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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

CORPORATIONS LEGISLATION AMENDMENT (AUDIT ENHANCEMENT) BILL 2011

EXPLANATORY MATERIAL

(Circulated by the authority of the
Parliamentary Secretary to the Treasurer, the Hon David Bradbury MP)

Consultation process

Request for feedback and comments

The Government is seeking your feedback and comments on the issues raised in the exposure draft of the Corporations Legislation Amendment (Audit Enhancement) Bill 2011.

The information will assist the Government in finalising the draft Bill for introduction into Parliament and will also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: COB 28 October 2011

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
AAT	Administrative Appeals Tribunal
AICD	Australian Institute of Company Directors
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
CLERP 9	Ninth Phase of the Corporate Law Economic Reform Program
CLERP 9 Act	*Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*
Corporations Act	*Corporations Act 2001*
CPAB	Canadian Public Accountability Board
CALDB	Companies Auditors and Liquidators Disciplinary Board
EC	European Commission
EU	European Union
FRC	Financial Reporting Council
G100	Group of 100
IFAC	International Federation of Accountants
PCAOB	Public Company Accounting Oversight Board (of US)
Treasury's audit quality paper	*Audit Quality in Australia: A Strategic Review*
UKFRC	UK Financial Reporting Council
UK	United Kingdom
US	United States of America

General outline and financial impact

General Outline

The former Chairman of the Financial Reporting Council (FRC) released Treasury's consultation paper *Audit quality in Australia: A strategic review* on 5 March 2010 for a two month consultation period.

Stakeholders have responded positively to Treasury's paper and to the consultative process that Treasury has undertaken. Stakeholders have recognised the timeliness of the paper because:

- the global financial crisis presented new complexities, risks and uncertainties for auditors (such as the opinion an auditor must make whether it is appropriate for the financial statements to have been prepared on a 'going concern' basis and the uncertainties around valuation during periods of market stress). Treasury's paper provided an opportunity to examine the impact of the uncertain economic environment on audit quality in Australia, including a 'stress test' on the robustness of the audit regulation framework and the performance of the audit profession; and

- it is more than six years since the major audit reforms were introduced by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) and the Treasury paper provided an opportunity to make a measured assessment whether Australia's audit regulation framework remains in line with best international standards and is consistent with recent international trends in relation to auditor oversight.

The methodology adopted in the Treasury paper was to identify the key drivers of audit quality in Australia and assess whether any measures should be taken to address any real or perceived threats to these drivers of audit quality.

The overall conclusion in Treasury's paper is that Australia's audit regulation framework is robust and stable, that the framework is in line with international best practice and that no fundamental changes to the framework are required.

Treasury's paper also recognised that Australia's financial reporting and audit regulation framework operates within a dynamic environment. In this context, Treasury's paper has indentified a significant number of important policy issues that warrant consideration by the Government and key stakeholders who have an interest in auditing.

Treasury completed its consultations with key stakeholders by holding roundtable discussions with stakeholders in Sydney on 2 November 2010 and in Melbourne on 3 November 2010.

A number of important legislative proposals were identified during the consultative process. The Government proposes to progress these reforms through the Corporations Legislation Amendment (Audit Enhancement) Bill 2011. It was agreed that stakeholders would be consulted on the draft legislation prior to the introduction of the Bill into Parliament.

The Bill implements the legislative proposals, which are explained below, arising from the consultative process.

Auditor rotation

The Bill retains the five year mandatory auditor rotation period but introduces more flexibility to allow the directors of a listed company or listed registered scheme to extend the rotation period for up to two years provided the directors comply with specified requirements designed to protect auditor independence and safeguard the quality of the audit.

If a listed company or listed registered scheme has an audit committee, the directors must comply with the recommendation of the audit committee if the directors decide to grant approval to an extension of the rotation period.

The audit committee's recommendation to the directors to grant approval for an extension is subject to the following requirements:

- the recommendation must be endorsed by a resolution passed by the members of the audit committee;
- the recommendation must state that the audit committee is satisfied that the approval:
  - is necessary to safeguard the quality of the audit provided to the company or scheme;

  - would not give rise to a conflict of interest situation as defined in section 324CD of the *Corporations Act 2001* (the Corporations Act); and

- the recommendation must be in writing and given to the directors, giving the reasons why the audit committee is satisfied that the extension is necessary to safeguard the quality of the audit and that it will not give rise to a conflict of interest situation.

The directors are not required to grant an approval merely because the audit committee has recommended that an approval be granted.

