The Institute of Chartered Accountants in Australia
and
CPA Australia

Detailed CLERP 9 submission

10 November 2003

Introduction

This memorandum provides a detailed commentary on those Items of the CLERP (Audit Reform and Corporate Disclosure) Bill ("**Bill**") which concern the Australian accounting profession. It has been prepared on behalf of The Institute of Chartered Accountants of Australia and the CPA Australia.

The submission adopts the same segmentation of the Bill, namely the 12 Schedules and their respective Parts. Reference to an item is to an item of the applicable Schedule of the Bill. Reference to a section is to a section that is amended by the applicable Schedule.

The format of the submission is to outline the arguments, and then to provide suggested redrafted sections to assist the review process. The Annexure to the submission is a consolidated revision to Schedule 1 Part 3 (Auditor Independence). In most cases we are proposing amendments to the draft legislation rather than outright deletion.

The CLERP 9 Commentary has raised issues for discussion. We have commented on a number of those issues. These are indicated in the text.

At the end of the submission we have included a section discussing appropriate penalties for contraventions of the provisions affecting members of the auditing profession.

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Schedule 1 – Audit Reform

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CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 1 - Audit Oversight - The financial reporting system

Item 11 - Financial Reporting Council functions

Concept or issues:

We generally support the Financial Reporting Council functions proposed.

We propose that the FRC has responsibility for oversight of the Financial Reporting Panel and suggest some amendments to s.225 to reflect this.

We note that the monitoring roles proposed in subsection 225(2)(h) and subsection 225(2B)(a) duplicate the role of ASIC. We suggest that a Memorandum of Understanding is required between ASIC and the FRC regarding allocation of responsibilities and co-operation.

Recommended action:

Amend

Redraft of Item:

s.225
Functions generally
(1) The FRC functions are:
- (a) to provide broad oversight of the processes for setting accounting standards in Australia; and
- (b) to provide broad oversight of the processes for setting auditing standards in Australia; and
- (c) to monitor the effectiveness of auditor independence requirements in Australia; and
- (d) to provide broad oversight of the activities and effectiveness of the Financial Reporting Panel; and
- ~~(d)~~(e) to give the Minister reports and advice about the matters referred to in paragraphs (a), (b), ~~and~~ (c) and (d); and
- ~~(e)~~(f) the functions specified in subsections (2) (specific accounting standards functions), (2A) (specific auditing standards functions) and (2B) (specific auditor independence functions); and
- ~~(f)~~(g) to establish appropriate consultative mechanisms; and
- ~~(g)~~(h) to advance and promote the main objects of this Part; and
- ~~(h)~~(i) any other functions that the Minister confers on the FRC by written notice to the FRC Chair.

Specific accounting standards functions
(2C) The FRC functions include:
- (a) appointing the members of the Financial Reporting Panel; and
- (b) approving and monitoring the Financial Reporting Panel's:
  - (i) priorities; and

(ii) business plans; and
(iii) budgets; and
(iv) staffing arrangements (including level, structure and composition of staffing); and

(c) determining the Financial Reporting Panel's broad strategic direction; and

(d) giving the Financial Reporting Panel's directions, advice or feedback on matters of general policy and on the Financial Reporting Panel's procedures; and

(e) monitoring the Financial Reporting Panel's interpretation of accounting standards having regard to the objectives of the AASB;

(f~~i~~) monitoring and periodically reviewing the level of funding, and the funding arrangements, for the Financial Reporting Panel.

CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 1 - Audit Oversight - The financial reporting system

Item number 14 - Information gathering powers

Concept or issues:

Document or Information

- Sections 225A(1) and 225A(2) grant the Chair of the FRC the power to require production of documents by the professional accounting bodies. Ideally these provisions should be limited to those documents which are already in the possession of the body receiving the notice, but we recognise that some generation of documents to satisfy the information request will be the most effective way to assist the FRC.

- Section 225A(3) also requires production of information or documents by auditors.

- We submit that a penalty under s.225A(7) or s.225A(8) should only be imposed for failure to deliver documents already in existence which are required under s.225A(1) or (3). To impose a penalty for failure to provide information which must be generated into a document is not appropriate. It is impossible to be certain whether information is sufficient to meet the requirement. This limitation is common in such clauses (see, for example, section 33 of the ASIC Act) and avoids criminal liability arising where the person receiving the notice does not have custody or control of existing requested documents at the time of request.

Scope of information that may be sought

- Paragraph 225A(3)(c) permits regulations to be made as to the scope of matters for which information can be sought. We propose limiting the power to the proper exercise of functions of the FRC.

Provision of copies

- Accounting firms are required to keep audit papers under the Corporations Act (new section 307B), the auditing standards, for client purposes, and to meet other potential regulator demands (eg the PCAOB).

- To ensure compliance with these requirements, the obligation under section 225A(3) to produce documents should be able to be fulfilled by the provision of copies. The copies provided could be certified as correct if the FRC requires.

Protection of auditors

- Section 225A(4) is intended to protect the auditors from any breach of a client confidentiality obligation. We are suggesting a clarification to these words and also that the protection is extended to include a breach of the Privacy Act, as the papers may well

contain personal information, the use or disclosure of which is restricted under that legislation.

- We seek certainty of qualified privilege for documents or information provided to the FRC in response to an information request under section 225A. We propose this as a clarification to section 1289 (as amended by Item 107 of the CLERP 9 Bill (see page • of this submission). This request is consistent with the protection already provided for disclosures made to ASIC under s.311.

- We also request protection from self-incrimination in materials provided to the FRC under s.225A. To ensure a free flow of information between auditors and the FRC, which would enhance the auditor monitoring functions of the FRC, auditors should be assured that materials they generate may not be used against them. Of course the relevant facts cannot be altered, or shielded, but the process of providing them to the FRC will be unduly hindered by legal review if the requested protection is not granted.

Penalties

- Section 225A(8) imposes a penalty on each member of an auditing firm that does not comply with a notice. We submit that this is unwarranted. It will never be the position in any firm of significant size that all partners will settle disclosures. We submit, that at the least, a defence should be provided to individual members of firms, analogous to the defences in s.307B (destruction of audit papers) and s.250RA (failure to attend AGM's). It is unfair to impose penalties on persons where they realistically have no control over the actions giving rise to the penalty.

Recommended action:

Amend

Redraft of Item:

225A Financial Reporting Council's information gathering powers

(1) The Chair of the FRC may give a professional accounting body written notice requiring the body to give the FRC:

(a) a copy of:

(i) a code of professional conduct of the body; or

(ii) a proposed code of professional conduct of the body; or

(iii) a proposed amendment of a code of professional conduct of the body; or

(b) information about the body's planning or performance of quality assurance reviews; or

(c) details of the body's investigation or disciplinary procedures.

A professional accounting body will be taken to have complied with this section if the body produces duplicate copies of the relevant documents.

(2) The notice:

(a) may require the body to give the FRC information under paragraph (1)(b) or (c) only to the extent to which the information relates to audit work done by Australian auditors; and

(b) may not require the body to give the FRC details of:

(i) the review of a particular audit; or
(ii) an investigation of, or disciplinary action taken against, a particular person.

(3) The Chair of the FRC may give an Australian auditor written notice requiring the auditor to give the FRC information about, or documents that relate to, one or more of the following:
(a) one or more audits conducted by the auditor or in which the auditor participated;
(b) the measures the auditor adopted, or the procedures the auditor put in place, to ensure that the auditor was, and continues to be, independent of entities it audits;
(c) any other matter prescribed by the regulations for the purposes of this paragraph and which is relevant to the FRC's proper exercise of its functions as described in section 225.

Without limiting this, the documents may be audit working papers. An auditor will be taken to have complied with this section if the auditor produces duplicate copies of the relevant documents.

(4) The notice may require the Australian auditor to give the FRC information or a document even if doing so would involve a breach of an obligation of confidentiality that the auditor owes an audited body or a breach of the *Privacy Act 1988* but no auditor will be liable in any action for breach of confidence or a breach of the *Privacy Act 1988* as a result of giving documents to the FRC for the purposes of this section.

(5) The notice under subsection (1) or (3) must specify:
(a) the information or documents the Australian auditor must give; and
(b) the period within which the Australian auditor must give the information or documents.

The period specified under paragraph (b) must be not less than 28 days after the day on which the notice is given.

(6) The Chair of the FRC may, by written notice to the Australian auditor, extend the period within which the auditor must give the information or documents.

(7) A person commits an offence if:
(a) the FRC gives the person notice to produce documents in the person's possession under subsection (1) or (3); and
(b) the person does not comply with the notice.

(8) A person commits an offence if:
(a) the person is a registered company auditor; and
(b) the person is a partner in an audit firm; and
(c) the FRC gives the firm a notice under subsection (~~2~~3); and
(d) the notice is not complied with.

(9) A partner in an audit firm does not commit an offence at a particular time because of a contravention of subsection (8) if the partner either:
(a) does not know at that time the circumstances that constitute the contravention of subsection (8) by the audit firm; or
(b) knows of those circumstances at that time but takes all reasonable steps to correct the contravention of subsection (8) by the audit firm as soon as possible after the partner becomes aware of those circumstances.

Note: A defendant bears an evidential burden in relation to the matters in subsection (9), see subsection 13.3(5) of the *Criminal Code*.

(10) Evidence or information included in a response under subsections (1) or (3) is not admissible in evidence against:

(a) a professional accounting body responding to a notice under subsection (1);

(b) an auditor responding to a notice under subsection (3); or

(c) any other representative of such a body or auditor (including a partner in an audit firm),

in any proceedings (other than proceedings for an offence against Division 136 or 137 of the *Criminal Code* based on the evidence or information given being false or misleading).

Note: Amendments relevant to this item are also proposed to section 1289 of the *Corporations Act* - see page 82 of these submissions.

CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 1 - Audit Oversight – AuASB matters

Issue 1.1
Issue 1.2
Issue 1.3

Issue 1.1: Does proposed paragraph 224(aa) adequately express the role auditing standards should be playing in Australia's financial reporting system?

Response

The Accounting Bodies support the views expressed by the Auditing and Assurance Standards Board (AuASB) in its submission that proposed paragraph 224(aa) is too narrow as the AuASB also issues audit standards and guidance for both non Corporations Act Audits and other assurance engagements. We support the proposed amendments to paragraph 224(aa) proposed by the AuASB.

Issue 1.2: Proposed section 227B is silent about the ability of the AuASB to formulate standards to be used for assurance engagements and to develop guidance material for auditors performing audit and assurance engagements. Comments are sought on whether the AuASB needs to be given such functions.

Response

The Accounting Bodies support the views expressed by the Auditing and Assurance Standards Board (AuASB) in its Submission that proposed section 227B needs to be amended to reflect a broadened mandate so that it can make assurance standards for other than just the Corporations Act, formulate guidance on auditing and assurance standards, and participate and contribute to the development of international standards and guidance.

Issue 1.3: Proposed subsection 227B(1) does not confer on the AUASB the function of developing conceptual framework for the purpose of evaluating proposed Australian and international auditing standards. Comments are sought on whether the AUASB needs to be given such a function.

Response

The Accounting Bodies support the views expressed by the Auditing and Assurance Standards Board in its Submission that it is not necessary to have a function of developing a conceptual framework for the purpose of evaluating proposed Australian and International Auditing Standards, as the Framework is already included in the existing Australian and International Auditing Standards.

CLERP 9 draft legislation:

Schedule 1 - Audit Reform
Part 1 - Audit Oversight

Item 22 - ASIC Act Section 235BA

Concept or issues:

Section 235BA requires the FRC to report annually to the Minister on its audit independence functions, including its findings and conclusions arising from those functions. The FRC report is tabled in Parliament and hence will be a public document.

There is a concern that the FRC report could disclose sensitive auditor or client information.

We note that under section 104 of the US Sarbanes-Oxley legislation, the Public Company Accounting Oversight Board has a similar monitoring role and has established the following regime:

- It must issue reports on each inspection as it comes out.
- Its draft inspection reports are provided to the auditors under review for their response and those responses are appended to the Board's report to the SEC and other relevant regulators, with appropriate redaction to protect information reasonably identified by the accounting firm as confidential.
- Further the Board may determine to protect confidential or proprietary information before it makes an inspection report public.
- An inspection report that deals with criticisms of or potential deficits in the quality control systems of the firm under inspection may not be made public if those criticisms or defects are addressed by the firm to the satisfaction of the PCAOB not later than 12 months after the report is issued.

Consistent with the approach of the US legislature, we request a legislative direction to the FRC that if it proposes to name an auditor in its annual report to the Minister then it must refer the relevant passage, in context, to the auditor concerned for comment, and must give proper consideration to timely responses, having regard to protecting the confidentiality of audit clients, and the legitimate business interests of auditors.

Recommended action:

Amend

Redraft of Item:

235BA Report on auditor independence functions

(1) As soon as practicable after 30 June in each year, and in any event before 31

October, the FRC must give the Minister a report on:

(a) the performance by the FRC, during the year that ended on 30 June in that year, of its functions under subsection 225(2B) (the auditor independence functions); and

(b) the findings and conclusions that the FRC reached in performing those functions; and

(c) the actions (if any) that were taken by the FRC in respect of those findings and conclusions.

The report may be given to the Minister separately or included in the report given to the Minister under section 235B.

(2) The Minister may grant an extension of time in special circumstances.

(3) The Minister must table the report in each House of the Parliament as soon as practicable.

(4) If the FRC proposes to name any auditor in its report, the FRC must, before giving its report to the Minister:

(a) give a copy of the final draft of its report (or the section of its final draft report referring to the auditor) to the auditor;

(b) allow at least 28 days after giving the auditor the report for the auditor to respond in writing to the final draft report or section; and

(c) fairly consider incorporating any response provided by the auditor.

(5) The FRC must not, in its report to the Minister:

(a) name any auditor;

(b) name any client of an auditor; or

(c) disclose any confidential information belonging to an auditor or a client of an auditor,

unless it considers it necessary to do so in order to discharge its functions under section 225 and having regard to:

(d) the confidentiality of the details or identities proposed to be disclosed; and

(e) the legitimate business interests and reputations of auditors and clients of auditors.

Note: Amendments relevant to this item are also proposed to section 1289 of the *Corporations Act* - see page 82 of these submissions.

CLERP 9 draft legislation:

Schedule 1 - Audit Reform
Part 1 - Audit Oversight
Items 36, 41: Auditing standards - adoption into law

Concept or issues:

Proposed section 307A gives auditing standards the force of law. Proposed section 989CA similarly requires audits of profit and loss statements and balance sheets (sic) to be conducted in accordance with the auditing standards and any such audit report must include any statements or disclosures required by the auditing standards.

Global Attitudes

We recognise the need for the auditing profession to work with the various securities regulators and clients to enhance the confidence of investors in international auditing standards. A key plank of the strategy is global uniformity. The current processes of the International Audit & Assurance Standards Board (IAASB) are being reviewed and reformed proposals. These reforms are a result of a collaborative effort between the International Federation of Accountants (IFAC) and the International Organisation of Securities Commission Offices (IOSCO).

This initiative has provided the basis for adoption of International Auditing & Assurance Standards across Europe. Whilst there were suggestions that other jurisdictions may consider legislative backing for auditing standards this is unlikely in light of the new reforms. Other jurisdictions appear to favour consistent application of high quality internationally accepted standards that are created within a robust framework.

The IFAC reform proposal relating to auditing standards has been endorsed by IOSCO (Chairman David Knott), Basel Committee, Federation of Accountants in Europe and the Financial Stability Forum.

It should be noted that the CLERP 9 proposals were released before these developments and it is important that Australia reassess its approach to ensure it moves with other capital markets rather than away.

Preferred position: do not give auditing standards the force of law.

We, together with the Auditing and Assurance Standards Board, have previously made extensive submissions as to the inappropriateness of giving auditing standards the force of law. The essence of our submissions was that:

- Unlike accounting standards, which are arguably able to prescribe clearly defined methods of preparing and presenting financial statements, auditing standards must address the parameters within which auditors must exercise their professional judgment in a large range of circumstances. Auditing standards therefore cannot readily be written in prescriptive terms.

- There is the risk that there will either be an impermissible degree of uncertainty in auditing standards drafted under the proposed regime (and corresponding difficulty of

objective enforcement) or the auditing standards will become unduly prescriptive and mechanical to the detriment of the quality of audits. This could encourage a "form over substance" approach which is contrary to both existing accounting and auditing standards, which require a "substance over form" approach.

- A quality audit requires auditors to have the ability to plan and conduct their audit in accordance with established professional standards in audit methodologies (which are constantly developing) and pursuant to the exercise of their own professional judgment.

- To accord auditing standards the force of law will inevitably slow down the process of making and amending auditing standards and make them more prescriptive and less able to adapt to changing business conditions and international auditing standards.

- Auditing standards are adequately enforced by the application of existing common law remedies (ie for breach of contract or in tort).

- No auditor should be exposed to a claim for breach of statutory duty arising solely as a result of the exercise by that auditor of his or her professional judgment.

We repeat our previous submissions that it is unnecessary and unduly restrictive on the conduct of audits to give auditing standards the force of law. We therefore press for deletion of these provisions. We endorse the further submissions from the Auditing and Assurance Standards Board in this regard.

However, if the policy strategy cannot be changed, so deletion is not accepted, then we propose:

(a) that the standards are given the force of law, but not made disallowable instruments (see page 18 of this submission).

(b) that the present standards are not adopted immediately, but are reviewed for implementation by the AuASB once that body is established, having regard to:

- each standard's relevance to the preparation of financial reports as required by the Corporations Act;

- each standard's terms and appropriateness as having the force of law.

(see page 22 of this submission).

(c) that relevant standards must be applied from the start of the next financial year of the relevant audit entity after they are adopted, or cease to be disallowable, as appropriate.

(see page 20 of this submission).

Preferred action:

Amend to remove all references to auditing standards having the force of law

CLERP 9 draft legislation:

Schedule 1 - Audit reform
Part 1 - Audit Oversight
Item 40: Disallowable Instruments

(Note: This paragraph only applies if our submission is not accepted that auditing standards are not given the force of law.)

Concept or issues:

S.336(2) states that auditing standards will be disallowable instruments for the purpose of the Acts Interpretation Act 1901.

The consequence of prescribing that auditing standards constitute disallowable instruments is to require them to be tabled before parliament for up to 30 sitting days, and they are liable to be disallowed during that time.

Auditing standards are statements of methodology for the conduct of an audit. They are presently prepared by the profession, in consultation with international professional bodies to ensure uniformity of process. They are constantly under review and revision to reflect best practice.

We suggest that the process of the tabling of the auditing standards before each House of Parliament (each of which can disallow the amendment) will render the auditing standards unduly rigid and prescriptive.

It is vital to the stability and credibility of global capital markets that Australian auditing standards harmonize and converge with international auditing standards issued by the IAAFB, in as timely a manner as possible. The cumbersome process for change through the Parliament leads to the risk that Australian auditing standards will become out-of-step with international auditing standards issued by the IAASB from time to time, which in turn could hinder business development in Australia.

We submit that the auditing standards can be given force of law without making them disallowable instruments.

The proposed amendments to the legislation could simply require compliance with auditing standards without providing that they be disallowable instruments (see for example section 13 of the Audit Act 1994 (Vic) and section 79 of the Financial Administration and Audit Act 1985 (WA)). The Canadian companies laws simply require compliance with the Canadian Institute of Chartered Accountants Handbook.

There will be a curious position where standards are said to apply, but may cease to apply for some part of the audit to which they relate. In any event the standard should not commence until the time for disallowance has elapsed. (See page 18 of this submission).

We note that under s.334 of the Corporations Act the accounting standards are currently disallowable instruments. For the reasons stated above regarding inflexibility this should be reviewed for accounting standards.

