reinsurance needs.
- (v) Internal audit services. Either of:
- (A) Internal audit services in an amount greater than 40% of the total hours expended on the audit client's internal audit activities in any one fiscal year, unless the audit client has less than \$200 million in total assets. (For purposes of this paragraph, the term internal audit services does not include operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements.); or
 - (B) Any internal audit services, or any operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements, for an audit client, unless:
 - (1) The audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with Section 13(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(b)(2));
 - (2) The audit client's management designates a competent employee or employees, preferably within senior management, to be responsible for the internal audit function;
 - (3) The audit client's management determines the scope, risk, and frequency of internal audit activities, including those to be performed by the accountant;
 - (4) The audit client's management evaluates the findings and results arising from the internal audit activities, including those performed by the accountant;
 - (5) The audit client's management evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the accountant; and

- (6) The audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls.
- (vi) **Management functions.** Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.
- (vii) **Human resources.**
- (A) Searching for or seeking out prospective candidates for managerial, executive, or director positions;
 - (B) Engaging in psychological testing, or other formal testing or evaluation programs;
 - (C) Undertaking reference checks of prospective candidates for an executive or director position;
 - (D) Acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or
 - (E) Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions).
- (viii) **Broker-dealer services.** Acting as a broker-dealer, promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.
- (ix) **Legal services.** Providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.
- (5) Contingent fees. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.
- (d) **Quality controls.** An accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided:
- (1) The covered person did not know of the circumstances giving rise to the lack of independence;
 - (2) The covered person's lack of independence was corrected as promptly as possible under the relevant circumstances after the covered person or accounting firm became aware of it; and
 - (3) The accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm's practice, that the accounting firm and its employees do not lack independence, and that covers at least all employees and associated entities of the accounting firm participating in the engagement, including employees and associated entities located outside of the United States.
 - (4) For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), a quality control system will not provide such reasonable assurance unless it has at least the following features:
 - (i) Written independence policies and procedures;
 - (ii) With respect to partners and managerial employees, an automated system to identify their investments in securities that might impair the accountant's independence;
 - (iii) With respect to all professionals, a system that provides timely information about entities from which the accountant is required to maintain independence;
 - (iv) An annual or on-going firm-wide training program about auditor independence;
 - (v) An annual internal inspection and testing program to monitor adherence to independence requirements;
 - (vi) Notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements;

- (vii) Written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and
- (viii) A disciplinary mechanism to ensure compliance with this section.

(e) **Transition and grandfathering.**

(1) Transition.

- (i) Appraisal or valuation services or fairness opinions and internal audit services. Until August 5, 2002, providing to an audit client the non-audit services set forth in paragraphs (c)(4)(iii) and (c)(4)(v) of this section will not impair an accountant's independence with respect to the audit client if performing those services did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Boards, or the accounting profession in the United States.
 - (ii) Other financial interests and employment relationships. Until May 7, 2001, having the financial interests set forth in paragraph (c)(1)(ii) of this section or the employment relationships set forth in paragraph (c)(2) of this section will not impair an accountant's independence with respect to the audit client if having those financial interests or employment relationships did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.
 - (iii) Quality controls. Until December 31, 2002, paragraph (d)(4) of this section shall not apply to offices of the accounting firm located outside of the United States.
- (2) Grandfathering. Financial interests included in paragraphs (c)(1)(ii)(A) and (c)(1)(ii)(F) of this section and employment relationships included in paragraph (c)(2) of this section in existence on [insert date 3 months after the effective date of this section], and contracts for the provision of services described in paragraph (c)(4)(ii) of this section in existence on [insert the effective date of this section] will not be deemed to impair an accountant's independence if they did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.
- (3) Settling financial arrangements with former professionals. To the extent not required by pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States, the requirement in paragraph (c)(2)(iii) of this section to settle financial arrangements with former professionals applies to situations that arise after the effective date of this section.

(f) **Definitions of terms.** For purposes of this section:

- (1) Accountant, as used in paragraphs (b) through (e) of this section, means a certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.
- (2) Accounting firm means an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States. Accounting firm also includes the organization's pension, retirement, investment, or similar plans.
- (3) Accounting role or financial reporting oversight role means a role in which a person is in a position to or does:
 - (i) Exercise more than minimal influence over the contents of the accounting records or anyone who prepares them; or
 - (ii) Exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

- (4) Affiliate of the audit client means:
- (i) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;
 - (ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;
 - (iii) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and
 - (iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.
- (5) Audit and professional engagement period includes both:
- (i) The period covered by any financial statements being audited or reviewed (the "audit period"); and
 - (ii) The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission (the "professional engagement period"):
 - (A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and
 - (B) The professional engagement period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant's audit client.
 - (iii) For audits of the financial statements of foreign private issuers, the "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.
- (6) Audit client means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client, other than, for purposes of paragraph (c)(1)(i) of this section, entities that are affiliates of the audit client only by virtue of paragraph (f)(4)(ii) or (f)(4)(iii) of this section.
- (7) Audit engagement team means all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.
- (8) Chain of command means all persons who:
- (i) Supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm's chief executive;
 - (ii) Evaluate the performance or recommend the compensation of the audit engagement partner; or
 - (iii) Provide quality control or other oversight of the audit.
- (9) Close family members means a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.
- (10) Contingent fee means, except as stated in the next sentence, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service. Solely for the purposes of this section, a fee is not a "contingent fee" if it is fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. Fees may vary depending, for example, on the complexity of services rendered.
- (11) Covered persons in the firm means the following partners, principals, shareholders, and employees of an accounting firm:
- (i) The "audit engagement team";
 - (ii) The "chain of command";

- (iii) Any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; and
 - (iv) Any other partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.
- (12) Group means two or more persons who act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant.
- (13) Immediate family members means a person's spouse, spousal equivalent, and dependents.
- (14) Investment company complex
- (i) "Investment company complex" includes:
 - (A) An investment company and its investment adviser or sponsor;
 - (B) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section, or any entity under common control with an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section if the entity:
 - (1) Is an investment adviser or sponsor; or
 - (2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and
 - (C) Any investment company or entity that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraph (f)(14)(i)(A) or (f)(14)(i)(B) of this section.
 - (ii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.
 - (iii) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.
- (15) Office means a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines.
- (16) Rabbi trust means an irrevocable trust whose assets are not accessible to the accounting firm until all benefit obligations have been met, but are subject to the claims of creditors in bankruptcy or insolvency.

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

4. The general authority citation for Part 240 is revised to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78l, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

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5. By amending § 240.14a-101 to add paragraph (e) to Item 9 to read as follows:

§ 240.14a-101 Schedule 14A Information required in proxy statement.

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Item 9. Independent public accountants. * * *

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- (e)(1) Disclose, under the caption Audit Fees, the aggregate fees billed for professional services rendered for the audit of the registrant's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in the registrant's Forms 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) for that fiscal year.
- (2) Disclose, under the caption Financial Information Systems Design and Implementation Fees, the aggregate fees billed for the professional services described in Paragraph (c)(4)(ii) of Rule 2-01 of Regulation S-X (17 CFR 210.2-01(c)(4)(ii)) rendered by the principal accountant for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.
- (3) Disclose, under the caption All Other Fees, the aggregate fees billed for services rendered by the principal accountant, other than the services covered in paragraphs (e)(1) and (e)(2) of this section, for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.
- (4) Disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of the services covered in paragraphs (e)(2) and (e)(3) of this section is compatible with maintaining the principal accountant's independence.
- (5) If greater than 50 percent, disclose the percentage of the hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.