Where a listed company or listed scheme does not have an audit committee, the directors may grant an approval to extend the rotation period provided the directors are satisfied that that the extension is necessary to safeguard the quality of the audit and that it will not give rise to a conflict of interest situation.

The directors must not grant an approval to extend the rotation period unless the individual auditor subject to the rotation requirement agrees in writing to the extension.

Within 14 days of granting the approval, the directors are required to give a copy of the resolution granting the approval to:

- the Australian Securities and Investments Commission (ASIC); and

- the individual auditor who is subject to the extension of the rotation requirement or where the auditor acts on behalf of an audit firm or audit company, to the firm or company.

Where the directors have granted an approval for the extension of the rotation period, the annual directors' report must include details of, and reasons for, the approval.

Date of effect: The 28th day after Royal Assent.

Financial impact: Nil.

Compliance cost impact: The amendments may reduce the compliance costs for audit firms in managing their audit partner rotation systems.

Summary of regulation impact statement

Regulation impact on business

Impact: The auditor rotation measures will impact on listed companies and listed registered schemes and the auditors who provide audits for those listed entities.

Main points:

- The main problem to be addressed is that a number of key stakeholders consider that the five year rotation period is too short and could be increased to seven years in line with the rotation period adopted by the European Union (EU) Statutory Audit Directive and the *Code of Ethics for Professional Accountants* adopted by the International Federation of Accountants (IFAC).

- It is argued that where audit partners are compelled to rotate off from an audit after five years, this requirement poses a risk that it may have a detrimental impact on audit quality because of the premature loss of expertise and knowledge about the audit and the audit client.

- There is strong stakeholder support for retaining the five year mandatory rotation period (keeping Australia in line with the mandatory rotation period in Canada, China, South Africa, the UK and the US) but giving the audit committee (or the directors where there is no audit committee) the power to extend the rotation period by a further two years, subject to safeguards to protect audit quality and auditor independence. The UK Financial Reporting Council (UKFRC) has recently introduced a similar approach.

- The main objective of the auditor rotation measures is to enhance audit quality without compromising auditor independence.

- The measures will reduce the regulatory burden for audit firms in managing their audit partner rotation systems given the geographic spread of listed entities in Australia and the limited pool of audit partners with relevant industry experience.

Annual transparency reports

The Bill introduces a requirement for the publication of an annual transparency report by firms conducting audits of ten or more Australian entities of the following categories: listed companies, listed registered schemes, authorised deposit-taking institutions (ADIs) and insurance companies.

The broad objective of the requirement is to improve audit quality by enhancing the transparency of audit firms. As Australia's larger audit firms are usually structured as partnerships, minimal information about their ownership, governance, business structure and activities is publicly available. Requiring audit firms to publish a transparency report will assist in addressing this situation by ensuring factual information about firms performing significant audits is available to existing and potential clients.

Introduction of a requirement for Australian audit firms to publish transparency reports will assist in bringing Australia into line with developments in Europe and North America in relation to the publication of transparency reports by such firms.

Date of effect: The 28th day after Royal Assent.

Proposal announced: Treasury consultation paper *Audit quality in Australia: A strategic review* released on 5 March 2010.

Financial impact: Nil.

Compliance cost impact: Compliance costs associated with the publication of a transparency report are expected to be low because the information required would already be available to each of the firms subject to the requirement. The quantum of these costs will vary depending on the size of the firm, the structure under which the firm operates in Australia and the ability of the firm to draw on the resources of international associates when preparing the report.

Summary of regulation impact statement

Regulation impact on business

Impact: The introduction of a requirement to publish an annual transparency report will impact primarily on the audit firms that are required to publish that report.

Main points:

- There is broad stakeholder support for the introduction of a transparency reporting requirement based on the requirements of the EU's Article 40.
- The Australian requirement should apply only to auditors of listed and other public interest entities (such as ADIs and insurance companies subject to prudential supervision by the Australian Prudential Regulation Authority).
- The obligation to publish a transparency report should be triggered where an Australian audit firm audits not less than ten listed or other public interest entities.

Auditor Independence functions

The Bill streamlines the auditor independence work of ASIC and the FRC by removing the existing auditor independence function from the FRC and, in its place, giving the FRC a role of providing the Minister and the professional accounting bodies strategic policy advice and reports in relation to the quality of audits conducted by Australian auditors.

The FRC's revised functions include giving the Minister and the professional accounting bodies strategic policy advice and reports in relation to the systems and processes used by: Australian auditors to comply with relevant legislative and professional requirements; and professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by such auditors.