Recommended action:

Delete s.336(2)

CLERP 9 draft legislation:

Schedule 1 - Audit Reform
Part 1 - Audit Oversight
Item 40

(Note: This paragraph only applies if our submission is not accepted that auditing standards are not given the force of law.)

Auditing standards - timing of adoption into law

Concept or issues:

The AUASB is given authority to make auditing standards, and that they are to apply as law from the commencement of the standard (ie adoption as a standard).

S.336(3) contemplates that standards will become applicable when adopted, or at a later time specified in the standard.

We submit that a standard should only apply for an audit of a financial report for a financial year or half-year of a financial year that begins after the standard becomes applicable.

An auditor's opinion is provided for the whole period under audit, so the obligations on the auditor as to the manner of conducting the audit should apply for the whole period.

Accordingly, we submit that s.336(3) should be amended to apply standards from the start of the next financial reporting year after the standard becomes applicable.

If our submission that standards should not be disallowable instruments is not accepted (see page 18), then we also submit that the standard should not become applicable until the period for disallowance or deemed disallowance has elapsed. The period for disallowance is up to 45 parliamentary sitting days, which could extend over some months. If standards are to have the force of law, then they should apply for the whole of the period to which the audit relates. That is the only practicable way to apply an auditing standard. Disallowance suggests some disapproval of the standard, and so it would be wrong to have it apply at any time in the audit process.

Accounting standards can be contrasted with auditing standards in this regard. Accounting standards apply to financial statements at a specified fixed time.

Recommended action:

Amend.

Redraft of Item:

Version 1 - Auditing standards no longer disallowable instruments

336 Auditing standards
AUASB's power to make auditing standards
(1) The AUASB may make auditing standards for the purposes of this Act. The

standards must be in writing and must not be inconsistent with this Act or the regulations.

~~(2) A standard made under subsection (1) is a disallowable instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*.~~

~~(3)~~(2) An auditing standard applies to financial reports in relation to:

(a) periods ~~ending~~ starting after the making ~~commencement~~ of the standard; or

(b) any later period starting ~~s ending, or starting,~~ on or after a later date specified in the standard~~,~~.

Version 2 - Auditing standards remain disallowable instruments

336 Auditing standards

AUASB's power to make auditing standards

(1) The AUASB may make auditing standards for the purposes of this Act. The standards must be in writing and must not be inconsistent with this Act or the regulations.

(2) A standard made under subsection (1) is a disallowable instrument for the purposes of section 46A of the *Acts Interpretation Act 1901*.

(2) An auditing standard applies to financial reports in relation to:

(a) periods ~~ending after the commencement of the standard~~ starting after the last day on which the relevant standard may be disallowed (or is deemed to be disallowed) by either House of Parliament under Part XII of the *Acts Interpretation Act 1901*; or

(b) any later period starting ~~s ending, or starting,~~ on or after a later date specified in the standard.

CLERP 9 draft legislation:

Schedule 1 - Audit Reform
Part 1 - Audit Oversight
Transitional Item - Schedule 12

(Note: This paragraph only applies if our submission is not accepted that auditing standards are not given the force of law.)

Auditing standards - Regulations

Concept or issues:

The transitional provision in s.1451 permits implementation of existing standards issued by AARF as law by regulation, for a minimum 2 year period.

Many of the current auditing standards issued by AARF are not currently in a form appropriate for having the force of law. Specifically:

- Not all auditing standards relate to the audit of a financial report under the Corporations Act - only the 300 to 700 series apply;

- The 100 series relates to the framework, the 200 series relates to responsibilities and the 800 and 900 series relates to other assurance and audit engagements.

- The language of current standards is discretionary or advisory and not sufficiently directive or appropriately prescriptive to give rise to legal liabilities. In our submission standards which address the manner of exercise of an auditor's professional judgment should not be given the force of law.

We recommend that regulations referred to in section 1451 only include audit standards which have been reviewed and approved by the AuASB, or AARF prior to commencement of the CLERP 9 amendments, as practical for adoption from the commencement date. As noted above the commencement date should only be the start of the next financial year. Remaining standards should be progressively reviewed, amended and adopted as appropriate.

We note that this approach is consistent with section 103 of the Sarbanes-Oxley Act. Under that section, the PCAOB may recognise as "generally accepted" any auditing standards established by certain professional accounting bodies, but the PCAOB must specifically address each standard.

Recommended action:

Amend

Redraft of Item:

1451 Adoption of auditing standards made by accounting profession before commencement

(1) The regulations may provide that a standard specified in the regulations (as in force from time to time) is to have effect, for the purposes of this Act, as if it

had been made by the AUASB under section 336 on the day specified in the regulations.

(2) The standard must be one which is both:

(a) made or issued by the Australian Accounting Research Foundation before the commencement day on behalf of CPA Australia and The Institute of Chartered Accountants in Australia. ; and

(b) either:

(i) approved by the AUASB as appropriate to have the status referred to in subsection (1); or

(ii) approved by the Australian Accounting Research Foundation before the commencement day as appropriate to have the status referred to in subsection (1) after the commencement day.

(3) The regulations may provide that the standard is to have effect as if it specified that it applies to periods ending, or starting, on or after a later date specified in the standard.

(4) Standards prescribed under subsection (1) cease to have effect as auditing standards:

(a) 2 years from the commencement day; or

(b) at any later date if so specified by regulations made under subsection (1) before the expiry of the 2 year period mentioned in (a).

CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 1 – Audit oversight

Item 36: Audit papers to be retained for 7 years after the date of the audit report

Concept or issues:

Description of documents

Section 307B requires the retention of "all documents (including audit working papers) prepared, considered or used by the auditor in accordance with the requirements of the auditing standards".

We submit this drafting is not clear. Are the documents to be retained in the manner required in the auditing standards (eg electronic filing), or are the documents all those reviewed in accordance with the auditing standards?

Under the wider construction of draft section 307B, the auditor will be required to take a copy of each and every document which he or she views during the course of the audit, whether or not it was considered material in the course of the audit. This requirement will lead to major increases in the time and cost involved in each audit. The requirement would also result in major increases in storage costs. An auditor considers a large number of documents in each audit, many of which are client documents and are retained by the client. Arguably a full copy of all company records viewed is required.

We suggest that the intent of the section is met by confining the retention obligation to audit working papers required to be kept by the auditing standards.

The auditing standards require the preparation of audit working papers which are the property of the auditor. The introduction to Standard 208, paras 1 to 3 follows:

> ".01 The purpose of this Auditing Standard (AUS) is to establish standards and provide guidance on documentation in the context of the audit of financial reports.
>
> 0.2 ***The auditor should document matters which are important in providing evidence to support the audit opinion and evidence that the audit was carried out in accordance with Australian Auditing Standards.***
>
> 0.3 "Documentation" means the material (working papers) prepared by, and for, or obtained and retained by the auditor in connection with the performance of the audit. Working papers may be in the form of data stored on paper, film, electronic media or other media."

The Australian standard is consistent with International Auditing Standard 15A 230 (Documentation). We submit that confining the section to audit working papers is sufficient and consistent with international practice.

For certainty we request the addition of words permitting retention of audit working papers in electronic and other non-paper forms. This is consistent with the auditing standards, and

current practice. Paper file copies are more susceptible to damage, costly to store, less easy to copy and use environmental resources in an inefficient manner.

No destruction

The obligation in draft s.307B is one of absolute retention and it is an offence not to retain relevant documents. It is possible for records to be destroyed for reasons beyond the control of the auditor (eg fire, theft). It is unfair for a penalty to be imposed for such events. We submit that the section is more fairly cast in terms of "not destroying" rather than "retaining".

If this is not accepted then there must be a defence for events beyond the control of the auditor. We have proposed (in the alternative) a defence of reasonable excuse, by analogy to proposed s.250RA(3) (Item 103).

Penalties

We note the statement that each member of a firm is liable for a breach of s.307A, unless a defence can be established. We submit that the words are unclear in application and propose some clarifications, particularly as to timing of awareness in the context of "retention" versus "destruction".

Recommended action:

Amend

Redraft of Item:

Version 1 - Offence to destroy

307B Audit papers to be retained for 7 years

(1) An auditor who conducts:

(a) an audit of the financial report for a financial year; or

(b) an audit or review of the financial report for a half-year;

must ~~retain all~~not destroy any document~~s~~ (including audit working papers) ~~prepared, considered or used~~required to be retained in relation to that audit or review by the auditing standards applicable to that audit or review ~~by the auditor in accordance with the requirements of the auditing standards~~ until:

(c) the end of 7 years after the date of the audit report prepared in relation to the audit or review to which the documents relate; or

(d) an earlier date determined by ASIC under subsection (2).

(2) ASIC may, on application by a person, determine, in writing, an earlier date for the documents for the purposes of paragraph (1)(d) if:

(a) the auditor is an individual auditor and the auditor:

(i) dies; or

(ii) ceases to be a registered company auditor;

(b) the auditor is an audit firm and the firm is dissolved (otherwise than simply as part of reconstitution of the firm because of the death, retirement or withdrawal of a member or members or because of the admission of a new member or members); or

(c) the auditor is an audit company and the company:

(i) is wound up; or
(ii) ceases to be an authorised audit company.

(3) In deciding whether to make a determination under subsection (2), ASIC must have regard to:
(a) whether ASIC is inquiring into or investigating any matters in respect of:
(i) the auditor; or
(ii) the audited body for the audit to which the documents relate; and
(b) whether the professional accounting bodies have any investigations or disciplinary action pending in relation to the auditor; and
(c) whether civil or criminal proceedings in relation to:
(i) the conduct of the audit; or
(ii) the contents of the financial report to which the documents relate;
have been commenced or are about to be commenced; and
(d) any other relevant matter.

(4) If an audit firm contravenes subsection (1):
(a) each member of the firm contravenes this subsection; and
(b) the firm itself does not commit an offence based on the contravention of subsection (1).

(5) A member of an audit firm does not commit an offence at a particular time because of a contravention of subsection (4) if the member either:
(a) does not know at that time of the circumstances that constitute the contravention of subsection (1) by the audit firm; or
(b) knows of those circumstances at that time but takes all reasonable steps to ~~correct~~ stop the contravention of subsection (1) by the audit firm as soon as possible after the member becomes aware of those circumstances.

[Note: A defendant bears an evidential burden in relation to the matters in subsection (5) see subsection 13.3(3) of the *Criminal Code*.]

(6) For the purposes of this section, an auditor will not be taken to have destroyed a document if the auditor has retained a copy of the document, which may include stored in an electronical file.

Version 2 - Offence not to retain (exception for events beyond auditor's control)

307B Audit papers to be retained for 7 years

(1) An auditor who conducts:
(a) an audit of the financial report for a financial year; or
(b) an audit or review of the financial report for a half-year;
must retain ~~all~~any document~~s~~ (including audit working papers) ~~prepared, considered or used~~ required to be retained in relation to that audit or review by the auditing standards applying at the time the document was created ~~by the auditor in accordance with the requirements of the auditing standards~~ until:
(c) the end of 7 years after the date of the audit report prepared in relation to the audit or review to which the documents relate; or
(d) an earlier date determined by ASIC under subsection (2).

(2) ASIC may, on application by a person, determine, in writing, an earlier date for the documents for the purposes of paragraph (1)(d) if:

(a) the auditor is an individual auditor and the auditor:
(i) dies; or
(ii) ceases to be a registered company auditor;
(b) the auditor is an audit firm and the firm is dissolved (otherwise than simply as part of reconstitution of the firm because of the death, retirement or withdrawal of a member or members or because of the admission of a new member or members); or
(c) the auditor is an audit company and the company:
(i) is wound up; or
(ii) ceases to be an authorised audit company.

(3) In deciding whether to make a determination under subsection (2), ASIC must have regard to:
(a) whether ASIC is inquiring into or investigating any matters in respect of:
(i) the auditor; or
(ii) the audited body for the audit to which the documents relate; and
(b) whether the professional accounting bodies have any investigations or disciplinary action pending in relation to the auditor; and
(c) whether civil or criminal proceedings in relation to:
(i) the conduct of the audit; or
(ii) the contents of the financial report to which the documents relate;
have been commenced or are about to be commenced; and
(d) any other relevant matter.

(4) If an audit firm contravenes subsection (1):
(a) each member of the firm contravenes this subsection; and
(b) the firm itself does not commit an offence based on the contravention of subsection (1).

(5) A member of an audit firm does not commit an offence ~~at a particular time~~ because of a contravention of subsection (4) if the member either:
(a) does not know ~~at that time~~ of the circumstances that constitute the contravention of subsection (1) by the audit firm; or
(b) knows of those circumstances ~~at that time~~ but takes all reasonable steps to correct the contravention of subsection (1) by the audit firm as soon as possible after the member becomes aware of those circumstances.

(6) Subsection (1) does not apply if the auditor has a reasonable excuse for not complying with the section, which includes where a document has been lost or destroyed due to circumstances outside the auditor's reasonable control.

Note: A defendant bears an evidential burden in relation to the matters in subsection (5) and (6), see subsection 13.3(3) of the *Criminal Code*.

(7) For the purposes of this section, an auditor will be taken to have retained a document if a copy of the document has been retained, which may include stored on an electronical file.

CLERP 9 draft legislation:

Schedule 1 - Audit Reform
Part 2 - Qualification of Auditors
Item 48: Annual statement by auditors

Concept or issues:

Section 1287A requires registered company auditors to lodge an annual statement with ASIC by 31 January. The content of the statement will be prescribed by the Regulations and the commentary states that it will include "details of the nature and complexity of major audit work undertaken by the auditor".

It is unclear whether the statement will be or could become publicly available. We request clarification that the statement will not require an auditor to disclose confidential information of, or about, its audit client.

Recommended action:

Amend

Redraft of Item:

1287A Annual statements by registered company auditors

(1) A person who is a registered company auditor at the end of a calendar year must, on or before the next 31 January, lodge with ASIC a statement in respect of:
  (a) that calendar year; or
  (b) if the person became registered as an auditor during that calendar year—the period between the date on which the person became registered and the end of that calendar year;
setting out such information as is prescribed in the regulations.

(2) ASIC may, on the application of the person made before the end of the period for lodging a statement under subsection (1), extend, or further extend, that period.

(3) Nothing in this section (or any regulations made for the purposes of this section) requires an auditor to disclose any confidential information of the auditor or the auditor's clients.

CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 2 – Qualifications of auditors

Item 51 - Conditions on registration of auditors

Concept or issues:

Imposition of conditions

The Commentary states that s.1289A is 'to provide ASIC with greater flexibility in considering applications for registration and to enhance post-registration supervision'. The conditions are to be of the kind specified in the regulations (which are not yet available).

The accounting professional organisations anticipate that they will be closely involved with relevant parties at the time the regulations are to be prepared, to ensure a suitable collaborative outcome for our industry.

We submit that the types of conditions and the criteria for imposing those restrictions should be referred to in s.1289A. We believe these restrictions should replicate the obligations to maintain quality and ethical standards of the type the professional bodies impose on their members and that is the only appropriate basis for any restriction on registration.

Subsequent Imposition of conditions

We also submit that the power to impose restrictions after registration is unfair. If a registered auditor fails to meet requirements, the CALDB is the proper place to consider the future activities of that auditor.

If this is not accepted then the matters ASIC should consider when deciding to impose a restriction after registration should be specified in s.1289A(4). In our view ASIC must have regard to the impact on the business of the auditor and the audit firm or audit company which engages the auditor or of which he or she is a partner or member, and ASIC may not have regard to matters which are properly within the purview of the CALDB.

Tiering of auditors

Paragraph 109 of the Commentary states that 'it would be possible for ASIC to register a person subject to a restriction on the types of entities the person may audit'. This particular restriction is contrary to the 1997 Government Working Party Report and the 2001 Ramsay Report which opposed having different classes or 'tiering' of auditors.

The reason for moving to an audit competency basis is due to the inflexibility of the current 'hours of experience' approach, and the ability to audit different types and sizes of entities is not reflected in greater or lesser audit competency.

If this provision becomes law there will be the opportunity for 'unrestricted' auditors to compete against auditors that are restricted (conditions) on the basis of perceived tiering even though both are equally competent.

We note that the proposed s.1289A was not publicly discussed prior to CLERP 9 being released. The amendments to auditor registration should be based on the 2 independent reports referred to above which have both been accepted by Government and the auditing profession, and do not provide a tiering of auditors.

Recommended action:

Amend

Redraft of Item:

Preferred Position:

Division 2A—Conditions on registration of auditors
1289A ASIC may impose conditions on registration

(1) Under this section, ASIC may impose only conditions of a kind specified in the regulations.

(2) Subject to this section, ASIC may, at ~~any~~ the time of granting registration to an auditor, ~~by giving written notice to a person registered as an auditor:~~

~~(a)~~ impose conditions~~, or additional conditions,~~ on ~~their~~ the auditor's registration by giving written notice to the auditor.~~; and~~

~~(b) vary or revoke conditions imposed on their registration.~~

(3) The only conditions which may be prescribed for the purposes of subsection (1) are those of a kind which may be imposed, or analogous to those which may be imposed, by a professional accounting body for the purposes of maintaining quality and the ethical standards of the body's members.

~~(3)~~(4) ASIC may ~~do so~~impose such conditions:

(a) on its own initiative; or

(b) if the registered company auditor lodges with ASIC an application for ASIC to do so, which is accompanied by the documents, if any, required by regulations made for the purposes of this paragraph.

Note: For fees in respect of lodging applications, see Part 9.10.

~~(4) Except where conditions are varied on the application of the registered company auditor, ASIC may only impose conditions or additional conditions, or vary the conditions, on registration after giving the auditor an opportunity:~~

~~(a) to appear, or be represented, at a hearing before ASIC that takes place in private; and~~

~~(b) to make submissions to ASIC in relation to the matter.~~

~~This subsection does not apply to ASIC imposing conditions at the time when the applicant is registered.~~

Alternative Position (imposition of conditions at any time):

Division 2A—Conditions on registration of auditors
1289A ASIC may impose conditions on registration

(1) Under this section, ASIC may impose only conditions of a kind specified in the regulations.

(2) Subject to this section, ASIC may, at any time, by giving written notice to a person registered as an auditor:

(a) impose conditions, or additional conditions, on their registration; and

(b) vary or revoke conditions imposed on their registration.

(3) The only conditions which may be prescribed for the purposes of subsection (1) are of a kind which may be imposed, or analogous to those which may be imposed, by a professional accounting body for the purposes of maintaining quality and the ethical standards of the body's members.

(43) ASIC may do so:

(a) on its own initiative; or

(b) if the registered company auditor lodges with ASIC an application for ASIC to do so, which is accompanied by the documents, if any, required by regulations made for the purposes of this paragraph.

Note: For fees in respect of lodging applications, see Part 9.10.

(54) Except where conditions are varied on the application of the registered company auditor, ASIC may only impose conditions or additional conditions, or vary the conditions, on registration after giving the auditor an opportunity:

(a) to appear, or be represented, at a hearing before ASIC that takes place in private; and

(b) to make submissions to ASIC in relation to the matter.

This subsection does not apply to ASIC imposing conditions at the time when the applicant is registered.

CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 2 – Qualifications of auditors

Item 54 – Cancellation of registration of auditors

Issue 1.4 in CLERP 9 Commentary

Concept or issues:

Section 1292 is to be amended to permit the CALDB to cancel an auditor's registration where audit work has not been performed for 5 years and it determines that the auditor has ceased to have the necessary practical experience.

The 1997 Audit Working Party and the 2001 Ramsay Report supported the proposition 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 auditor to show cause why his or her registration should not be cancelled."

We submit that 'audit competency' is more sophisticated than simply the hours based test in the current draft. It is quite possible for a person who has not done any substantive audit to remain a competent auditor. An example is an auditor who has moved from active line auditing to a supervisory role (eg say audit quality control) and who then moves back to signing audit reports. A 'show cause' requirement should be included in the Bill and linked to the audit competency test rather than the hours/practical experience test.

Generally we prefer an approach that looks to competency generally, and not to an hours based approach.

Recommended action:

Amend

Redraft of Item:

Amend to change reference to "audit competency".

54 After paragraph 1292(1)(a)

Insert:

(b) the person either:

(i) has not performed any audit work during a continuous period of not less than 5 years; or

(ii) has not performed any significant audit work during a continuous period of not less than 5 years;

and, as a result, has ceased to have the ~~practical experience~~ audit competency necessary for carrying out audits for the purposes of this Act; or

Schedule 1 – Audit reform

Part 3 - Auditor appointment, independence and rotation requirements

Overview

The accounting industry recognises the need to address the credibility issues arising out of recent corporate collapses, most typified by Enron and locally, HIH. The international auditing community has been working assiduously to this end, and is co-operating with regulators in many jurisdictions. Professional Statement F.1 *Professional Independence* adopted by ICAA and CPAA was a response to this perceived need and is based on best international practice.

We were surprised that the auditor independence requirements proposed in the Bill go beyond Professional Statement F.1, and also what was anticipated by both the Ramsay Report and the September 2002 CLERP 9 Discussion Paper. In many respects they go beyond the recommendations of Mr Justice Owen in the HIH Royal Commission Report. In this regard we note that the industry has not had the opportunity to make representations to Treasury about the HIHRC recommendations and some of them are very difficult to implement in practice.

The proposals in this Bill go further than the proposals in other countries, and notably the Sarbanes-Oxley requirements. At a time when the accounting and auditing standards are being converged, it would be unfortunate that the professional requirements were to diverge.

We also note that the approach adopted in the audit independence proposals appears to be prescriptive black-letter law which is at odds with the Government's commitment to a 'principles-based' approach for CLERP 9. We question whether there has been an appropriate recognition of the co-regulatory environment in regards to the often very detailed independence rules contained in the CLERP 9 provisions.

The following pages are a very detailed review of each provision. The proposals, if adopted as currently written, will have a dramatic impact on the structure of the auditing profession, and particularly the ability of the mid-tier and small-tier firms to participate in the audit business. The profession has concerns about whether it will be able to recruit the best young accounting graduates, as their potential career paths will be greatly restricted. The pool of people with financial expertise to join board audit committees, to meet corporate governance best practice and the ASX Corporate Governance Council recommendations, will be much reduced.

Generally the provisions will restrict competition between auditors, for clients and for employees. Some of the restraints that will be noted to be imposed on employees would ordinarily be seen as unreasonable.

It is our submission that the proposals will adversely impact the business community, to an extent that the benefits of the statutory independence requirements cannot justify. The costs of audit and accounting services will inevitably increase, to accommodate rotation, duplication of services from separate suppliers and monitoring of compliance. Treasury should not underestimate the cost and disruption to audit entities of changing audit firms as the result of an inadvertent breach, or a technical breach that arises due to actions beyond the

practical control of the audit firm (eg the actions of the estranged spouse of a partner). More importantly, the quality of audit at a time of hasty change over will be compromised.

We submit that the provisions require more than what is necessary to protect the actuality, and the appearance, that auditors are exercising impartial and objective professional judgment.

The key themes of our submissions on auditor independence are:

- there needs to be certainty as to the requirements necessary to maintain independence, and so the "might" test should be "would" or at most "is likely to";

- there needs to be an objective materiality threshold - auditors and their families operate in the business community and there will be interactions that cannot be avoided;

- there needs to be reasonable opportunity to remedy circumstances that could contravene the provisions.

- the provisions should align as much as possible to best international practice;

- auditors should not be responsible for actions of people beyond their most immediate family, who they can reasonably expect to influence, namely spouses, minor children and others who are dependent.

For ease of reference we have consolidated all proposed amendments in an annotated version of Schedule 1 Part 3 in the annexure to this submission. The Annexure also contains a number of technical corrections which are self-explanatory and are not referred to in this submission.

Scope of "audit"

Item 59 - s.9 definition of "audit"

Concept or issues:

Audit is not comprehensively defined in the Corporations Act. The proposed s.9 definition is only used to clarify that "audit" includes the review of half-yearly financial reports.

The auditor independence requirements and other provisions relating to an "audit" should be limited to those audits required under Part 2M.3 of the Corporations Act (which deals with yearly and half-yearly financial reports). If this is not the case, compliance audits and financial audits performed in Australian as part of audits required in offshore jurisdictions will be unnecessarily subjected to Australian law in addition to the law of the 'head' jurisdiction.

Recommended action

Amend the definition of "audit" as set out below.

Section 9

audit means an audit or review required under Part 2M.3 of this Act and includes a review of a financial report for a half-year.

Scope of "member"

Existing s.9 definition of "member"

Concept or issues:

The term "member of a firm" and similar phrases are used throughout the CLERP 9 legislation. The existing definition of "member" in section 9 should be amended to ensure clarity of this term in the context of firms.

Recommended action:

Amend s.9 as indicated below.

Section 9

"member":

(a) in relation to a managed investment scheme - means a person who holds an interest in the scheme;

(b) in relation to a firm - means a person who holds a partnership in that firm; or

(e) in relation to a company - means a person who is a member under section 231.

Disclosure of non-audit fees

Item 83 - ss.300(11B)(a) and 300(11C) (disclosure of non-audit fees)

Concept or issues:

Section 300(11C)(b) requires listed companies to disclose in their annual reports the dollar amount paid to an auditor for **each** non-audit service during the financial year.

We support the disclosure of amounts paid to auditors for both audit and non-audit services. However, if this requirement is applied as a requirement to disclose the fees paid for each separate engagement, this could lead to the disclosure of a large number of individual services. In many cases, the disclosure of individual items and amounts paid for those items would be more confusing than if the non-audit services and the fees paid for them were grouped by type.

If s.300(11C)(b) is included in the final legislation, it should be amended to refer to "each **type** of those non-audit services". This is consistent with the approach of the Sarbanes-Oxley rules, which require disclosure of fees summarised by type of service

We believe that the disclosure of fees paid for non-audit services is already addressed appropriately by the Accounting Standards and related audit assurance guidance.

Currently, Accounting Standard 1034 *Financial Report Presentation and Disclosures* requires disclosure of fees paid to auditors. The Standard is augmented by Audit and Assurance Alert 11 *Communicating with entities in relation to auditor independence*, a guidance note produced by the Auditing and Assurance Standards Board which sets out further guidelines on suitable disclosure (including appropriate groupings for different types of services).

The inclusion of the disclosure requirement in s.300 is inconsistent with the Government's previous policy approach of removing detailed disclosure requirements from the legislation in preference for reliance on the Accounting Standards. This policy approaches reflects the greater ability of the Accounting Standards to be updated or revised in a timely manner to meet future market needs.

Recommended action:

Amend s.300(11C)(b) as set out below.

Section 300(11C)(b)

(b) the dollar amount that the listed company paid for each **type** of those non-audit services.

The section 307C auditor independence declaration
Item 85 - s.307C auditor independence declaration

Concept or issues:

General comment

We support the s.307C requirement for lead auditors to make a declaration of compliance with the auditor independence requirements.

However, we are concerned that, under the proposed independence requirements, many lead auditors will not have the necessary knowledge to provide the independence declaration, whether or not there have been any actual contraventions of the auditor independence requirements.

Arguably the cumulative effect of the Corporations Act provisions is that if the auditor cannot sign the independence report then the audited company cannot lodge a complete directors' annual or half-yearly report, so breaches the statutory obligation to provide same. The only remedy is to retain a new auditor. In that event the existing auditor must resign, with the consent of ASIC. If this were to occur during the audit process then there is clear disruption to the audit and a greater risk of delay in issue of the financial reports and, most importantly, compromise of the audit efficacy. This consequence may not have been intended. The position needs to be clarified. If it is intended then we submit that the consequence, for audited entities as much as for the audit firms concerned, is out of all proportion to the danger that is sought to be cured by the new provisions. Some amelioration is necessary and we have suggested below that auditors are permitted to make qualified declarations.

Our concerns about the ability of auditors to comply with the auditor independence requirements and prevent a contravention that may arise from the actions of third parties outside their control are set out separately in this submission. Our specific observations on section 307C and opportunities to improve the requirement follow.

Not contravened versus complied

The audit independence provisions (general and specific) state that an audit firm contravenes the those provisions if certain situations arise.

The s.307C certificate requires a statement of compliance. Logically "compliance" means "no contravention", but the mere fact of the different terminology may suggest some higher test. We therefore submit that there must be symmetry of terminology, for certainty of position.

Audits to which non-compliance will apply

Section 307C does not specify that compliance with the auditor independence requirements is limited to the audit in question. For example, if the lead auditor (or a professional member of the audit team) has not complied with the independence requirements in relation to an audit of XYZ Ltd, the lead auditor will not be able to provide a section 307C declaration to either:

- XYZ Ltd; or
- any other client which the lead auditor (or a professional member of the audit team) has audited or reviewed.

Furthermore, s.307C does not specify a time period for non-compliance with the independence requirements or applicable codes of professional conduct. For example, if the lead auditor (or a professional member of the audit team) has not complied with either set of requirements in relation to an audit conducted in 2007, the lead auditor will not be able to provide a s.307C certificate in either 2007 or any future year.

We have suggested improvements to s.307C to clarify its operation with respect to these issues.

Qualified declarations

As discussed above, we suggest that an auditor should be permitted to issue a qualified s.307C declaration where a contravention of the auditor independence requirements has occurred. The declaration would provide full disclosure of the circumstances of the contravention.

The disclosure of the circumstances would allow users of financial statements to assess those circumstances. Under proposed s.250PA, shareholders would have the opportunity to put questions to the auditor regarding the contravention.

Auditors would continue to be bound by their duties under the Corporations Act, the auditing standards and the common law to exercise objective and impartial judgment in relation to the conduct of the audit and the formation of the audit opinion.

The contravention would clearly be a contravention subject to the penalty provisions in the Corporations Act.

Transitional - application of s.307C

Section 1456 provides that new Division 3 of Part 2M.4 will apply in relation to financial years beginning on or after the commencement date.

For consistency with s.1456, s.1450 should be amended to clarify that s.307C applies to financial years beginning on or after the commencement date.

Transitional - application of Division 5

Section 1456 delays the operation of Division 5 for a 2 year transitional period.

However, a s.307C declaration is required for the two financial years occurring in that transitional period. As "audit [sic] independence requirements of this Act" is defined in item 65 to include Division 5 of Part 2M.4, a s.307C declaration given in the transitional period will technically need to warrant compliance with Division 5 even though that Division does not apply to that period.

The definition of "auditor independence requirements of this Act" should be amended to address this problem.

Recommended action:

Recommend amendments as set out below.

Section 9

auditor independence requirements of this Act means the requirements of Divisions 3 and 4 of Part 2M.4 and, to the extent that it applies to the relevant financial year, Division 5 of Part 2M.4.

Sections 307C(1) and (2)

… has:

(c) not contravened the auditor independence requirements of this Act; and

(d) not contravened any applicable codes of professional conduct,

in relation to the audit or review of the audited body for the relevant financial period (other than where the circumstances of any contravention are fully disclosed in the written declaration).

Section 1450

Sections 307A, 307B, 307C and 989CA apply to…

General auditor independence requirement

Item 87 - Subdivision A of Division 3 (general requirements for auditor independence)

Concept or issues:

General comments

We support the introduction of a general statement of principle requiring an auditor to be independent. This enhancement was recommended in the October 2001 Ramsay Report and proposed in the September 2002 CLERP 9 proposal paper. Mr Justice Owen also endorsed a principles-based approach as being preferable to a prescriptive, black-letter set of rules in the HIHRC Report.

However, in order to achieve the Federal Government's objectives, the standard for independence must be workable. To be workable, it must be objective and certain.

The test as drafted is not practical in its application. It:

- is not an objective test and is not capable of clear application. This will result in inconsistent determinations and lead to significant unintended consequences;
- imposes criminal liability on all partners of audit firms, even in circumstances where events occur that are outside the control or knowledge of the audit firm or the individual partners (notwithstanding the limited defences available); and
- applies a more restrictive standard than equivalent overseas regulatory regimes, including the US Sarbanes-Oxley Act and section 8 of the International Federation of Accountants Code of Ethics, which are reflected in Professional Standard F.1.

By way of comparison, the standard of independence under the Sarbanes-Oxley Act appears in Rule 2-01(b) of SEC Regulation S-X as follows:

> "*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.*" (our emphasis)

In our submission the standard of independence proposed under Division 3 of Part 2M.4 is so restrictive that it will damage the profession and the role of the auditor in the capital markets without producing corresponding benefits to users of audited financial statements. It will also severely restrict the ability of Australian business to access essential skills and resources and will add significantly to the cost of compliance.

These fundamental matters are able to be addressed by modifications to the general standard described below. We believe that the modifications proposed will maintain the independence of the audit function while avoiding unnecessary restrictions on auditors and audited bodies.

"Auditor independence issue" vs "conflict of interest situation"

Section 324CB currently refers to "conflict of interest" situations. "Conflict of interest" has a well understood meaning in the law of fiduciary relationships and refers to the conflict between a fiduciary's personal interest and his or her duty to a principal.

We suggest that use of the words "conflict of interest" in s.324CB is inappropriate. While the section covers some circumstances which come within the accepted scope of "conflict of interest", it also covers circumstances of real or perceived impairment of auditor independence which can arise through relationships which do not directly involve, or are beyond the control of, the auditor (eg a relationship between a former partner and the audited body).

The inappropriate use of "conflict of interest" in s.324CB will lead to public and professional confusion over both the accepted meaning of those words and the application of the general independence requirement.

The words "conflict of interest situation" should be replaced with "auditor independence issue". These words more appropriately describe the nature of the s.324CB test and the underlying policy.

Strict liability, criminal penalties and the need for certainty

The independence standard must be certain as it will impose criminal liability for contravention.

This position is supported by comments of Mason, Wilson and Deane JJ in *Boughey* (1986) 60 ALJR 422 at 426 that "a *basic objective of any general codification of the criminal law should be…… the expression of the elements of an offence in terms which can be comprehended by the citizen who is obliged to observe the law and (where appropriate) by a jury of citizens empanelled to participate in its enforcement*". As the criminal offences under s.324CA are provisions of strict liability (with no need for *mens rea* to be established), the need for certainty as to what constitutes the offence is fundamental.

Furthermore, the need for certainty is reinforced by the fact that s.324CA also imposes criminal consequences on auditors in circumstances where breaches can occur through no deliberate act of the auditor or the audit firm, and possibly even without the knowledge of its members (ie actions of family members and former employees and partners).

Degrees of impairment and materiality

Impairment is determined in degrees and not in absolute terms. The use of the "impairment" concept in s.324CB reflects that independence is a matter of degree ie a "grey" issue that cannot be determined on a black-or-white basis. There appears to recognition in section 7.2.2 of the HIHRC Report of this important principle.

However, s.324CB does not recognise that impairment of the ability to be objective is a matter of degree. Under the current standard, circumstances that impair the ability of an auditor to be objective and impartial to a minimal or insignificant degree can lead to a contravention of the general auditor independence requirement.

The lack of consideration of **materiality** in s.324CB is a serious practical limitation. Materiality must be recognised as a primary consideration when assessing impairment or independence situations. However, to avoid confusion of the meaning of "materiality" with the use of that term in accounting standards, we suggest that s.324CB adopt "significantly", which is a term used in Professional Statement F.1.

We therefore propose that s.324CB incorporates a "significantly impaired" standard to eliminate insignificant and immaterial circumstances.

"Might"

The use of the term "might" in the draft legislation means that an auditor independence issue could exist where there is only a very low level of possibility of impairment.

Circumstances present in many (if not all) audits engagements could give rise to "reasonable grounds for concern" that the ability for objective and impartial judgment **might** be impaired, such as:

- the risk of termination of the audit engagement due to conflicts with management;
- debate between an auditor and a client's chief financial officer regarding appropriate accounting policies;
- an actual or perceived conflict of interest between the interests of the audit client and the interests of another client of the firm.

In each case, there is a low level of possibility that the auditor's ability to exercise objective and impartial judgment might be impaired, notwithstanding that it is not probable that any impairment would or is likely actually to arise. In particular, it is not probable that a material or significant impairment of independence will have occurred.

Indeed, it is arguable that the existence of a remuneration relationship between client and auditor of itself would give any person, even armed with full knowledge of the facts and circumstances, reasonable grounds for concern that the auditor's ability to exercise objective and impartial judgment might be impaired in every audit.

Rule 2.01(b) in SEC Regulation S-X (quoted above) establishes a more practical standard by using the word "**would**". The Ramsay Report also proposed a standard based on the use of "**would**", as did the September 2002 CLERP 9 proposals.

While we believe that a standard based on "would" will provide both an effective safeguard for audit independence and a practical standard capable of implementation, we note that Owen J's view in the HIHRC Report was that this standard was too high.

If the Government shares this view, we suggest that "might" be replaced with "**is likely to**". While this standard requires a lower level of certainty than "would", we believe it is the minimum standard capable of practical implementation while still retaining a rigorous general independence standard. This amendment will clarify that the s.324CB test should not apply when there is a small possibility of actual or perceived impairment of the audit function.

"Reasonable grounds for concern"

The s.324CB(1)(b) test incorporates the concept of "reasonable grounds for concern". "Concern" is a concept spanning a number of degrees and a concern may be:

- an insignificant concern;
- a minor concern; or
- a major concern.

As such, "concern", whether used in tandem with "might", "is likely to" or even "would", could result in section 324CB(1) being triggered in a number of situations where it is highly improbable that any impairment to auditor independence would arise.

By way of comparison, the US approach in S-X 2.01(b) (quoted above) is to require that "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" (emphasis added). The use of "would conclude" sets a far more practical threshold than the Australian approach.

We prefer the US approach for the purposes of consistency in international standards and practicality in implementation. However, we recognise the Government's concern regarding the perception of the audit function. As such, we suggest that s.324CB(1)(b) utilise the concept of "**to conclude**" rather than "for concern". This "to conclude" standard, in conjunction with "is likely to", requires less certainty than the S-X 2.01(b) "would conclude" standard but is far more workable than the current s.324CB(1)(b).

Recommended action:

Amend s324CB as below

Section 324CB

324CB Auditor independence issue

(1) For the purposes of section 324CA, an ***auditor independence issue*** exists in relation to an audited body at a particular time, if circumstances exist at that time that:

(a) significantly impair, or are likely to significantly impair, the ability of the auditor, or a professional member of the audit team, to exercise objective and impartial judgment in relation to the conduct of an audit of the audited body; or

(b) would give a person, with full knowledge of the facts and circumstances, reasonable grounds to conclude that the ability of the auditor, or a professional member of the audit team, to exercise objective and impartial judgment in relation to the conduct of an audit of the audited body is, or is likely to be, significantly impaired.

Incidental amendments are required to replace refers to "conflict of interest situation" with "auditor independence issue". These amendments are indicated in Annexure A.

Quality control system - "reasonably capable"

Item 87 - s.324CA(2)(d) ("reasonably capable")

Concept or issues:

Section 324CA(2)(d) refers to a quality control system "reasonably capable of making the individual auditor, audit firm or audit company aware of the existence of" a conflict of interest situation.

We note that s.324CJ(2) refers to a quality control system "that provides reasonable assurance (taking into account the size and nature of the audit practice of the firm or the authorised company) that the firm or audit company and its employees comply with the requirements of [Subdivision A and B]".

We suggest that the wording used in s.324CJ(2) is adapted and applied in s.324CA(2)(d) to ensure consistency between the standards of quality control systems required under ss.324CA(2)(d) and 324CJ. This will reduce the likelihood of a court inferring that a different standard of quality control system is required under each section.