In conjunction with these changes:

- the FRC will be relieved of the requirement to prepare an annual report on the performance of its auditor independence functions. Particulars of any strategic policy advice and reports provided by the FRC as part of its revised functions will be included in the annual report to the Minister on the operations of the FRC; and
- the FRC's information gathering powers will be limited to obtaining information from the professional accounting bodies.

Date of effect: The day of Royal Assent.

Proposal announced: Treasury consultation paper *Audit quality in Australia: A strategic review* released on 5 March 2010.

Financial impact: Nil.

Compliance cost impact: The amendments are expected to reduce the administrative costs currently incurred by the FRC in carrying out the auditor independence functions. Costs incurred by stakeholder bodies in respect of meetings with the FRC may also be reduced.

Summary of regulation impact statement

Regulation impact on business

Impact: The changes to the FRC's auditor independence functions will impact primarily on the Government and regulators (particularly ASIC and FRC). Some stakeholders, such as audit firms, are expected to experience a reduction in the level of burden the current arrangements place on them.

Main points:

- There is strong stakeholder support for streamlining the auditor independence work of ASIC and the FRC by removing the existing auditor independence function from the FRC and giving the FRC a strategic policy advisory role in relation to audit quality.
- Stakeholders considered that making this change would remove the duplication between the 'operational' nature of the FRC's existing function and ASIC's audit inspection program.
- Giving the FRC a strategic policy advisory function would benefit the Government in that it would be able to draw on the depth and diversity of expertise within the FRC.

Audit deficiency notifications and reports

ASIC is the key regulator under the Corporations Act and has responsibility for the surveillance, investigation and enforcement of the financial reporting requirements of the Corporations Act, including the enforcement of auditor independence and audit quality requirements. The

scope of ASIC's audit inspection powers was enhanced by the *Australian Securities and Investments Commission Amendment (Audit Inspection) Act 2007*. The amendments introduced by this Act ensured that ASIC's audit inspection and information gathering powers were brought into line with corresponding powers granted to key overseas audit regulators.

The objective of ASIC's audit inspection program is to promote high quality external audits of financial reports of listed and other public interest entities in Australia so that users can have greater confidence in financial reports. ASIC publishes its generic public inspection reports periodically to better inform all firms, the investing public, companies, audit committees and other interested stakeholders of findings and areas of focus.

After each inspection, ASIC issues the firm with a confidential inspection report and the firm responds as to how it will deal with the issues which ASIC has identified. ASIC then revisits the firm, generally after around 12 months, to gauge the extent to which the firm has taken remedial action.

Although there is no legal obligation to report publicly, ASIC's usual practice is to publish on the ASIC website, a public report which sets out key themes and issues identified by ASIC's audit inspection program during the preceding inspection period (which may be up to 15 months). These public reports are prepared on an aggregated basis across firms and are intended to inform stakeholders of systemic themes and issues with the objective of contributing to better audit quality by all firms. These public reports do not attribute specific matters to any firm or audit client of a firm. Section 127 of the ASIC Act prevents ASIC from issuing public individual firm reports without the consent of the audit firm concerned.

During the course of the preparation of Treasury's audit quality paper, ASIC informed Treasury that in a number of important overseas jurisdictions, the independent audit regulator is permitted to make public disclosure about defects in an individual audit firm's quality control systems, subject to appropriate natural justice protections.

In the US, the PCAOB is required by the Sarbanes Oxley Act to produce public inspection reports, although portions of the complete report are omitted to comply with confidentiality requirements in the Act. The Sarbanes Oxley Act provides a framework for a remedial process whereby firms have 12 months to remedy defects in their quality control systems to prevent these defects being made public.

In the UK, the Audit Inspection Unit, part of the UKFRC's Professional Oversight Board, issues a confidential report to the audit firm inspected.

In addition to the confidential report, the Audit Inspection Unit publishes both an annual overview report on its audit inspection activities and a high level public report on the inspection of an individual audit firm, detailing findings from reviews of individual audits (without client names) concerning failures to comply with auditing standards or good practice. Criticism (if relevant) of the audit firm's quality control policies and procedures is also made public. Specific reports are also issued to engagement partners of deficiencies in the file reviewed with an expectation that this is shared with the relevant client audit committee or board of directors.

In Canada, the Canadian Public Accountability Board (CPAB), produces private reports of findings and recommendations to the individual firms inspected. Failure to implement one or more recommendations to CPAB's satisfaction within a prescribed timeframe (generally six months) may result in CPAB making public the relevant portions of the inspection report.