Recommended action:

Amend s.324CA(2)(d) as below.

Section 324CA(2)(d)

(d) the relevant person, or one of the relevant people referred to in paragraph (c), would have been aware of the existence of the auditor independence issue if the individual auditor, audit firm or audit company had in place a quality control system that provides reasonable assurance (taking into account the size and nature of the audit practice of the individual auditor, the audit firm or the audit company) that the individual auditor, audit firm or audit company would be made aware of the existence of such an auditor independence issue.

The specific independence test - opportunity to remedy a contravention

Item 87 - ss.324CC - 324CF (specific independence requirements)

Concept or issues:

In the context of the general auditor independence requirement, s.324CA provides auditors with an opportunity to "take all reasonable steps to ensure that the conflict of interest situation ceases to exist". A similar opportunity is given to auditors, partners of audit firms and directors of audit companies under s.324CJ before criminal liability for breaches of the specific independence requirements will arise.

However, ss.324CC - 324CE do not provide individual auditors, audit firms and audit companies with any opportunity to remedy the occurrence of a proscribed event in s.324CF(1).

For example, if a professional member of the audit team unexpectedly inherits shares in an audit client, a contravention of s.324CD(1) will occur, regardless of whether the professional member disposes of the shares as soon as possible.

Auditors should have a reasonable opportunity to take all steps reasonably necessary to ensure that any potential impairment of auditor independence is minimised or removed, so that it does not have a material impact on the conduct of the audit. The fact the event has occurred but been properly dealt with should not result in a contravention of the specific independence requirements.

Furthermore, a contravention should not occur where the auditor does not have knowledge of the circumstances causing the contravention but does have a quality control system in place for detecting contraventions. If this is not the case, auditors will be unable to provide s.307C declarations as they cannot ever be certain that a proscribed situation has arisen which has not yet come to their attention.

Recommended action:

We propose that an additional provision is included in each of s.324CC(1), 324CD(1) and 324CE(1) based on s.324CJ. These provisions appear in the Annexure.

Generally, the new provision will provide that no contravention of subsection (1) occurs if:

- the individual auditor, audit firm or audit company either:
    - does not know at the particular time referred to in subsection (1) of the circumstances that constitute the contravention; or
    - knows of those circumstances at that time but takes all reasonable steps to correct the contravention as soon as possible after the person becomes aware of those circumstances; and
- the individual auditor, audit firm or audit company has in place a quality control system that provides reasonable assurance (taking into account the size and nature of the audit practice of the individual auditor, audit firm or audit company) that the individual auditor, audit firm or audit company and its employees comply with the requirements of Subdivision B.

Appropriate adjustments have been made in the proposed amendments for members of audit firms. These adjustments are based on the provisions in s.324CA that deal with audit firms.

The second limb of this provision sets a higher standard than s.324CJ as it requires a more objective assessment of the quality control system, rather than referring to the auditor's "reasonable grounds to believe". This places appropriate emphasis on the need for auditors to implement and maintain quality control systems.

The specific independence test - "immediate family member"

Item 87 - ss.324CC - 324CF (specific independence requirements)
Item 68 - s.9 (definition of "immediate family member")

Concept or issues:

The tables set out in ss.324CD and 324CF cover activities of various third parties who are not in an employment or partnership relationship with the audit firm. The current wide definition of "immediate" family members is unworkable. For example, a firm will be in contravention of s.324CD(1) where:

- an immediate family member (including an adult sibling or step-parent) of a professional member of the audit team has a $1 investment in the audited body; or

- an immediate family member of a subcontracted non-audit service provider holds 1% of the units in a unit trust which has a non-material investment in the audited body.

Inclusion of more distant relatives in this definition is inconsistent with definitions applied in overseas jurisdictions. In the US context, Rule 2.01(f)(13) in SEC Regulation S-X defines immediate family members as a person's spouse, spousal equivalent or dependents. Professional Statement F.1 adopts the almost identical definition of "a spouse (or equivalent) or dependent".

Professor Ramsay at page 42 of his Report recommends restrictions on employment of "immediate family members" in preference to "close family members", as adopted by IFAC. Similarly at page 52 of the Report he recommends restrictions on investments in clients, but these are confined to the "immediate family" of restricted persons.

In practice, individual auditors, audit companies and audit firms and their individual partners will have no practical mechanism for monitoring and controlling the activities of "immediate family members" (as currently defined) of partners, professional employees and non-audit service providers and their employees in order to prevent contravention of s.324CD(1).

Furthermore, lead auditors will be unable to provide s.307C declarations due to the impossibility of determining whether such third persons have entered into arrangements which trigger a contravention of s.324CD(1).

The extension of the section 324CD(1) requirements to immediate family members of non-audit service providers and their employees is also excessive and in many cases will severely restrict the ability of auditors to obtain third party expertise necessary to carry out the audit function. This will impact adversely on the quality of audit services and, consequently, the quality of Australian financial reporting.

It is unlikely that many of the situations captured by widely defining "immediate family members" could realistically have any actual or perceived impact on the conduct or independence of an audit or the public perception of that. This is particularly the case in relation to items 10 and 11 in s.324CF(1), which are not subject to materiality requirements. The general test in s.324CB will cover that type of circumstance in any event.

We suggest that the definition of "immediate family member" should be redrafted to mirror the SEC Regulation S-X and Professional Statement F.1 approach to ensure both a workable standard and consistency with international auditor independence standards.

We also note that potential independence threats arising in relation to family members that would not be covered under our proposed definition are already appropriately addressed in Professional Standard F.1, consistent with the requirements of the US SEC and other jurisdictions.

Recommended action:

Recommend amendment of the definition of immediate family member as set out below.

Section 9 (item 68)

Insert:

immediate family member for a person means:

(a) the person's spouse or de facto spouse; or

(b) a dependant of the person.

We note that the "dependant" concept is currently used in the Corporations Act see (eg Part 5.8A) and has an accepted meaning.

The specific independence test - "audit-critical employee"

Item 87 - ss.324CD(1) and 324CF(1) (restrictions on persons being audit-critical employees)

Item 62 - s.9 definition of "audit-critical employee"

Concept or issues:

The definition of "audit-critical employee" refers to an employee who "is able, because of the position which the person is employed, to affect the efficacy of the conduct of the audit".

This definition is very broad in scope and could include, for example, an employee with access to inventory which is the subject of an audit stock count.

By way of contrast, Rule 2.01(f)(3)(ii) of SEC Regulation S-X uses the concept of "financial reporting oversight role" in a similar context to "audit-critical employee". That concept is defined as:

> "*a role in which the person is in a position to or does 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, or any equivalent position*".

We suggest that paragraph (b) partially incorporate this definition by requiring an audit-critical employee to be a person who:

> *is in a position to or does exercise significant influence over the contents of the financial report (taken as a whole) or the conduct of the audit.*

This suggested wording will preserve the focus of the original paragraph (b) on the conduct of the audit but will look to an affect on the contents of the final financial report. This will bring the "audit-critical employee" closer to the US SEC definition of "financial reporting oversight role" for the purposes of achieving international consistency.

The addition of the "significant influence" concept is required to avoid "audit-critical employees" encompassing a wide range of employees who may have a real, but insignificant, impact on the audit function. We note that the general independence requirement would cover situations involving people who do not have significant influence.

Recommended action:

Amend definition of audit-critical employee as set out below.

Section 9

audit-critical employee, in relation to a company, or the responsible entity for a registered scheme, that is the audited body for an audit, means a person who:

(a)	is an employee of the company or of the responsible entity for the registered scheme; and
(b)	is in a position to or does exercise significant influence over the contents of the financial report (taken as a whole) or the conduct of the audit.

The specific independence test - former partner and employees under ss.324CD - the independence test

Item 87 - ss.324CC(3), 324CD(3), and 324CE(3) (restrictions on former partners and employees becoming officers or audit-critical employees)

Concept or issues:

The s.324CD(3)(c) limb of the independence test

Paragraph (c) is impractical for both former members and former professional employees. It is not possible for a firm to conclude with certainty that either a former member or former professional employee does not have any rights against the firm in relation to their former partnership interest or employment.

All former partners will have rights of some description against their former firm, by way of indemnities for liabilities incurred whilst a partner, restrictions on approaching clients, and under the current proposal, not taking actions that would cause the firm to breach the independence provisions in the Corporations Act.

Furthermore, paragraph (c) is inconsistent with paragraph (d) of the independence test. Paragraph (d) provides an exception to its prohibition on financial arrangements where the arrangement is "an arrangement providing for regular payments of a fixed pre-determined dollar amount which is not dependent on the revenues, profits or earnings of the firm". Such an arrangement is most likely to arise from a person's former partnership interest or employment with the firm, hence giving rise to a right contemplated by paragraph (c).

We believe that paragraph (c) was really intended to catch commission arrangements of the type that was described in evidence to the HIH Royal Commission. We agree this should be explicitly prohibited and have suggested a new paragraph (c)(i) to specifically address this form of arrangement.

The s.324CD(3)(d) limb of the independence test

Paragraph (d) refers to "financial arrangements with the firm in relation to the accounting and audit practice conducted by the firm (other than an arrangement providing for regular payments of a fixed pre-determined dollar amount which is not dependent on the revenues, profits or earnings of the firm)".

This paragraph will have a wide impact. It is common practice for retiring partners of audit firms to have continuing rights against the firm, including rights to indemnities and contributions relating to professional liability issues and rights to receive payments (eg payments in lieu of superannuation).

Professional Statement F.1 requires that any payment to a former partner under an existing financial arrangement with the firm be made in accordance with "fixed pre-determined arrangements" (see paragraph 2.42). To make paragraph (d) workable, the approach of Professional Statement F.1 should be adopted in preference to the existing language. In addition, rights to indemnities and contributions should also be excluded to preserve liability coverage for former partners which relates to their former partnership interest in the firm.

This will provide far greater certainty and accommodates existing arrangements for retired partners that are impossible to change retrospectively.

To streamline the drafting of s.324CD(3), we have reformulated the amended paragraph (d) as a new paragraph (c)(ii).

Recommended action:

Amend ss.324CC(3), s.324CD(3) and 324CE(3) as set out in the Annexure.

Section 324CD(3)(c) is reproduced below for convenience.

Section 324CD(3)(c)

(c) has no financial arrangements with the firm to receive:

(i) any commissions or like payments directly attributable to work generated by the former member or former employee for the accounting and audit practice conducted by the firm; or

(ii) any other payments or benefits, other than payments or benefits under:

(A) fixed pre-determined arrangements for providing benefits or payments to the former member or former employee; or

(B) any right to indemnity or contribution,

in relation to the person's former partnership interest in, or employment by, the firm.

The specific independence test - former partner and employees under ss.324CD and 324CF - transitional issues

Item 87 - s.324CC(1) items 9 and 10, s.324CD(1) items 11 and 12, s.324CE(1) items 11 and 12

Concept or issues:

Section 324CD (in combination with s.324CF) applies to former members of audit firms (item 11 in s.324CD(1)) and former professional employees of audit firms (item 12).

Similar items appear in ss.324CC and 324CE.

Where an employee or partner resigns **on or after** the commencement date of the legislation, an audit firm has only very limited forms of protection against a contravention of the audit independence requirements, these being:

- the prohibitions in ss.324CG, 324CH and 324CI will operate prospectively and only apply to a former partner or employee becoming an officer of a client; and

- the audit firm may be able to impose restraint of trade requirements on the departing partner or employee (although these will be subject to court review, discussed separately in this submission).

However, the scope of items 11 and 12 in s.324CD(1) is not limited to partners or employees who resign **after** the commencement date. An audit firm will not have protection from either sections 324CG - 324CI or from any restraint of trade requirements against a former partner or employee of an audit firm who resigned **before** the commencement date and also becomes an officer or audit-critical employee of a client, resulting in a contravention of s.324CD(1).

As a result, audit firms will be in a position where they cannot continue in an audit engagement due to the actions of a third party over whom they have no control. This problem is compounded by the various other difficulties associated with the proposed legislation (eg shortcomings in the s.324CD(3) independence test, the expansion of the scope of "officer" in s.324CK, the wide and ambiguous scope of "audit-critical employee").

On the basis of the discussion above, items 11 and 12 in s.324CD(1) should only apply on a prospective basis. It should be noted that, where a partner or employee has left prior to the commencement date, the general independence test will protect the perception of independence issue in material cases.

This is particularly the case if the amendments to the independence test in s.324CD(3) we have suggested elsewhere in this submission are not accepted. If those amendments are not accepted, most audit firms will be in a position where former partners and employees hold positions with current clients which may lead to a contravention of s.324CD(1) (eg where a former partner retains rights against the audit firm arising from professional indemnity coverage) and the audit firms are unable to remedy the situation without the agreement of the former partners and employees. It is reasonable to expect that in many cases, that agreement will not be forthcoming.

Recommended action:

Amend ss.324CC(1), 324CD(1) and 324CE(1) as set out in the Annexure.

Insert a new ss.324CC(4), 324CD(5) and 324CE(5) as set out in the Annexure.

The specific independence test - "non-audit service provider"

Item 87 - ss.324CD(1) and 324CF(1)
Item 73 - s.9 definition of "non-audit service provider"

Concept or issues:

Sections 324CD(1) and 324CF(1) together have the effect that non-audit service providers that fail to meet the maximum hours test cannot hold certain assets relating to an audited body.

The comparable requirements in Sarbanes-Oxley rules and paragraph 2.18 of Professional Statement F.1 apply only to partners and managerial employees. The proposed approach in Subdivision B, together with the definition of "non-audit service provider", are not consistent with these requirements, particularly as the Subdivision B requirements extend to the immediate family members of non-audit service providers. We suggest that the definition of "non audit service provider" only extend to partners of the audit firm and employees of the audit firm (or of an entity acting for, or on behalf of, the audit firm).

Recommended action:

Amend s.9 definition of "non-audit service provider" as below.

non-audit services provider for an auditor conducting an audit if an audited body means a person who:

(a) is not a professional member of the audit team conducting the audit of the audited body; and

(b) is either:

  (i) if the auditor is an individual auditor—a managerial employee of the individual auditor (or of an entity acting for, or on behalf of, the individual auditor); or

  (ii) if the auditor is an audit firm—a member of the audit firm or a managerial employee of the audit firm (or of an entity acting for, or on behalf of, the audit firm); or

  (iii) if the auditor is an audit company—a director of the audit company or a managerial employee of the audit company (or of an entity acting for, or on behalf of, the audit company); and

(c) provides, or has provided, services (other than services related to the conduct of an audit) to the audited body.

The specific independence test - proscribed investments under section 324CF

Item 87 - s.324CF(1) (items 11 - 14)
Item 70 - s.9 definition of "investment"

Concept or issues:

Items 10 - 14 in the s.324CF(1) table refer to types of "investment".

Derivative arrangements

Paragraph (f) of the definition of "investment" includes derivative arrangements with value or consideration that "ultimately determined, derived from or varies by reference to an investment in the company, disclosing entity or body covered by paragraph (a), (b), (c), (d) or (e)".

This definition is ambiguous in its scope and could capture derivatives which vary in value with reference to a market index (eg the ASX All Ordinaries) where the company, disclosing entity or body in question is included in the index. We have suggested amendments to paragraph (f) of the definition to clarify that such arrangements are not within the scope of the definition.

Materiality

Item 11 in the table in s.324CF(1) applies to a broad range of individuals, including the immediate family members of both professional members of an audit team and non-audit service providers.

Item 11 is not qualified by a materiality requirement. As such, s.324CD(1) will be contravened where an immediate family member (currently defined on a wide basis to include such persons as step-parents and estranged spouses) of a professional member of the audit team or a non-audit service provider holds a small parcel of units in a unit trust that holds shares in an audit client, where the terms of the unit trust provide each unitholder with a proportionate interest in every asset of the unit trust.

In contrast, Professional Statement F.1 contemplates a materiality requirement for persons holding indirect financial interests in audit clients.

We suggest that a materiality qualification is required for situations covered by item 11 to ensure that *de minimis* interests which are highly unlikely to significantly impair the independence of an audit do not trigger a contravention of the specific auditor independence requirements. As an amended item 11 have substantially the same effect as item 12, item 11 should simpy be deleted.

While it is conceivable these amendments could result in certain situations no longer being covered by the Subdivision B specific independence requirement (eg where a lead auditor directly holds shares in an audit client but the holding is not material), the Subdivision A general audit independence requirements will apply in all such situations where there is a real or perceived impairment of the independence of the audit function.

Recommended action:

Amend paragraph (f) in the definition of "investment" as below.

Delete item 11 in s.324CF(1).

Section 9 (item 70)

investment in a company, disclosing entity or other body means:

(a) a share in the company, disclosing entity or body; or

(b) a debenture of the company, disclosing entity or body; or

(c) a legal or equitable interest in:

  (i) a share in the company, disclosing entity or body; or

  (ii) a debenture of the company, disclosing entity or body; or

(d) an option to acquire (whether by way of issue or transfer) an investment in the company, disclosing entity or body covered by paragraph (a), (b) or (c); or

(e) an option to dispose of an investment in the company, disclosing entity or body covered by paragraph (a), (b)or (c); or

(f) an interest a person holds under an arrangement that is a derivative if:

  (i) the consideration to be provided under the arrangement; or

  (ii) the value of the arrangement;

  is, to a significant degree, ultimately determined, derived from or varies by reference to an investment in the company, disclosing entity or body covered by paragraph (a), (b), (c), (d) or (e).

Section 9 (item 71)

investment in a registered scheme means:

(a) an interest in the scheme; or

(b) a legal or equitable interest in an interest in the scheme; or

(c) an option to acquire (whether by way of issue or transfer) an investment in the scheme covered by paragraph (a) or (b); or

(d) an option to dispose of an investment in the scheme covered by paragraph (a) or (b); or

(e) an interest a person holds under an arrangement that is a derivative if:

  (i) the consideration to be provided under the arrangement; or

  (ii) the value of the arrangement;

  is, to a significant degree, ultimately determined, derived from or varies by reference to an investment in the scheme covered by paragraph (a), (b), (c) or (d); or

(f) an investment in the responsible entity of the scheme.

The specific independence test - comments on miscellaneous section 324CF(1) items

Item 87 - s.324CF(1)

Concept or issues:

Item 15

Item 15 in s.324CF(1) proscribes auditors, partners in audit firms, professional members of audit teams and certain other entities owing an amount of more than $5,000 to an audit client, a related body corporate of the client or an entity that the client controls.

This provision could apply to items such as:

- any debts owed by an audit firm's service company to a client that have been incurred in the ordinary course of business (eg for stationery supplies, cleaning services); and

- amounts owed by partners, officers or employees of the auditor in relation to car leases and credit card arrangements.

To address the first bullet point above, a new s.324CF(9) should be inserted to ensure trade debts arising in the ordinary course of business are disregarded for the purposes of item 15.

To address the second point, a new s.324CF(10) should be inserted which is based on Rule 2-01(c)(ii)(A) of SEC Regulation S-X.

Item 16

Item 16 in s.324CF(1) proscribes debts owed to auditors, professional members of audit teams, their immediate family members and certain other entities to an audit client, a related body corporate of the client or an entity that the client controls.

This provision could apply to:

- cash deposits held with an audit client (or a related/controlled entity), as cash deposits are effectively 'loans' to the audit client; and

- debts arising out of ordinary business dealings between an audit client (or a related/controlled entity) and immediate family members of professional members of the audit team.

Considering the wide definition of "immediate family member", the second item above could apply to effectively prohibit business dealings between an adult sibling or parent of a professional member of the audit team and an audit client. This unnecessarily interferes with commercial activity.

We have suggested a new s.324CF(11) to ensure that cash deposits and similar transactions arising in the ordinary course of business of the audit client (or a related/controlled entity) are disregarded for the purposes of item 16. This suggested subsection is based on existing s.324CF(5).

Our suggested new s.324CF(9) should address the situation identified in the second item above.

Recommended action:

Insert new ss.324CF(9), (10) and (11) as below.

Section 324CF

Ordinary commercial debt exception

(9) For the purposes of items 15, 16 and 18 of the table in subsection (1), disregard any debt that:

(a) arises in the ordinary course of the business of:

(i) the audited body; or

(ii) the related body corporate; or

(iii) the controlled entity; and

(b) is incurred under the terms and conditions that would normally apply to the provision of goods or services to or by the audited body, the related body corporate or the controlled entity.

Other financial arrangement exception

(10) For the purposes of items 15 and 18 of the table in subsection (1), disregard any loan that:

(a) arises in the ordinary course of the business of:

(i) the audited body; or

(ii) the related body corporate; or

(iii) the controlled entity; and

(b) arises from one of the following:

(i) automobile loans and leases collateralised by the automobile;

(ii) loans fully collateralised by the cash surrender value of an insurance policy;

(iii) loans fully collateralised by cash deposits at the entity referred to in paragraph (a);

(iv) a credit card facility, provided the credit card balance owed to the entity referred to in paragraph (a) does not exceed $10,000 on a current basis taking into account the payment due date and any available grace period; and

(c) is incurred on the terms and conditions that would normally apply to the relevant arrangement with that entity.

Deposit exception

(11) For the purposes of item 16 of the table in subsection (1), disregard a debt owed by the audited body, the related body corporate or the controlled entity if:

(a) the body corporate or entity is:

(i) an Australian ADI; or

(ii) a body corporate registered under the *Life Insurance Act 1995*; and

(b) the debt arose because of a cash deposit or similar transaction made by the person

with the body corporate or entity in the ordinary course of the business of the body corporate or the controlled entity.

Specific independence requirement - "associated entities"
Item 87 - s.324CF(3)
Item 79 - s.50AAA (associated entities)

Concept or issues:

General comments

Section 324CF(3) extends the application of ss.324CC – 324CE to "associated entities" of listed entities (other than registered schemes). This extension operates in respect of all items in s.324CF(1) and is not limited to situations where a person becomes an officer of an audit client. The definition of "associated entities" in s.50AAA (item 79) is very broad.

Section 324CF(3), in conjunction with s.50AAA, significantly increases the monitoring task required of an audit firm to ensure that compliance with the specific auditor independence requirements. In particular, the provisions will extend the scope of necessary investigation to offshore companies, including those located in jurisdictions where the necessary information is not readily available.

The effect of these provisions should be taken into account when considering our suggested amendments to the specific independence requirements.

Furthermore, the Government should consider removing these provisions from the final legislation. While it is conceivable that the deletion of s.324CF(3) could result a serious impairment to audit independence failing to trigger the specific audit independence requirements, such a threat would be covered by the Subdivision A general audit independence requirement.

Section 50AAA

Section 324CF(3) refers to "an associated entity of the audited body".

However, s.50AAA refers to entities being "associated [entities]" and is drafted so that an audited body could be either an "associate" or "principal". This is clearly not the intention of the drafters, as this undermines the distinction between s.50AAA(3) and s.50AAA(4).

We have suggested amendments to s.50AAA to correct this error.

Recommended action:

Amend s.50AAA as set out below.

Redraft of provision

To be included only if the recommended action is to amend the provision

Amend s.50AAA(1) as follows:

(1) One entity (the *associate*) is an associated entity of an audited body (the *principal*) if subsection (2), (3), (4), (5), (6) or (7) is satisfied.

Specific independence requirements - cooling off periods and restrictions for former partners and employees
Item 87 - ss.324CG to 324CI

Concept or issues:

General

Sections 324CG to 324CI set out employment prohibitions and cooling off periods for former partners of audit firms, directors of audit companies and retiring professional members of audit teams.

The proposals are rules-based and more onerous than the Sarbanes Oxley Act requirements in the United States in length and applicability.

The proposals impact a large number of individuals and will have the effect of reducing the number of quality accounting and finance resources available for Australian companies. In particular, the restriction in s.324CI will limit the ability of listed entities to comply with the ASX Corporate Governance Council's recommendation that audit committees comprise of only independent members, including "at least one member who has financial expertise (ie is a qualified accountant or other financial professional with experience of financial and accounting maters)".

The proposals will also impact severely on the future recruitment of auditors, due to the significantly reduced ability of former auditors to find post-auditing employment. This will reduce the pool of audit professionals in Australia.

The proposals will also impact on an audited body's ability to choose audit service providers. If a director of an audited body is a former member of a firm and is still within the cooling off period, the company will be effectively prohibited from choosing that firm.

While sections 324CG - 324CI refer to the former partner, former director or former employee contravening the relevant prohibition, the sections form part of Division 3 of Part 2M.4. As such, a breach of these prohibitions by a former partner or employee acting beyond the control of an audit firm will be a breach of the "auditor independence requirements" of the Corporations Act (see item 65) and hence will prevent a lead auditor from providing an audit client with an unqualified section 307C declaration.

Finally, the onerous nature of the proposals could represent an unlawful restraint on trade. If that were so, auditors could not legally constrain former staff from joining an audit client.

Length of the cooling off periods

Section 324CH requires a 4 year cooling off period for professional members of the audit team. In comparison, Europe requires a 2 year cooling off period and the US Sarbanes-Oxley Act requires a 1 year cooling off period. In light of these international requirements, we submit that a 4 year cooling off period is unnecessary to achieve auditor independence and will adversely impact the quality of resources available to audited bodies in Australia.

Section 324CG requires a 2 year cooling off period for partners of an audit firm who were not members of the audit team. The US and Europe do not require any cooling off periods for partners who have not participated in the audit of a particular client. We consider this proposal is more onerous than necessary. The proposal wrongly assumes that an ex-partner who may not have been in the same office or industry would have influence over the auditor in the performance of an audit of the client.

While we would prefer a 1 year cooling off period only for the professional members of the audit team, similar to the US requirements, we recognise the Government's concern regarding the perception of the audit function. Accordingly, we are prepared to accept that ss.324CG and 324CH require a 2 year cooling off period for former partners and (subject to our comments below) professional members of the audit team respectively.

Application to professional employees other than key senior audit personnel

The s.324CH cooling off period applies to all "professional members of the audit team". Under s.324AE, that term includes employees who participate "in the conduct of the audit and, in the course of doing so, exercise professional judgment in relation to the application of or compliance with accounting standards, auditing standards or the provisions of the Corporations Act dealing with financial reporting and the conduct of audits". This definition will include junior and middle tier audit personnel and extends as far as graduates employed by the firm.

The finance and accounting industry in Australia thrives on the education of professionals in the firms who ultimately are employed in commerce. The inclusion of all professional members of the audit team in s.324CH is excessive and incorrectly assumes that a graduate auditor (for example) would have influence over the conduct and results of a future audit.

Furthermore, the scope of s.324CH is inconsistent with the recommendations in the HIHRC Report. In section 7.2.3 of the HIHRC Report, Mr Justice Owen stated:

> "*I note that the restriction proposed by CLERP 9 applies only to former members (that is partners) of an audit firm. I consider that the employment by an audit client of* ***other key senior personnel in the audit team*** *might also lead to the compromise of the independence of the audit firm, or at least the perception of such a compromise. This is because of the close relationships they are likely to have forged with other members of the audit team. Those relationships increase the possibility of management being able to exert influence over the auditor. Serious consideration should be given to expanding the restriction to* ***key senior audit personnel***." (emphasis added)

As noted above, "professional member of the audit team" extends beyond "key senior audit personnel" and hence s.324CH goes beyond the Justice Owen's recommendation. We submit that s.324CH should be limited to those professional employees who are "key senior professional members of the audit team".

We do not suggest that the definition of "professional member of the audit team" in s.324AE should be amended to cover only key senior audit personnel. We accept that the wider scope of that concept is appropriate for the purposes of ss.324CC - 324CF.

Application to specialists

The s.324CH cooling off period also extends to all professional members of the audit team, regardless of hours spent on the audit engagement. In comparison, the Sarbanes-Oxley rules specify that 10 hours of service on the audit are required before the cooling off period applies. An audit engagement will often use specialists (eg, industry, tax, accounting etc) who provide a few hours of service on a client will be caught by the current definition of "professional member of the audit team". These specialists will not have any real or perceived influence on the conduct or outcome of an audit and should be excluded from the s.324CH requirement.

This exclusion will be achieved if the legislation adopted the "key senior members of the audit team approach" recommended above.

Alternatively, s.324CH should only apply where a professional member of the audit team has provided more than 10 hours of services in the conduct of any relevant audit. This alternative proposal is not reflected in the amended Part 3 accompanying this submission.

Application where the auditor is no longer the auditor of the entity

Sections 324CG and 324CH apply to audited bodies to which an audit firm is no longer the auditor. This is likely to have an excessive and sometimes arbitrary impact as it is common that an audited body would have changed the auditor more than once. This has the practical effect excluding former partners and professional employees of multiple firms from acting as an officer or director.

Consider a situation where Firm A has been the auditor of XYZ Limited ("**XYZ**") since 2011. Firm B was XYZ Limited former auditor and last performed its audit in 2010. Partner A retires from Firm A in 2012, while Partner B retires from Firm B in 2022. Partner A acted on the audit of XYZ in 2011, while Partner B has never acted on an audit of XYZ. In this situation

- the cooling off period for Partner A ends in 2016; and
- the cooling off period for Partner B ends in 2024 (even though Firm B has not acted as auditor of XYZ since 2010 and Partner B has had no audit involvement with XYZ).

This result is more extreme than the general policy of auditor independence or the specific policies underlying ss.324CG and 324CI could require.

To address this anomaly, sections ss.324CG and 324CI should be amended so that the cooling off period commence when the former partner or employee's connection to the audited body ceases.

In the case of s.324CG, this can be achieved by providing that the relevant waiting period commences on the earlier of:

- the departure time; and
- the time that the relevant audit firm ceased to be the auditor of the audited body.

In the example above, the cooling-off period for Partner B would thus end in 2012, 2 years after Firm B ceased to be auditor of XYZ. Of course, Partner B would be prohibited from

becoming an officer of XYZ under section 324CD and Professional Statement F.1 until the partner ceased to be a partner in 2022.

In the case of s.324CI, the relevant waiting period should commence on the earlier of:

- the departure time; and
- the time that the person ceased to be a key senior member of the audit team for any audit of the audited body.

Restriction on multiple former audit firm partners or audit company directors

Section 324CI is excessive and more onerous than Sarbanes-Oxley, which contain no single partner requirements.

We submit that the proposals are unnecessary given the cooling off period requirements under s.324CG. This cooling off period is sufficient to ensure the independence of both the ongoing auditor and the former partners or audit company directors.

There is no time limit on the proposals. As a result, if a partner retired from an audit firm in his early thirties and became an officer of a client, no one other former partner from that firm would be able to become an officer of the client until the first former partner ceased to hold office. In some cases, this may not occur for 20 - 30 years. This restriction is excessive and will adversely impact the availability of accounting and finance talent.

Furthermore, it is difficult to see why a person who was once a partner in an audit firm should be 'tainted' for the remainder of their lives for the purposes of s.324CI.

We believe the general auditor independence test is sufficient protection for these types of situations.

Prospective operation

Paragraph 160 of the Commentary states that "section 324CG will operate prospectively and will apply in relation to a member of an audit firm or a director of an audited body [we assume this should refer to an audit company] who retires or resigns from the audit firm or the audit company **at some time after the commencement of the legislation**" (emphasis added).

Similar statements are made in paragraphs 167 and 173 in relation to sections 324CH and 324CI respectively.

Sections 324CG, 324CH and 324CI do not contain this qualification.

Section 1456 (Schedule 12) states that Division 3 of Part 2M.4 applies to audits and reviews of those financial years and half-years which commence on or after the commencement date. This transitional provision does not match the nature of sections 324CG - 324CH, which are prohibitions on persons becoming an officer of a client or former client of the audit firm or audit company.

We have suggested amendments to ss. 324CG - 324.CI and s.1456 to ensure the prospective operation of these provisions.

Listed audited bodies and related bodies corporate

Positions affected by the cooling off period are those captured by the definition of "officer".

Sections 324CG to 324CI each extend the scope of "audited body" where the audited body is a listed entity so that the restrictions extend to officers of related body corporates of the audited body.

The scope of "related body corporate" is broad and includes many situations that do not involve 100% ownership. In some situations, this could include:

- an offshore body corporate in a position to cast 51% of the votes at a general meeting of a listed audited body; or

- an offshore company in which a listed audited entity holds less than 50% but is able to control the composition of the board.

The scope of the term "officer" is also extended by section 324CK, which is discussed separately in this submission.

As a breach of ss.324CG - 324CI would cause the audit firm to contravene the auditor independence requirements, audit firms will be required to monitor a wide range of body corporates which are related to listed audit clients. Many of these will be neither Australian registered companies nor wholly-owned by the listed audit client.

This significantly increases the extent of monitoring required from an audit firm. In many cases, it will be impossible to obtain the information needed to determine whether sections 324CG, 324CH or 324CI have been breached. In turn, this will prevent an auditor providing an unqualified section 307C declaration to its listed audit clients.

To ensure that audit firms are capable of effectively monitoring for compliance with the specific auditor independence requirements, the listed entity deeming provisions should be deleted from ss.324CG - 324CI. Section 324CK should also be amended as suggested elsewhere in this submission.

To the extent that this may allow a former partner or employee to become an officer of a company currently covered by the extended scope of ss.324CH - 324CI such that there is likely to be a real or perceived material impairment the independence of an audit, the general auditor independence test should be sufficient to cover such a situation.

Recommended action:

Amended ss.324CG and 324CH as follows.

Delete s.324CI.

Amend s.1456 as follows.

Section 324CG

(1) A person contravenes this section if:

(a) the person ceases to be:

(i) a member of an audit firm; or

(ii) a director of an audit company;

at a particular time after the commencement date (the ***departure time***); and

(b) at any time before the departure time, the audit firm or audit company has engaged in an audit of an audited body; and

(c) before the end of the relevant waiting period, the person becomes, or continues to be, an officer of the audited body; and

(d) the audited body is not a small proprietary company for the most recently ended financial year.

(2) The relevant waiting period ends 2 years after the earlier of:

(a) the departure time; and

(b) the time that the audit firm or audit company ceases to be engaged in audit activity in relation to the audited body.

(3) In this section 324CG, ***commencement date*** has the same meaning given to it in section 1449.

Section 324CH

(1) A person contravenes this section if:

(a) the person ceases to be a professional employee of an individual auditor, an audit firm or an audit company, at a particular time after the commencement date (the ***departure time***); and

(b) at any time before the departure time, the individual auditor, audit firm or audit company has engaged in an audit of an audited body; and

(c) the person was a key senior professional member of the audit team for the audit; and

(d) before the end of the relevant waiting period, the person becomes, or continues to be, an officer of the audited body; and

(e) the audited body is not a small proprietary company for the most recently ended financial year.

(2) The relevant waiting period ends 2 years after the earlier of:

(a) the time at which the employee ceases to be a key senior professional member of an audit team for any audit of the audited body; and

(b) the departure date.

(3) In this section 324CH, ***commencement date*** has the same meaning given to it in section 1449.

Section 1456

Sections 324CA to 324CF apply to:

(a) an audit of the financial report for a financial year; or

(b) an audit or review of the financial report for a half-year in a financial year;

if the financial year begins on or after the commencement day.

Section 324CK
Item 87 - s.324CK

Concept or issues:

Section 324CK(1) extends the concept of "officer" in Division 3 of Part 3 of Schedule 1 to include related bodies corporate and entities controlled by the company.

Section 324CK(1)(b) also deems a person to currently be an officer of a company if he or she has been at any time in the preceding 12 months:

- an officer or promoter of the relevant company;
- a related body corporate of the company; or
- an entity that the company controlled.

While s.324CK is based on existing ss.324(4) - (6), the impact of s.324CK is far wider under the expanded auditor independence requirements in Subdivision B. As a breach of those requirements will cause the audit firm to contravene the auditor independence requirements, audit firms will be required to monitor a wide range of entities which are related to audit clients. Many of these will be neither Australian registered companies nor wholly-owned by the audit client. In many cases, entities covered by section 324CK will be located in jurisdictions where the necessary information is not readily available.

This significantly increases the extent and difficulty of the monitoring task to be undertaken by audit firms. In many cases, it will be impossible to obtain the information needed to determine whether a contravention of Division 3 has occurred due to the operation of section 324CK. In turn, this will prevent an auditor providing a section 307C declaration to its listed audit clients and will prevent those clients from lodging a complete directors' statement.

While the removal of section 324CK could arguably sanction situations involving related bodies corporate of a listed audit client which clearly threatened independence, we suggest that the general auditor independence test in Subdivision A should be sufficient to cover such a situation. As such, the deletion of section 324CK would not reduce the overall level of protection against impairment of auditor independence provided by Division 3.

Alternatively, the scope section 324CK(1) should be limited to those entities where the ownership interest of the relevant body corporate or entity is material to that body corporate. We have proposed amendments to give effect to this suggestion.

Recommended action:

Delete section 324CK or amend s.324CK(1)as below.

Section 324CK(1)

(1) For the purposes of this Division, a person is taken to be an officer of a company if:

(a) the person is an officer of:

(i) a related body corporate; or

(ii) an entity that the company controls; or

(b) the person has, at any time within the immediately preceding period of 12 months, been an officer or promoter of:

(i) the company; or

(ii) a related body corporate; or

(iii) an entity that the company controlled at that time,

and, in the case of paragraph (a) and subparagraphs (b)(ii) and (b)(iii), the ownership interests of the relevant body corporate or entity is material to that body corporate.

Deliberately disqualifying auditors
Item 87 - s.324CL

Concept or issues:

Division 4 is titled "deliberately disqualifying auditor". However, s.324CL does not specify that an individual or audit company that brings about a state of affairs must do so with the intention of causing a contravention of Division 2 or 3.

The Commentary states that s.324CL is intended to replicate the effect of existing s.324(16). Section 324(16) prohibits an auditor from 'knowingly disqualifying' himself or herself or the firm ie an intention to cause disqualification is required. Section 324CL should include a similar explicit intention component.

Recommended action:

Amend s.324CL as below.

Section 324CL

Individual auditor

(1) An individual contravenes this subsection if:

(a) the individual is appointed auditor of a company or registered scheme; and

(b) while the appointment continues, the individual brings about a state of affairs with the intention of causing a contravention of Division 2 or 3; and

(c) the individual cannot, while that state of affairs continues, act as auditor of the company or scheme without contravening Division 2 or 3.

Audit firm

(2) A member of a firm contravenes this subsection if:

(a) the firm is appointed auditor of a company or a registered scheme; and

(b) while the appointment continues, the member brings about a state of affairs with the intention of causing a contravention of Division 2 or 3; and

(c) the firm cannot, while that state of affairs continues, act as auditor of the company or scheme without contravening Division 2 or 3.

Audit company

(3) A person who is:

(a) a member of a company; or

(b) a director of a company; or

(c) a lead auditor in relation to an audit conducted by a company;

contravenes this subsection if:

(d) the company is appointed auditor of a company or a registered scheme; and

(e) while the appointment continues, the person brings about a state of affairs with the intention of causing a contravention of Division 2 or 3; and

(f) the company cannot, while that state of affairs continues, act as auditor of the

company or scheme without contravening Division 2 or 3.

Rotation of auditors

Item 87 - s.324DA - 324DD (rotation of auditors)
Item 95 - ss.342A - 342B (modification of rotation requirements)
Item 74 - s.9 definition of "play a significant role"

Concept or issues:

The general principle of reducing the rotation period for lead and review auditors of listed entities from the current period of 7 years is agreed to, but does give rise to the following concerns which apply in particular to medium- and small-sized and regional auditing practices.