Treasury discussed the various options for ASIC public reporting on individual audit firms with stakeholders during the consultation process on Treasury's audit quality paper. The majority consensus among stakeholders was to support a reporting model along the lines of the more restrictive Canadian approach. This approach would allow ASIC to issue a public report on an individual audit firm only after the firm had failed to take remedial action to address an audit defect identified by ASIC within a prescribed time frame. The following reasons were advanced in favour of this reporting model:

- it should be a significant driver of audit quality because it would provide a strong incentive for an audit firm to take remedial action to address an audit deficiency identified by ASIC in order to avoid the publication of an adverse public report by ASIC;
- this reporting model would be able to operate in a timely manner;
- it should not impose any significant additional financial/resource burdens on either ASIC or the audit firms; and
- the model could incorporate adequate time for remediation processes by an audit firm.

The amendments in Schedule 2, Part 2 of the Bill have adopted the more restrictive approach under the Canadian public reporting model. ASIC is given the power to issue an audit deficiency report in relation to specified

failures by the audit firm that ASIC has identified during the exercise of its statutory audit functions:

- a failure by the auditor to comply with the auditing standards;
- a failure by the auditor to comply with the auditor independence requirements in the Corporations Act;
- a failure by the auditor to comply with any applicable code of professional conduct; or
- a failure by the auditor to comply with the provisions of the Corporations Act dealing with the conduct of audits.

ASIC is required to notify the auditor of the identified audit deficiency and to set out any remedial action that ASIC thinks necessary to remedy the deficiency. ASIC must also invite the auditor to make written submissions to ASIC, within six months, about the deficiency and any remedial action taken or proposed to be taken to remedy the deficiency.

At any time after the end of the six month period, ASIC may prepare an audit deficiency report if ASIC is satisfied that the Australian auditor has not taken appropriate remedial action to remedy the identified audit deficiency. Before preparing the report, ASIC must take into account any submissions received from the auditor and whether or not the auditor has taken any remedial action to remedy the deficiency.

ASIC may, if it considers it appropriate to do so, publish the report on the ASIC website. ASIC must give a copy of the audit deficiency report to the Australian auditor at least seven days before publishing the report on its website.

Date of effect: The day of Royal Assent.

Financial impact: Nil.

Compliance cost impact: The amendments should not impose any significant additional costs on either ASIC or Australian auditors.

Summary of regulation impact statement

Regulation impact on business

Impact: The audit notification and report measures will impact on ASIC and Australian auditors that fail to remedy an audit deficiency identified by ASIC after six months from notification by ASIC.

Main points:

- ASIC is currently prohibited from publishing information about an audit deficiency in relation to an individual audit firm because of the confidentiality restrictions in section 127 of the ASIC Act.
- Audit oversight regulators in a number of key overseas jurisdictions have been given the power to publish reports on individual audit firms.
- After consultation with stakeholders, there was a majority consensus that it would be appropriate for Australia to adopt a restrictive reporting model based on the approach undertaken in Canada by the CPAB.
- This reporting model gives ASIC the power to prepare and publish a report on an individual audit firm where the firm has failed to take steps to satisfactorily address an audit deficiency identified by ASIC within six months of notification by ASIC.
- The reporting model provides a strong incentive for an audit firm to take appropriate remedial action without imposing any significant additional costs on either ASIC or the audit firm.

Communications with corporations, registered schemes and disclosing entities

During the consultation process on Treasury's audit quality paper, ASIC proposed that it should be able to communicate directly with the audited body (and particularly the entity's audit committee) in relation to significant matters which it identifies during the course of the exercise of ASIC's statutory functions in relation to an audit.

A significant matter could relate to a matter concerning the audit client's accounting or disclosure practices or to the conduct of the audit by the audit firm. ASIC has explained that it was placed in a difficult position where it became aware of significant matters affecting the audit of a company during the inspection or surveillance of an audit firm and yet it was unable to disclose this to the audited body or its audit committee. ASIC is prevented from making such disclosures to the audited body or its audit committee without the audit firm's consent because of the confidentiality requirements in section 127 of the ASIC Act.

The amendments allow ASIC to disclose information to the directors, the audit committee or a senior manager of a company, responsible entity or disclosing entity concerning the conduct of the audit or compliance by the audited body with the requirements in Chapter 2M to prepare financial statements and reports, or with the continuous disclosure requirements of sections 674 and 675 of the Corporations Act. The information that is authorised to be disclosed must have been obtained by ASIC in the course of the exercise of its functions and powers in relation to audit.