Negative impact on competition

As drafted, the rotation requirements in effect place a minimum size requirement on firms that are to undertake listed company audits. Firms must have at least 4 appropriately experienced audit partners in order to meet the rotation requirements for both lead auditor and review auditor. Such size requirements are particularly onerous given Australia's geographic/commercial spread. This will have a substantial impact on smaller audit firms.

Currently there are approximately 120 organisations (ie sole practitioners or firms) auditing approximately 1400 ASX-listed public companies. Many of these firms will struggle to meet the rotation requirements, including the regional centres (eg Perth and Adelaide) of the second tier firms. Even the 'Big 4' firms will have difficulties where particular offices do not have the required 4 appropriately experienced audit partners.

We believe that the outcome of the current draft legislation will be that most small- and medium-sized firms will choose to exit the listed public company audit market and it is likely that less than 20 of the larger firms will be left doing this work. This will reduce competition and increase costs significantly, particularly for small- and medium-capital listed public companies. As well as affecting these clients, this could have a major detrimental effect on the viability of many of these smaller accounting practices.

Review partners

On smaller listed company audit engagements, the review partner may not have any direct interaction with the client and the review partner's role is principally one of quality control. Hence, in such smaller listed company engagements, the review partner's professional judgement is less likely to be impaired through over-familiarity and there is less of a need for review auditor rotation.

Increased costs to business

The mandatory rotation of the lead and review audit partner will increase the compliance costs to business, particularly if applied to all listed companies, due to learning curve costs arising on each rotation. While such costs may be more readily borne by large listed entities and are arguably offset by the perceived benefit to shareholders and other users of financial reports, Division 5 makes no distinction regarding size. Given the number of very small listed companies (eg junior explorers), these requirements will significantly increase the cost of audits without delivering any corresponding benefit to shareholders.

Impact of audit quality

The rotation requirements for both the lead and review partner may reduce audit quality, particularly in relation to specialist industries or in smaller firms where less experienced auditors may be rotated on. This may reduce the quality of financial reports, contrary to the policy underlying Division 5.

There is no linkage in Division 5 between the auditor competency standards and the requirements for public company auditors/rotation.

Increased demand on a reduced pool of auditors

Increased requirements for auditor rotation are likely to create a need for an increase in the number of public company auditors. However, the proposed independence requirements on auditors is likely to reduce the number of public company auditors, as individuals and firms decide that it the effort and cost to comply with the independence requirements is too high to continue to practice in this area. This will create significant issues for the auditing profession and audited businesses.

Recommended action:

We suggest that the requirement to rotate a review auditor should be limited to the entities included in the ASX All Ordinaries index to ease the burden on smaller companies and regional business.

To achieve this, the s.9 definition of "play a significant role" (item 74) should be amended as below.

Paragraph (b)(ii) of the s.9 definition of "play a significant role"

(ii) acts, on behalf of the firm or company:

(A) as a lead auditor in relation to an audit of the company or scheme for that financial year or for a half-year falling within that financial year; or

(B) if the company or scheme is included in the All Ordinaries Index at the beginning of the financial year - as a review auditor in relation to an audit of the company or scheme for that financial year or for a half-year falling within that financial year.

We note that the time at which membership of the All Ordinaries Index is relevant is the same as that specified in proposed s300(11D)(a)(i).

CLERP 9 draft legislation:

Schedule 1 - Audit Reform
Part 4 - Audit companies
Item 100: ASIC may impose restrictions on an authorised audit company

Concept or issues:

We recognise that the auditing profession's request for incorporation of audit firms has been granted. For the incorporation of audit firms to proceed in the manner previously discussed with the accounting profession then a number of amendments will be necessary. The powers given to ASIC in the present draft to impose conditions and remove registration, and the dramatic effect on all audits of cancellation or suspension, create too high a risk to the business.

The following comments explain the regulatory issues that a firm wishing to incorporate will need to address.

Company constitution

- Section 1299B deals with eligibility for registration as an authorised audit company. The section does not accommodate multidisciplinary practices, as the majority of votes must be held by registered company auditors and each director must be a registered company auditor.

- Authorised audit companies with more than 50 members will fall within the scope of the Chapter 6 takeover provisions, which will hamper dealings with the audit company's shares. Chapter 6D prospectus disclosure requirements are also likely to apply to issues of securities by the audit company.

Conditions for registration

- Section 1299D allows ASIC to impose conditions on the registration of an authorised audit company. These can be of the type specified in the regulations or otherwise to be determined by ASIC. There are no restrictions on the types of conditions specified in the Regulations.

Conditions imposed subsequent to registration

- Section 1299D(2) permits ASIC to impose conditions or restrictions after the company is registered, by notice to the company.

- ASIC's power to impose conditions subsequent to registration creates great uncertainty for audit companies. This uncertainty is further increased by the unfettered scope of restrictions ASIC may impose.

Suspension or cancellation of registration

- Section 1299I allows ASIC to cancel or suspend the registration of a company as an authorised audit company if it ceases to be eligible to be registered as an authorised audit

company or the company fails to meet the conditions imposed by ASIC under section 1299D. The cancellation has immediate effect (section 1299M).

- The effect of cancellation or suspension is to vacate all audits being undertaken by the company. This imposes a significant penalty on the audit company and its owners and staff, and also on the companies it audits. They may not be able to comply with their statutory obligation to publish audited accounts.

Recommended action:

Amend

- **Recommend** that the scope of ASIC's power to impose conditions on audit companies is limited to matters consistent with the conditions for eligibility for registration, namely constitution and corporate structure, such that the audit company has control of matters relevant to deregistration. These matters should be specified or otherwise defined in the legislation.

- **Recommend** that conditions on registration cannot be imposed after registration.

- **Recommend** that matters more properly dealt with by the CALDB cannot be the subject of ASIC-imposed conditions.

Redraft of Item:

1299D Registration may be subject to conditions

(1) The company's registration as an authorised audit company is subject to:
  (a) the provisions of this Part; and
  (b) the conditions ~~or restrictions~~ specified in the regulations; and
  (c) any other conditions ~~or restrictions~~ determined by ASIC.

(2) ASIC may determine conditions ~~or restrictions~~ for the purposes of paragraph (1)(c) ~~either~~ only at the time when the company is registered as an authorised audit company ~~or~~ and not subsequently.

(3) ASIC determines a condition ~~or restriction~~ by written notice to the company.

(4) Regulations made for the purposes of paragraph (1)(b) and conditions made by ASIC under paragraph 1(c) may only relate to the audit company's corporate structure and constitution and not to the activities the audit company may undertake.

(5) The only conditions which ASIC may determine for the purposes of paragraph (1)(c) are those of a kind specified in the regulations made for the purposes of paragraph (1)(b).

CLERP 9 Draft Item

Schedule 1 – Audit Reform
Part 5 – Auditors and AGM

Items 102 to 104

Concept or issues:

These provisions are designed to improve shareholder participation in annual general meetings by facilitating shareholders asking questions of the auditor, requiring that those questions are provided to meeting attendees and by requiring that a qualified member of the audit team attend the annual general meeting.

We agree with the principles in the legislation but submit that the drafting is inconsistent or impractical. Particular issues of principle are:

- tying of time for submission of questions to proxies is too short - generally 48 hours, not necessarily business hours. We suggest 5 business days. This will enable a proper sorting of questions by the auditor and enhance the prospect that the auditor can prepare answers for the meeting;

- the reference to a meeting attendee being "in a position to answer questions about the audit" is unclear and unnecessary.

Recommended action:

Amend

Redraft of Item:

250PA Written questions to auditor submitted by members of listed company before AGM

(1) A member of a listed company who is entitled to cast a vote at the AGM may submit a written question to the auditor under this section if the question is relevant to:
  (a) the content of the auditor's report to be considered at the AGM; or
  (b) the conduct of the audit of the annual financial report to be considered at the AGM.
  The member submits the question to the auditor by giving it to the listed company.

(2) The time by which the question must be received by the listed company (the ***submission time***) is 5 business days before the scheduled time for the AGM~~the same as the time by which a proxy appointment for the AGM must be received by the company to be effective~~.

(3) Despite the question being one that is addressed to the auditor, the listed company may:
  (a) examine the contents of the question; and
  (b) make a copy of the question.

(4) The listed company must, within 1 business day after ~~as soon as practicable~~

~~after~~ the question is received by the company, pass the question on to the auditor. The company must pass the question on to the auditor even if the company believes the question is not relevant to the matters specified in paragraph (1)(a) or (b).

(5) The auditor must prepare, and give to the listed company, a document (the ***question list***) that sets out the questions that:

(a) the listed company has passed on to the auditor; and

(b) the auditor considers to be relevant to the matters specified in paragraphs (1)(a) or (b).

The question list must be prepared, and given to the listed company, as soon as practicable after the submission time and a reasonable time before the AGM.

(6) The auditor does not need to include a question in the question list if:

(a) the question list includes a question that is the same in substance as that question (even if it is differently expressed); or

(b) it is not practicable to include the question in the question list, or to decide whether to include the question in the question list, because of the time when the question is passed on to the auditor.

(7) The listed company must, at or before the start of the AGM, make copies of the question list reasonably available to the members attending the AGM.

103 After section 250R

Insert:

250RA Auditor required to attend listed company's AGM

(1) If a listed company's auditor for a financial year is an individual, the auditor must:

(a) attend the company's AGM at which the audit report for that financial year is considered; or

(b) arrange to be represented, at that AGM, by a person who is a suitably qualified member of the audit team that conducted the audit.~~:~~

~~(i) is a suitably qualified member of the audit team that conducted the audit; and~~

~~(ii) is in a position to answer questions about the audit.~~

(2) If a listed company's auditor for a financial year is an audit firm or audit company, the auditor must ensure that the auditor is represented, at the AGM at which the audit report for that financial year is considered, by a person who~~:~~

~~(a)~~ is a suitably qualified member of the audit team that conducted the audit.~~; and~~

~~(b) is in a position to answer questions about the audit.~~

(3) Subsection (1) or (2) does not apply if the auditor has a reasonable excuse for not complying with the subsection.

Note: A defendant bears an evidential burden in relation to the matters in subsection (3), see subsection 13.3(3) of the *Criminal Code*.

(4) If an audit firm contravenes subsection (2):

(a) each member of the firm contravenes this subsection; and

(b) the audit firm itself does not commit an offence based on the contravention of subsection (2).

(5) If an audit company contravenes subsection (2), each director of the company contravenes this subsection.

Note: The company itself commits an offence based on the contravention of subsection (2).

(6) A person who is member of an audit firm, or a director of an audit company, does not commit an offence at a particular time because of a contravention of

subsection (4) or (5) if the person either:

(a) does not know at that time of the circumstances that constitute the contravention of subsection (2) by the audit firm or audit company; or

(b) does know of those circumstances at that time but takes all reasonable steps to correct the contravention of subsection (1) by the audit firm or audit company as soon as possible after the person becomes aware of those circumstances.

Note: A defendant bears an evidential burden in relation to the matters in subsection (6), see subsection 13.3(3) of the *Criminal Code*.

CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 6 – Qualified Privilege

Items 106 and 107

Concept or issues:

- We support the extension of qualified privilege as provided for in s.990L and s.1289 and regard these as appropriate given the proposed extension to auditor's duties and the introduction of incorporation of audit companies.

- We wish to clarify that the qualified privilege given to an auditor extends to an audit firm and all its members.

- We seek extension of the qualified privilege right to the following circumstances:
  - documents or information provided to the Financial Reporting Council (proposed s.225A ASIC Act);
  - documents or information provided to the Financial Reporting Panel;
  - documents or information provided to a plaintiff about a potential concurrent wrongdoer under the proportionate liability provisions of the proposed legislation (see commentary for schedule 3, items 1-6 - page 111 of this submission);
  - information provided to the CALDB;
  - documents provided to other regulators or government bodies with oversight responsibility (eg PCAOB).

Recommended action:

Amend

Redraft of Item:

990L Qualified privilege for auditor etc.

Qualified privilege for auditor

(1) An auditor of the licensee has qualified privilege in respect of:

(a) a statement that the auditor makes, orally or in writing, in the course of the auditor's duties as auditor; or

(b) the lodging of a report under subsection 990K(1); or

(c) the sending of a report to:

(i) the licensee; or

(ii) a licensed market or a licensed CS facility;

under subsection 990K(1)~~.~~; or

(d) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Financial Reporting Panel which do not otherwise attract the protection of section 239CI(2) of the ASIC Act;

(e) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Financial Reporting Council; or

(f) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Companies Auditors and Liquidators Disciplinary Board which do not otherwise attract the protection of section 221(3) of the ASIC Act; or

(g) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor in response to a request from one of the United States of America's Public Companies Accounting Oversight Board or Securities and Exchange Commission or to another foreign body vested with oversight or regulatory powers similar to those bodies.

~~Note: If the auditor is an audit company, the company has qualified privilege under this subsection in respect of statements made, and reports lodged or sent, by individuals on behalf of the company if those statements and notices can be properly attributed to the company.~~

Qualified privilege for registered company auditor acting on behalf of audit company

(2) If the auditor of the licensee is an audit company, a registered company auditor acting on behalf of the company has qualified privilege in respect of:

(a) any statement that the registered company auditor makes (orally or in writing) in the course of the performance, on behalf of the company, of the company's duties as auditor; or

(b) the lodging by the registered company auditor, on behalf of the company, of a report under subsection 990K(1); or

(c) the sending by the registered company auditor, on behalf of the company, of a report to:

(i) the licensee; or

(ii) a licensed market or a licensed CS facility;

under subsection 990K(1); or~~.~~

(d) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Financial Reporting Panel which do not otherwise attract the protection of section 239CI(2) of the ASIC Act; or

(e) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Financial Reporting Council; or

(f) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Companies Auditors and Liquidators Disciplinary Board which do not otherwise attract the protection of section 221(3) of the ASIC Act; or

(g) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor in response to a request one of the Unites States of America's Public Companies Accounting Oversight Board or Securities and Exchange Commission or to another foreign body vested with oversight or regulatory powers similar to those bodies.

Qualified privilege for subsequent publication

(3) A person has qualified privilege in respect of the publishing of a document:

(a) prepared by an auditor of the licensee in the course of the auditor's duties as auditor; or

(b) required by or under this Chapter to be lodged with ASIC (whether or not the document has been so lodged).

(4) A person has qualified privilege in respect of the publishing of any statement:

(a) made by an auditor of the licensee as mentioned in subsection (1); or

(b) any statement made by a registered company auditor as mentioned in subsection (2).

(5) If an auditor is an audit company, the company has qualified privilege under subsection (1) in respect of statements made, and reports lodged or sent, by individuals on behalf of the company if those statements and notices can be properly attributed to the company.

(6) If an auditor practises as a member or employee of an audit firm, each member of the audit firm has qualified privilege under subsection (1) in respect of statements made, and notices given, by the auditor on behalf of the audit firm if the auditor was acting in the course of the audit firm's business.

107 Section 1289

Repeal the section, substitute:

1289 Auditors and other persons to enjoy qualified privilege in certain circumstances

Qualified privilege for auditor

(1) An auditor has qualified privilege in respect of:

(a) any statement that the auditor makes (orally or in writing) in the course of the auditor's duties as auditor; or

(b) any statement that the auditor makes (orally or in writing) on:

(i) a directors' report under section 298 or 306; or

(ii) any statement, report or other document that is taken, for any purpose, to be part of that report; or

(c) notifying ASIC of a matter under section 311;~~.~~

(d) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Financial Reporting Panel which do not otherwise attract the protection of section 239CI(2) of the ASIC Act;

(e) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Financial Reporting Council;

(f) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor to the Companies Auditors and Liquidators Disciplinary Board which do not otherwise attract the protection of section 221(3) of the ASIC Act;

(g) a statement that the auditor makes, orally or in writing, and a document or other information provided by the auditor in response to a request from one of the United States of America's Public Companies or Accounting Oversight Board or Securities and Exchange Commission or to another foreign body vested with oversight or regulatory powers similar to those bodies.

~~Note: If the auditor is an audit company, the company has qualified privilege under this subsection in respect of statements made, and notices given, by individuals on behalf of the company if those statements and notices can be properly attributed to the company.~~

Qualified privilege for registered company auditor acting on behalf of audit company

(2) If the auditor is an audit company, a registered company auditor acting on behalf of the company has qualified privilege in respect of:

(a) any statement that the registered company auditor makes (orally or in writing) in the course of the performance, on the behalf of the company, of the company's duties as auditor; or

(b) any statement that the registered company auditor makes (orally or in writing), on behalf of the company, on:

(i) a directors' report under section 298 or 306; or

(ii) any statement, report or other document that is taken, for any purpose, to be part of that report; or

(c) a notification of a matter that the registered company auditor gives ASIC, on behalf of the company, under section 311.

Extent of auditor's duties—answering questions put to auditor by members

(3) For the purposes of this section, an auditor's duties as auditor include:

(a) answering questions put to the auditor (or the auditor's representative) at an AGM; and

(b) providing answers to questions that are submitted to the auditor under section 250PA.

Qualified privilege for person representing auditor at AGM

(4) A person who represents an auditor at an AGM has qualified privilege in respect of any statement that the person makes in the course of representing the auditor at that AGM.

Qualified privilege for subsequent publication

(5) A person has qualified privilege in respect of the publishing of a document that:

(a) is prepared by an auditor in the course of the auditor's duties; or

(b) required by or under this Act to be lodged (whether or not the document has been lodged).

(6) A person has qualified privilege in respect of the publishing of any statement:

(a) made by an auditor as mentioned in subsection (1); or

(b) made by a registered company auditor as mentioned in subsection (2); or

(c) made by a person as mentioned in subsection (4).

(7) If an auditor is an audit company, the company has qualified privilege under subsection (1) in respect of statements made, and reports lodged or sent, by individuals on behalf of the company if those statements and notices can be properly attributed to the company.

(8) If an auditor practises as a member or employee of an audit firm, each member of the audit firm has qualified privilege under subsection (1) in respect of statements made, and notices given, by the auditor on behalf of the audit firm if the auditor was acting in the course of the audit firm's business.

Qualified privilege for proportionate liability notifications

(9) A defendant, including an auditor, who gives written notice to a plaintiff for the purposes of any of the following sections will have a defence of qualified privilege in respect of that written notice and any statements contained in any part of that notice:

(a) section 1041N of this Act; or

(b) section 12GR of the ASIC Act; or

(c) section 87CD of the *Trade Practices Act 1974*.

CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 7 – Expansion of auditors' duties
Items 108 to 112: Section 311
Section 601HG(4)
Section 990K(2)

Concept or issues:

We make the general comment that the extension in scope of these provisions from those foreshadowed by the CLERP 9 September 2002 paper, particularly removing s.311(1)(b), is most troubling to our industry. The collective effect of the provisions is to make the auditor a law enforcer, and we submit this is not conducive to the full and frank disclosure that generates the best possible audited financial reports.

We support the general comments made by industry about the proposal.

Our comments below highlight our issues, and make some suggestions to restore a practical balance to the general reform propositions that were made in the original CLERP 9 proposal and in the Ramsay Report.

Deletion of current section 311(1)(b)

We submit that section 311(1)(b) should be reinstated, to qualify all limbs of the disclosure obligation.

The existing section 311(1) requires an auditor to notify ASIC in writing if the auditor has reasonable grounds to suspect that a contravention of the Corporations Act has occurred only if the auditor believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors.

We submit that the second limb of the section 311 obligation allows effective and proper corporate governance processes to operate while providing auditors with a means of acting where those processes fail or are likely to fail. Good governance practice places responsibility for legal compliance with directors so if a board of directors can adequately deal with the contravention, by for example directing rectification and/or proper disclosure to relevant authorities, then no further action is required. It is only where an auditor is not satisfied as to those processes addressing the contravention that notification to ASIC is appropriate.

To amend the obligation such that an auditor must notify ASIC even if the contravention has already been, or will shortly be addressed, frustrates effective and proper corporate governance and may have the unintended consequence of auditors being limited to all but necessary discussions with a client to reduce the prospect of the auditor identifying circumstances that could give rise to a suspicion of a contravention.

Technically, without the addition, an auditor must report all contraventions, including those ASIC is already aware of.

The deletion of section 311(1)(b) was not one of the proposals in CLERP 9, nor was it a recommendation from the HIH Royal Commission. The Commentary notes that experience indicates that section 311 has been used infrequently and limited reports are made to ASIC under the section. We submit that the number of reports is not a true indication as to whether the section has been used to ensure that possible contraventions are investigated and, if necessary, addressed.

We are suggesting that a better course, consistent with good corporate governance, is to reinstate the current s.311(b)~~, but~~ and to strengthen the level of confidence an auditor must have that the board has dealt, or is dealing with the issue, by having the auditor form the view that the event "has not been adequately dealt with after bringing it to the attention of the directors".

Additional bases of notification

We accept the addition of paragraphs s.311(1)(b) and (c). However we submit that the conduct of which notification is required should be limited to fraudulent or dishonest conduct for the purpose of rendering the financial reports materially misleading.

The proposed section 311 requires an auditor to notify ASIC of any attempt to unduly influence, coerce, manipulate or mislead any person involved in the conduct of the audit or otherwise interfere with the proper conduct of the audit.

The description of notifiable conduct is very broad and requires auditors to exercise judgment as to whether actions fall within the broad criteria. For instance, could an employee of a client who is slow to provide information in response to a reasonable information request be said to be attempting to unduly mislead an auditor or interfere with the audit? Could a robust discussion in good faith about the meaning of an accounting standard, or the value of an asset, be coercion?

Given the strict liability attaching to the section, this ambiguity is unacceptable. An auditor should not be placed in the position where they are left in any doubt as to whether a criminal offence will be committed by failing to notify (which is the result if the auditor is unsure whether particular conduct does or doesn't constitute "undue influence"). Mason, Wilson and Deane JJ sitting in the High Court in *Boughey* (1986) 60 ALJR 422 at 426 emphasised that "a *basic objective of any general codification of the criminal law should be…… the expression of the elements of an offence in terms which can be comprehended by the citizen who is obliged to observe the law and (where appropriate) by a jury of citizens empanelled to participate in its enforcement*".

Under section 303 of the Sarbanes-Oxley Act it is unlawful for any officer or director of any issuer, or any person acting under their direction, to take any action to "fraudulently influence, coerce, manipulate or mislead" their auditor "for the purpose of rendering such financial statements materially misleading".

We submit that this represents a clearer and more appropriate test, that is focussed on the conduct which is of concern. We propose adding dishonestly to fraudulently, which imposes a higher test.

As an auditor is concerned only with the contents of financial accounts, and the review has a materiality basis, it is also important to confine the disclosure obligation to events that materially impact the financial reports.

Having made a judgment as to whether certain actions constitute the relevant conduct, an auditor must notify ASIC irrespective of whether the actions have impacted on the outcome of the audit. We submit that this may lead to an auditor spending numerous hours preparing notifications to ASIC for conduct having no impact on the outcome of the audit. This will not improve the quality of audit reports and will require significant resources from ASIC to deal with notifications.

For the reasons outlined above, existing section 311(1)(b) should also be retained and applied to these new bases.

Persons responsible for notifiable conduct

It is unclear what action ASIC will take against a person, having received a notification under sections 311(1)(a)(ii) and (iii) as to that person's conduct. The concepts of undue influence, coercion or interference in the proper conduct of an audit do not appear elsewhere in the Corporations Act. Current sections 310 and 312 deal with a company's obligations to an auditor and we submit may not be broad enough to cover the possible notifications.

Accordingly, we submit that provisions should be included in the Act such that engaging by a company officer in the notifiable conduct under s.311 is an offence under the Act. This will be a more direct means of discouraging undesirable conduct.

Reporting period

We submit that an obligation to report to ASIC within seven days of becoming aware of the circumstances is insufficient to enable the auditor to consider the circumstances and decide whether they properly require notification under proposed section 311. It may also be that some circumstances can be readily investigated and reported while others take longer. Accordingly, we submit that a fixed time for all notifications is inappropriate and instead notifications should be required to be made "within a reasonable time" and in any event 28 days. This will allow some balancing of the seriousness of the contravention or conduct involved, the degree of investigation required and the practicalities of informing ASIC.

While the Corporations Act imposes other 7-day notification requirements (see, for example, section 990K), those requirements apply in situations where the notifiable matters come within the scope of the audit or review and are clearly and readily identifiable.

Audit team obligation

We understand and accept the rationale for s.311(5), but believe that it is unfair to expect persons who are not professional members of an audit team to exercise judgment on such substantive matters, and to be exposed to penalties for not doing so. We suggest deletion of proposed s.311(7)(e).

Recommended action:

Amend

Redraft of Item:

108 Section 311

311 Reporting to ASIC

(1) An individual auditor conducting an audit contravenes this subsection if:

(a) the auditor is aware of circumstances that:

(i) the auditor has reasonable grounds to suspect amount to a contravention of this Act; or

(ii) amount to an attempt, in relation to the audit, by any person fraudulently or dishonestly to ~~unduly~~ influence, coerce, manipulate or mislead a person involved in the conduct of the audit (see subsection (7)) for the purpose of rendering the financial statements materially misleading;

(iii) amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit for the purpose of rendering the financial statements materially misleading; and

(b) the auditor believes that the contravention of the Act or the conduct referred to in paragraphs (ii) or (iii) has not been adequately dealt with after bringing it to the attention of the directors; and

(c~~b~~) the auditor does not notify ASIC in writing of those circumstances within a reasonable time~~as soon as practicable,~~ and in any case within ~~7~~ 28 days, after the auditor becomes aware of those circumstances.

(2) An audit firm or audit company conducting an audit contravenes this subsection if:

(a) the lead auditor for the audit is aware of circumstances that:

(i) the lead auditor has reasonable grounds to suspect amount to a contravention of this Act; or

(ii) amount to an attempt, in relation to the audit, by any person fraudulently or dishonestly to ~~unduly~~ influence, coerce, manipulate or mislead a person involved in the conduct of the audit (see subsection (7)) for the purpose of rendering the financial statements materially misleading; or

(iii) amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit for the purpose of rendering the financial statements materially misleading; and

(b) the lead auditor believes that the contravention of the Act or the conduct referred to in paragraphs (ii) or (iii) has not been adequately dealt with after bringing it to the attention of the directors.

(c~~b~~) the lead auditor does not notify ASIC in writing of those circumstances within a reasonable time ~~as soon as practicable,~~ and in any case within ~~7~~28 days, after the lead auditor becomes aware of those circumstances.

(3) If an audit firm contravenes subsection (2):

(a) the lead auditor contravenes this subsection; and

(b) the firm itself does not commit an offence based on the contravention of subsection (2).

(4) If an audit company contravenes subsection (2), the lead auditor contravenes this subsection.

Note: The audit company itself commits an offence based on the contravention of subsection (2).

(5) A person contravenes this subsection if:

(a) the person is:
(i) a review auditor for an audit; or
(ii) a professional member of the audit team for an audit; and
(b) the person is aware of circumstances that:
(i) the person has reasonable grounds to suspect amount to a contravention of this Act; or
(ii) amount to an attempt by any person fraudulently or dishonestly to ~~unduly~~ influence, coerce, manipulate or mislead a person involved in the audit (see subsection (7~~8~~)) for the purpose of rendering the financial statements materially misleading; or
(iii) amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit for the purpose of rendering the financial statements materially misleading; and
(c) the person does not inform:
(i) if an individual auditor is conducting the audit—the individual auditor; or
(ii) if an audit firm or audit company is conducting the audit—the lead auditor for that audit;
of those circumstances within a reasonable time~~as soon as practicable, and in any case within 7 days~~, after the person becomes aware of those circumstances.

(6) for an offence based on subsection (1) or (2), strict liability applies to the conduct, notifying ASIC in writing.
Note: For ***strict liability***, see section 6.1 of the *Criminal Code*.

(7) In this section:
person involved in an audit means:
(a) the auditor; or
(b) the lead auditor for the audit; or
(c) the review auditor for the audit; or
(d) a professional member of the audit team for the audit. ~~; or~~
~~(e) any other person involved in the conduct of the audit.~~

Note: Corresponding changes should be made to sections 601HG(4) and section 990K(2).

Note: We have not at this point included drafting prohibiting conduct that is reportable under s.311(1)(b) or (c).

CLERP 9 draft legislation:

Schedule 1 – Audit reform
Part 8 – Companies Auditors and Liquidators Disciplinary Board

Item 118

Concept or issues:

Nomination to Minister of members of CALDB by ICAA

The Boards of the ICAA and CPA Australia have now replaced their respective National Councils. Therefore, ss.203(1)(c) and (d) need to be amended to replace "National Council" with "Board" in the case of the ICAA and "Board of Directors" in the case of CPA Australia.

Recommended action:

Amend

Redraft of Item:

(1) The Disciplinary Board consists of:
- (a) a Chairperson; and
- (b) a Deputy Chairperson; and
- (c) 3 members that the Minister selects from a panel of 7 persons nominated by the Board ~~National Council~~ of the Institute of Chartered Accountants in Australia; and
- (d) 3 members that the Minister selects from a panel of 7 persons nominated by the ~~National~~ Board of Directors ~~Council~~ of CPA Australia; and
- (e) 4 members that the Minister selects who are eligible under subsection (2A) for appointment as a member.

CLERP 9 draft legislation:

Naming of audit firms
Section 1296
Issue 1.5

Concept or issues:

Issue 1.5 on page 70 of the CLERP 9 Commentary calls for submissions on whether notices of disciplinary action issued by CALDB in relation to an individual (either to impose a cancellation or suspension or other penalty or not) should disclose the details of the firm of which the individual is a member.

Response:

We accept that disclosure of the name of the firm which a disciplined auditor is a member can occur.

This should be the firm of which the person was a member when the event occurred and not, a new firm, if there has been a change of position.

Schedule 2 – Financial reporting

Part 1	**-**	**True and fair view**	**see below**
Part 2	**-**	**CEO and CFO declarations in relation to listed entity's financial reporting**	**no comment**
Part 3	**-**	**Content of directors' report for listed public companies**	**no comment**
Part 4	**-**	**Financial Reporting Panel**	**see below**

CLERP 9 draft legislation:
Schedule 2, Part 1 – True and Fair View.
Items 1 to 8.

Concept or issues:

Australian accounting standards are principle-based and apply substance over form. Transactions are accounted for in accordance with accounting standards, with the overall requirement that the substance of a transaction, not just its legal form, is considered when assessing the nature of any particular transaction.

We submit that the proper place to include the information is in the financial reports, not the directors statement. In these circumstances it is not necessary for there to be a separate comment by the auditor on the inclusion. These points are discussed below.

Information to be in Financial Reports

Additional information necessary to show a true and fair view should be provided in the financial reports (and not the directors' statement). The financial reports, in the notes to the statements, should be explicit as to reason for inclusion and the directors should provide a sufficiently detailed explanation as to why that information is necessary. Making additional comment in the directors' statement may confuse or complicate the issues being addressed, or at best simply be duplication.

Auditor comments financial reports as a whole

The auditor is required to form an opinion as to whether the financial report (which includes the financial statements and the notes to the statements) complies with accounting standards and gives a true and fair view (section 307). As the additional information regarding true and fair would be explicitly included in the notes and would be accompanied by a full explanation by the directors as to why the information is necessary, there is no reason to make particular reference to the note in the auditors report.

We do not believe it is appropriate for auditors to specifically address additional information that the director's determine to include in the notes, in isolation from the balance of the financial report. That may unduly emphasise one aspect of the report.

Recommended action:

Amend

Redraft of Items:

298(1)

~~Insert:~~

~~(1A) If the financial report for a financial year includes additional information under paragraph 295(3)(c) (information included to give true and fair view of financial position and performance), the directors' report for the financial year must also:~~

~~(a) set out the directors' reasons for forming the opinion that the inclusion~~

~~of that additional information was necessary to give the true and fair view required by section 297; and~~

~~(b) specify where that additional information can be found in the financial report.~~

3 Paragraphs 303(4)(a) and (b)

Repeal the paragraphs.

4 At the end of subsection 303(4)

Add:

; and (d) whether, in the directors' opinion, the financial statement and notes are in accordance with this Act, including:

(i) section 304 (compliance with accounting standards); and

(ii) section 305 (true and fair view).

5 At the end of section 306

~~Add:~~

~~(2) If the financial report for a half-year includes additional information under paragraph 303(3)(c) (information included to give true and fair view of financial position and performance), the directors' report for the half-year must also:~~

~~(a) set out the directors' reasons for forming the opinion that the inclusion of that additional information was necessary to give the true and fair view required by section 305; and~~

~~(b) specify where that information can be found in the financial report.~~

6 After paragraph 307(a)

~~Insert:~~

~~(aa) if the financial report includes additional information under paragraph 295(3)(c) or 303(3)(c) (information included to give true and fair view of financial position and performance) whether the inclusion of that additional information was necessary to give the true and fair view required by section 297 or 305; and~~

7 Before subsection 308(4)

~~Insert:~~

~~(3B) If the financial report includes additional information under paragraph 295(3)(c) (information included to give true and fair view of financial position and performance), the auditor's report must also include a statement of the auditor's opinion on whether the inclusion of that additional information was necessary to give the true and fair view required by section 297.~~

8 Before subsection 309(6)

~~Insert:~~

~~(5B) If the financial report includes additional information under paragraph 303(3)(c) (information included to give true and fair view of financial position and performance), the auditor's report must also include a statement of the auditor's opinion on whether the inclusion of that additional information was necessary to give the true and fair view required by section 305.~~

9 Amend section 297

The financial statements and notes for a financial year must give a true and fair view of:

(a) the financial position and performance of the company, registered scheme or disclosing entity; and

(b) if consolidated financial statements are required - the financial position and performance of the consolidated entity.

This section does not affect the obligation under section 296 for a financial report to comply with accounting standards.

Note: If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under paragraph 295(3)(c) including a statement as to the directors' reasons for forming that opinion.

Amend section 305

The financial statements and notes for a half-year must give a true and fair view of :

(a) the financial position and performance of the disclosing entity; or

(b) if consolidated financial statements are required - the financial position and performance of the consolidated entity.

This section does not affect the obligation under section 304 for financial reports to comply with accounting standards.

Note: If the financial statements prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under paragraph 303(3)(c) including a statement as to the directors' reasons for forming that opinion.

CLERP 9 draft legislation:

Schedule 2 – Financial reporting
Part 4 – Financial Reporting Panel

Item 18: FRP membership
Issue 2.1

Concept or issues:

ASIC Act - establishment of FRP

We agree in principle with the establishment of a Financial Reporting Panel. We note that it will be important to ensure there are sufficient skilled members free of conflicts of interest to handle all referrals expeditiously and believe 10 is the minimum number, though do not suggest the legislation needs to be amended to reflect this.

In our view the Financial Reporting Council (FRC) should oversee the establishment and constitution of the FRP. The reasons for this are that:

- FRC is the body with overall responsibility for setting accounting standards and interpretative guidelines – FRP, as adjudicator, is also an interpretative body for the standards.

- The authoritative stature of determinations of the FRP will be enhanced by its alignment to the independent FRC.

- FRC can provide an appropriate link between the standard setters (AASB and UIG) and the FRP's interpretation including ensuring that standard setters consider matters that FRP's activities indicate need additional standards.

- The linkage is important to mitigate the risk that the FRP issues decisions inconsistent with international accounting standard interpretations.

If the FRC is to have oversight then its Chairman will have the powers of appointment to membership given to the Minister on the present draft of the ASIC Act.

We have also amended the FRC functions to include oversight (see Item 11 on page 6 of this submission).

Panel membership (s239AB)

There should be a requirement that at least a majority of members of any Panel have relevant expertise in financial reporting with specific accounting knowledge. As any panel must interpret and apply accounting standards it is important the panel has sufficient experience and depth of accounting skills.

Recommended action:

Amend

Redraft of Item:

239AB Membership

(1) The Financial Reporting Panel consists of such members, not fewer than 5, as hold office in accordance with this Part.

(2) The ~~Minister~~ FRC Chair is to appoint the members of the Financial Reporting Panel.

(3) Each of the members may be appointed as a full-time member or as a part-time member.

(4) The ~~Minister~~ FRC Chair must not appoint a person as a member unless the ~~Minister~~ FRC Chair is satisfied that the person is qualified for appointment because of his or her knowledge of, or experience in, one or more of the following fields:

(a) accounting;
(b) auditing;
(c) business;
(d) the administration of companies;
(e) law.

(5) The performance of the functions or the exercise of the powers of the Financial Reporting Panel is not affected merely because its membership is not as prescribed by subsection (1), unless a continuous period of 3 months has elapsed since its membership ceased to be as so prescribed.

239AC Chairperson

The ~~Minister~~ FRC Chair is to appoint as Chair~~person~~ of the Financial Reporting Panel a person who is, or is to be, a member.

239AG Resignation

A person may resign as a member or Chair~~person~~ by writing signed and delivered to the ~~Minister~~FRC Chair.

239AH Termination of appointment

The ~~Minister~~ FRC Chair may terminate a member's appointment because of misbehaviour, or the physical or mental incapacity, of the member or if the member:

(a) becomes bankrupt, applies to take the benefit of a law for the relief of bankrupt or insolvent debtors, compounds with his or her creditors or assigns remuneration or property for their benefit; or

(b) is a full-time member and engages without the ~~Minister's~~ FRC Chair's consent in paid employment outside the duties of the member's office; or

(c) is a full-time member and is absent from duty, except on leave granted in accordance with section 239AJ, for 14 consecutive days, or for 28 days in any period of 12 months; or

(e) without reasonable excuse, contravenes section 239BB.

239AJ Leave of absence

(1) A full-time member has such recreation leave entitlements as are determined by the Remuneration Tribunal.

(2) The ~~Minister~~ FRC Chair may grant a full-time member leave of absence, other than recreation leave, on such terms and conditions as to remuneration or otherwise as the ~~Minister~~ FRC Chair determines.

239AL Acting Chairperson

(1) The ~~Minister~~ FRC Chair may appoint a member to act as Chair~~person~~:

(a) during a vacancy in the office of Chair~~person~~ (whether or not an appointment has previously been made to the office); or

(b) during all periods when the Chair~~person~~ is absent from duty or from Australia or is, for any other reason, unable to perform the functions of the office.

(2) Anything done by, or in relation to, a person purporting to act under an appointment under subsection (1) is not invalid merely because:

(a) the occasion for the appointment had not arisen; or

(b) there was a defect or irregularity in connection with the appointment; or

(c) the appointment had ceased to have effect; or

(d) the occasion to act had not arisen or had ceased.

CLERP 9 draft legislation:

Right of auditor to make submissions to the Financial Reporting Panel
Schedule 2, Part 4
Items 18, 21

Concept or issues:

The FRP will be established to resolve disputes between ASIC and companies concerning accounting treatments in financial reports. In most instances those reports will have been audited.

Each decision of the FRP may reflect on the auditor who has provided the audit opinion on the relevant report. The auditors of financial reports that are considered by the FRP should be entitled to be notified of a referral, and to make submissions, independent of the lodging entity, about the relevant reports.

The FRP report is published widely, through ASIC and the ASX. That may give rise to claims against the lodging entity, its directors or its auditors. It is therefore essential that all issues are fairly ventilated in the public forum. Any published FRP report must therefore be required to set out the FRP's reasons for its determination.

This approach will also:

- ensure the panel's decisions are useful both to the parties involved and to other audit entities and their auditors
- ensure that the decisions taken and interpretations made can feed back into the standard setting process e.g. other parties under the FRC umbrella (AASB and UIG) can see the decisions, evaluate them and, where appropriate, respond via the FRC.

We recommend that the auditor should be given the following rights:

- right to be present at all proceedings (s239CC(6) and (7))
- right to notification of ASIC's intention to refer a matter to the FRP at the same time as the relevant company (section 323EB);
- right to protection from statements (s323EC(2))
- right to have its response appended to ASIC's referral to the FRP (s323ED);
- right to make written submissions to the FRP (s323EF);
- FRP report to set out reasons (s323EG); and
- right to receive a copy of the FRP report (section 323EG).

Recommended action:

Amend

Redraft of Item:

s.239CC

(5) The Financial Reporting Panel may give directions as to the persons who may be present at proceedings that take place in private.

(6) A person must not be present at proceedings that take place in private unless the person is:

(a) the Chairperson; or

(b) a member of the Financial Reporting Panel; or

(c) a person representing the lodging entity;

(d) another person who is entitled to be given an opportunity to appear at the proceedings; or

(e) a person representing ASIC; or

(f) a member of the staff of the Financial Reporting Panel approved by the Panel;

(g) an auditor of a financial report under consideration as part of those proceedings; or

~~(g)~~(h) entitled to be present because of a direction under subsection (4).

239CF Quorum

(1) In Financial Reporting Panel proceedings, 2 members form a quorum.

(2) In any proceedings before the Financial Reporting Panel, at least half of the members of the Panel present must have expertise in financial reporting and knowledge of accounting practices.

323EB ASIC to notify lodging entity of proposed referral

(1) If ASIC proposes to refer the financial report to the Financial Reporting Panel, ASIC must give the lodging entity and the auditor of that financial report written notice of the proposed referral.

(2) The notice must:

(a) identify the relevant financial reporting requirement or requirements; and

(b) set out, in relation to each relevant financial reporting requirement:

(i) the reasons for ASIC's opinion that the financial report does not comply with that requirement; and

(ii) the changes that, in ASIC's opinion, would need to be made to the financial report to ensure that it does comply with that requirement; and

(c) include a statement setting out the effect of section 323EC; and

(d) be in the prescribed form.

323EC Lodging entity and auditor ~~to~~ respon~~d~~se to ASIC notice

(1) The lodging entity must, within 14 days after receiving the notice, give ASIC a written response that, in relation to each relevant financial reporting requirement identified under paragraph 323EB(2)(a), either:

(a) states that the lodging entity proposes to amend the financial report to incorporate the changes referred to in subparagraph 323EB(2)(b)(ii) (the ***ASIC proposed changes***); or

(b) states that the lodging entity:

(i) does not agree that the ASIC proposed changes should be made; and

(ii) proposes instead to amend the financial report to incorporate the

changes set out in the response (the ***alternative changes***); and sets out the lodging entity's reasons for its opinion that the financial report would comply with the relevant financial reporting requirement if the alternative changes were made; or

(c) states that the lodging entity does not agree that the ASIC proposed changes should be made and sets out the lodging entity's reasons for its opinion that the financial report as originally lodged complies with the relevant financial reporting requirement.

(2) Evidence or information included in a response under subsection (1) is not admissible in evidence against:

(a) the lodging entity; or

(b) a director of the lodging entity; or

(c) any other representative of the lodging entity; or

(d) the auditor of the relevant financial report,

in any proceedings (other than proceedings for an offence against Division 136 or 137 of the *Criminal Code* based on the evidence or information given being false or misleading).

(3) ASIC must also provide the auditor with a copy of the lodging entity's response to ASIC given pursuant to subsection (1) and the auditor is entitled, within 14 days following receipt of the lodging entity's response, to give ASIC a written response to the lodging entity's response.

(4) Evidence or information included in an auditor's response under subsection (3) is not admissible in evidence against:

(a) the auditor; or

(b) any partner of the firm of the auditor (if applicable);

(c) any registered company auditor, where the auditor is an audit company; or

(d) any other representative of the auditor;

in any proceedings (other than proceedings for an offence against Division 136 or 137 of the *Criminal Code* based on the evidence or information given being false or misleading).

323ED Referral to Financial Reporting Panel

(1) The referral of the financial report to the Financial Reporting Panel must:

(a) identify the relevant financial reporting requirement or requirements that the financial report, in ASIC's opinion, does not comply with; and

(b) set out:

(i) the reasons for ASIC's opinion that the financial report does not comply with that requirement or those requirements; and

(ii) the changes that, in ASIC's opinion, would need to be made to the financial report to ensure that it does comply with that requirement or those requirements; and

(c) be accompanied by a copy of:

(i) the notice that ASIC gave the lodging entity under section 323EB; ~~and~~

(ii) any response that the lodging entity gave ASIC under section 323EC; and

(iii) any response that the auditor gave ASIC under section 323EC(3); and

(d) be made within 14 days after:

(i) the ~~lodging entity~~auditor gives ASIC the response under section 323EC(3) to the lodging entity's response under section 323EC(1); or

(ii) the time for the ~~lodging entity~~auditor to give ASIC that response ends without the ~~lodging entity~~auditor having given that response.

(2) The referral must be made in the prescribed form.

(3) ASIC must give the lodging entity and the auditor of the financial report a copy of the referral on the day on which the referral is made.

323EE Stay on ASIC proceedings

(1) ASIC may not initiate, or take any further steps in relation to, proceedings against the lodging entity, or the lodging entity's directors, or the auditors of the financial report in relation to the relevant financial reporting requirement or any of the relevant financial reporting requirements specified in the notice under section 323EB during the initial stay period.

(2) The ***initial stay period***:

(a) starts when ASIC gives the lodging entity the notice under section 323EB; and

(b) ends:

(i) at the end of the period of 14 days referred to in paragraph 323ED(1)(d) if ASIC does not refer the financial report to the Financial Reporting Panel within that period; and

(ii) on the day on which ASIC refers the financial report to the Financial Reporting Panel if ASIC does refer the financial report to the Financial Reporting Panel within that period.

Note: For a financial reporting requirement that is then referred to the Financial Reporting Panel there will be a further stay under subsection (2). This further stay does not operate for a financial reporting requirement that was covered by the initial section 323EB notice but is not referred on to the Financial Reporting Panel.

(3) Subject to subsection (4), ASIC may initiate or continue proceedings of the kind referred to in subsection (1) after the initial stay period ends.

(4) If ASIC refers the financial report to the Financial Reporting Panel in relation to a relevant financial reporting requirement or requirements, ASIC may not initiate, or take any further steps in relation to, proceedings against the lodging entity, or the lodging entity's directors, in relation to that relevant financial reporting requirement or any of those relevant financial reporting requirements during the follow on stay period.

(5) The ***follow on stay period***:

(a) starts when ASIC refers the financial report to the Financial Reporting Panel; and

(b) ends on the day on which the Financial Reporting Panel gives ASIC a copy of its report in relation to the financial report.

(6) To avoid doubt, ASIC may initiate or continue proceedings of the kind referred to in subsection (4) after the day on which the follow on stay period ends.

323EF Financial Reporting Panel to obtain submissions from ASIC, ~~and~~ lodging entity and auditor

(1) The Financial Reporting Panel must, within 7 days after the financial report is referred to the Panel, give ~~both~~ the lodging entity, the auditor of the financial report and ASIC a written notice of the day by which they may make written submissions to the Panel on whether the financial report complies with the relevant financial reporting requirement or requirements.

(2) The day specified in the notice must be not less than 14 days after the day on which the notice is given.

323EG Financial Reporting Panel to consider and report on financial report referred to it under section 323EB

(1) The Financial Reporting Panel must:

(a) consider the financial report; and

(b) prepare a report that:

(i) states, in relation to each relevant financial reporting requirement, whether, in the Panel's opinion, the financial report complies with that requirement; ~~and~~

(ii) if the Panel determines that the financial report does not, in the Panel's opinion, comply with the relevant financial reporting requirement—set out the changes that, in the Panel's opinion, would need to be made to the financial report to ensure that it does comply with that requirement. The report must not disclose any confidential commercial information obtained by the Panel in the course of its consideration of the financial report; and~~.~~

(iii) sets out the reasons for the conclusions of the Panel in relation to (i) and (ii) above.

(2) The Financial Reporting Panel must give a copy of the report to:

(a) the lodging entity; ~~and~~

(b) the auditor of the financial report;

~~(b)~~(c) ASIC; and

~~(c)~~(d) the relevant market operator if the financial report referred to the Panel was one of a listed company or listed registered scheme.

Subject to subsection (3), the copies must be given within 60 days after the day on which the financial statement is referred to the Panel (the ***referral day***).

(3) The copies may be given more than 60 days after the referral day, but not more than 90 days after the referral day, if the Financial Reporting Panel gives notice to the lodging entity, the auditor of the financial report and ASIC of the extension within 60 days after the referral day.

(4) ASIC must take such steps as it considers reasonable and appropriate to publicise:

(a) the Financial Reporting Panel's report; and

(b) if the Financial Reporting Panel's report sets out changes that, in the Panel's opinion, would need to be made to the financial report to ensure that it complies with a financial reporting requirement—whether the lodging entity has amended, or indicated that it intends to amend, the financial report to incorporate those changes.

Without limiting this, ASIC may make the report and the information referred to in paragraph (4)(b) available on the Internet.

(5) If a copy of the report is given to the relevant market operator under paragraph (2)(c), the relevant market operator must take such steps as it considers reasonable and

appropriate to make the report available to the users of the market.

Note: Changes are also proposed to section 1289 (qualified privilege) in respect of submissions, etc, by auditors to the Financial Reporting Panel.

CLERP 9 draft legislation:

Schedule 2, Part 4
Item 18 (s239AH)

Right of company and auditor to submit a response to a draft FRP annual report

Concept or issues:

- Section 239AH requires the FRP to lodge an annual report to the Minister for tabling in Parliament.

- A lodging entity and its auditor should be entitled to ensure the annual reports do not prejudice their position.

- We request a legislative direction to the FRP that if it proposes to name an auditor in its annual report to the Minister that is to be tabled in parliament that it must refer the relevant passage, in context, to the auditor concerned for comment, and must give proper consideration to timely responses, having regard to protecting the confidentiality of audit clients, and the legitimate business interests of auditors.

Recommended action:

Amend

Redraft of Item:

239AM Annual report

(1) The Financial Reporting Panel must, as soon as practicable after 30 June, and in any event before 31 October, in each year:
  (a) prepare a report describing the operations of the Panel during the year that ended on 30 June in that year; and
  (b) give to the Minister a copy of the report.

(2) If a copy of a report is given to the Minister under subsection (1), he or she must cause a copy of the report to be laid before each House of the Parliament within 15 sitting days of that House after he or she receives the first-mentioned copy.

(3) If the Financial Report Panel proposes to name any auditor in its report, the Financial Report Panel must, before giving its report to the Minister:
  (a) give a copy of the final draft of its report (or the section of its final draft report referring to the auditor) to the auditor;
  (b) allow at least 21 days after giving the auditor the report for the auditor to respond in writing to the final draft report or section; and
  (c) fairly consider incorporating any response provided by the auditor.

(5) The Financial Report Panel must not, in its report to the Minister:
  (a) name any auditor;
  (b) name any client of an auditor; or
  (c) disclose any confidential information belonging to an auditor or a client of an auditor,

unless it considers it necessary to do so in order to discharge its functions and

powers conferred on it by or under the corporations legislation and having regard to:

(d) the confidentiality of the details or identities proposed to be disclosed; and

(e) the legitimate business interests and reputations of the auditor and clients of the auditor.

CLERP 9 draft legislation:

Right of company to refer a dispute with ASIC to the FRP
Schedule 2, Part 4

Item 19
Issue 2.2

Concept or issues:

ASIC has a discretion to refer a matter to FRP (s323EA(1)). The section should be amended to permit the lodging entity to refer a matter to FRP, where ASIC has commenced proceedings against a lodging entity or its directors in relation to a financial reporting requirement. In the event of such a referral the ASIC proceedings would be stayed, until relevant submissions are made by ASIC, the lodging party and the auditor of the relevant financial report.

This change is essential to ensure that the objectives of the legislation are met which we believe are:

- to provide a less expensive alternative to court proceedings
- to ensure that matters are heard by persons with particular expertise
- to enable matters to be dealt with more expeditiously and improve the likelihood of speedy rectification of inappropriate financial reporting

We believe the objectives of the legislation would be advanced by enabling a lodging entity to refer a dispute to the FRP in advance of publication of the financial statements, however we have not drafted these provisions.

Recommended action:

Amend

Redraft of Item:

323EA ASIC or lodging entity may refer financial report to the Financial Reporting Panel

(1) (no change).

(2) (no change).

(3) Where ASIC has initiated proceedings in a court against a lodging entity alleging non-compliance with the requirements referred to in subsection (1)(b) in a financial report lodged with ASIC, the lodging entity may refer the dispute to the Financial Reporting Panel.

(4) Where a lodging entity refers a matter to the Financial Reporting Panel under subsection (3):

(a) the proceedings in the court will be stayed until the Panel gives its report to ASIC under section 323EG(2); and

(b) ASIC must follow the procedure set out in sections 323EB and 323ED as if it had referred the matter to the Panel.

Schedule 3 – Proportionate liability

CLERP 9 draft legislation:

Schedule 3 – Proportionate Liability

Items 1 to 6
ASIC Act - Part 2 - Sub-division 6A
CA - Part 7.10 – Division 2AA
TPA - Part VIA –

Concept or issues:

We support the introduction of a regime of Proportionate Liability for concurrent wrongdoers in relation to claims for damages for economic loss for misleading or deceptive conduct in breach of Section 52 of the *Trade Practices Act*, Section 12DA of the *Australian Securities and Investments Commission Act* and Section 1041H of the *Corporations Act* as proposed in Schedule 3 of the draft Bill. This initiative will ensure that damages are awarded to accord with the party's culpability and remove the inequities created by joint and several liability. It will also address the ongoing concerns over the availability and affordable of professional indemnity insurance.

We submit that a defending party notifying of a possible concurrent wrong-doer should be able to raise a defence of qualified privilege. Without this protection the situation could arise where a defendant names another person to access the legislative provision, and that person seeks to sue the naming defendant for its loss as a result of being named. This would defeat the purpose of the proportionate liability provisions.

Recommended action:

Amend

Redraft of Item:

See new section 1289(9) (qualified privilege) (page 82).

Schedule 4 – Enforcement

Part 1 – Protection of employees reporting breaches to ASIC	**No comment**
Part 2 – Disqualification of directors	**No comment**
Part 3 – Civil penalty Items	**No comment**

Schedule 5 – Remuneration of directors and executives

CLERP 9 draft legislation:

Remuneration of directors and executives

Schedule 5
Items: 1 to 13

Concept or issues:

The director's report is to include a separate and clearly identified section, titled "Remuneration Report", which discusses board policy in relation to, and details of, remuneration of directors, secretaries and senior managers of the company and, if consolidated financial statements are required, of other group executives.

We agree with the increased disclosure requirements but believe that it would be preferable for all disclosure requirements to be made in a manner either required by or consistent with the applicable accounting standards.

Accounting Standards AASB 1017, 1028 and 1034 contain requirements for disclosure of directors' and executives' remuneration. It is confusing for users and preparers of financial statements to have different disclosures in different locations report.

Recommended action:

Amend

Redraft of Item:

12 After subsection 300A(1)

Insert:

(1A) The material referred to in subsection (1) must be included in the directors' report under the heading "Remuneration report".

(1B) For the purposes of paragraph (1)(c):

(a) a person is a ***company executive*** of the company if the person is a secretary or senior manager of the company; and

(b) a person is a ***relevant group executive*** of the company if the person:

(i) is a group executive of the consolidated entity; and

(ii) is not a director of the company.

(1C) Without limiting paragraph (1)(c), the regulations may~~:~~

~~(a) provide that the value of an element of remuneration is to be determined, for the purposes of this section, in a particular way or by reference to a particular standard; and~~

~~(b)~~ provide that details to be given of an element of remuneration must relate to the remuneration provided in:

(i) the financial year to which the directors' report relates; and

(ii) the earlier financial years specified in the regulations.

(1D) For the purposes of paragraph (1)(c), the value of an element of remuneration is to be determined, for the purposes of this section, by reference to the applicable accounting standard or standards.

Schedule 6 – Continuous disclosure

Part 1 – General	**See below**
Part 2 – Infringement notices	**No comment**

CLERP 9 draft legislation:

Continuous Disclosure

Schedule 6

Sections 674(2A); 675 (2A)
Items 1 and 2

Concept or issues:

- We support the imposition of potential liability on an individual who actively participates in a contravention of the continuous disclosure regime by a listed entity. We do not, however, support the application of the section 79 definition of "involved in a contravention" as proposed by the draft legislation without additional provisions. The definition of "involved" in section 79 of the Act, includes a person who "has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention".

- We support the extension of liability to persons who are in a position to make the listed disclosing entity's disclosure decision and then to effect the disclosure. We do not, however, support the extension of liability to persons who might be involved in the decision making process but who cannot effect disclosure.

  For example, by the current draft text, an accountant who is consulted on a financial matter that is disclosable to the market could be a person involved in the contravention if disclosure does not occur. The accountant can recommend disclosure but cannot compel disclosure. Knowledge of the information and non-disclosure could be enough for such an adviser to have contravened the subsection. The situation is quite different to a capital raising where professional advisers have formal roles and involvement in the process.

- The Commentary (para 437) notes that the section is only intended to be applied against those with a real involvement in the contravention of the provisions. We submit that the drafting should confine the possibility of a penalty to a person in that situation.

Recommended action:

Amend

Redraft of Item:

Amend sections 674(2A) and 675(2A) as follows:

(2A) ~~A person~~An officer or senior manager of a listed disclosing entity who is involved in ~~a listed disclosing~~ that entity's contravention of subsection (2) contravenes this subsection.

Schedule 7 – Disclosure rules

No comment

Schedule 8 – Shareholders participation and information

No comment

Schedule 9 – Officers, senior managers and employees

No comment

Schedule 10 – Management of conflicts of interest by financial services licensees

No comment

Schedule 11 – Miscellaneous amendments

No comment

Schedule 12 – Transitional Items

Part 1

- We have commented on s1450 ~~and page • of~~as part of this submission.
- We have commented on s.1451 as part of this submission.
- We have commented on s.1454 as part of this submission.
- We have commented on s1456 as part of this submission.
- We wish to be involved with you in the further development of the transitional rules prior to tabling of the legislation.

Penalties

The Commentary seeks submission on appropriate penalties for breaching the provisions of the proposed legislation.

As a general principle, we do not believe that any of the provisions affecting auditors, audit firms or audit companies under the proposed legislation should be treated as civil penalty provisions. This could unfairly expose auditors to the lower burden of proof standard. As outlined in this submission the draft Bill imposes obligations that are not readily ascertainable, in that they require a judgment about conduct or impact. In a number of instances the conduct complained of is not wholly, or even substantially within the control of the person concerned.

The civil penalty provisions also include a number of other sanctions, including disqualification orders. We submit that these are not appropriate in the context of auditors and alternative disciplinary regimes already exist to cover this.

We note that in many instances a contravention by the audit firm of a section is said to be a contravention by each audit firm member. We understand the legal reason for this - that a firm is not a legal entity. However we submit the legislation does not adequately deal with a protection of "innocent" firm members, who in most instances will not be aware of the relevant conduct. We have addressed this at relevant places in the submission.

A more general point to note regarding treatment of audit firm members is that it would be inequitable for all firm members to be penalised for the same amount that an individual auditor is penalised. A number of firms have in excess of 300 members, and the maximum penalty that should be recoverable from all firm members collectively is the amount that could be recovered from an audit company for the same contravention.