Date of effect: The day of Royal Assent.

Financial impact: Nil.

Compliance cost impact: The amendments should not impose any significant additional costs on ASIC, audited bodies or Australian auditors.

Summary of regulation impact statement

Regulation impact on business

Impact: The measures will impact on ASIC, audited bodies (and their audit committees) and Australian auditors.

Main points:

- ASIC's inability at present to provide such information to an audit committee (or the company), which would assist the directors in fulfilling their responsibilities in relation to the preparation of the company's financial statements and the audit of those financial statements constitutes a regulatory failure.
- There is the risk that ASIC's inability to communicate quickly to the audited body (or its audit committee) about

defects in either the conduct of the audit or matters relating to the company's accounting or disclosure practices inhibits the audited body and the board of directors from fulfilling their obligations.

Chapter 1
Auditor rotation requirements

Outline of chapter

1.1 Part 1 of Schedule 1 to the Bill contains the amendments to the auditor rotation requirements in the Corporations Act.

1.2 The Bill retains the five year mandatory auditor rotation period but introduces more flexibility to allow the directors of a listed company or listed registered scheme to extend the rotation period for up to two years provided the directors comply with specified requirements designed to protect auditor independence and safeguard the quality of the audit.

1.3 If a listed company or listed registered scheme has an audit committee, the directors must comply with the recommendation of the audit committee if the directors decide to grant approval to an extension of the rotation period.

1.4 The audit committee's recommendation to the directors to grant approval for an extension is subject to the following requirements:

- the recommendation must be endorsed by a resolution passed by the members of the audit committee;
- the recommendation must state that the audit committee is satisfied that the approval:
  - is necessary to safeguard the quality of the audit provided to the company or scheme; and
  - would not give rise to a conflict of interest situation as defined in section 324CD of the Corporations Act 2001 (the Corporations Act); and
- the recommendation must be in writing and given to the directors, giving the reasons why the audit committee is satisfied that the extension is necessary to safeguard the quality of the audit and that it will not give rise to a conflict of interest situation.

1.5 The directors are not required to grant an approval merely because the audit committee has recommended that an approval be granted.

1.6 Where a listed company or listed scheme does not have an audit committee, the directors may grant an approval to extend the rotation period provided the directors are satisfied that that the extension is necessary to safeguard the quality of the audit and that it will not give rise to a conflict of interest situation.

1.7 The directors must not grant an approval to extend the rotation period unless the individual auditor subject to the rotation requirement agrees in writing to the extension.

1.8 Within 14 days of granting the approval, the directors are required to give a copy of the resolution granting the approval to:

- the Australian Securities and Investments Commission (ASIC); and
- the individual auditor who is subject to the extension of the rotation requirement.

1.9 Where the directors have granted an approval for the extension of the rotation period, the annual directors' report must include details of, and reasons for, the approval.

Context of amendments

1.10 The length of a relationship between senior audit personnel and an audit client presents clear risks in relation to auditor independence. Mandatory audit partner rotation requirements have been introduced in Australia and many overseas jurisdictions to address the familiarity threat arising from a long association between audit partners and the client. The *Code of Ethics for Professional Accountants* issued by the IFAC also contains auditor rotation requirements.

1.11 The key policy issue in determining an appropriate rotation period is to strike the right balance between auditor independence and objectivity on the one hand and the retention of knowledge and experience relating to the audit of the client on the other hand. While mandatory audit partner rotation addresses the familiarity threat, it can also involve a significant loss of knowledge held by the rotating partner about the audit client which can impact on audit quality.

1.12 The Review of the Independence of Australian Company Auditors (the Ramsay report), which was released in October 2001, recommended that there should be mandatory rotation of an audit partner responsible for the audit of a listed company after a maximum of seven years and that there should be a period of at least two years before the partner can again be involved in the audit of a client.

1.13 The CLERP 9 Act introduced a rotation period of five years in relation to the lead engagement and review partners for the audit of a listed company which brought the Australian rotation period into line with the new requirements in the UK and in the US under the Sarbanes Oxley Act. The CLERP 9 Act retained the two year time out period recommended by the Ramsay report rather than the more onerous time out period of five years adopted in the UK and US. Canada also introduced a five year rotation period with a five year time out period. China, Singapore and South Africa have adopted a five year rotation period with a two year time out period.

1.14 Treasury sought views from stakeholders on the existing rotation period in its consultation paper *Audit Quality in Australia: A Strategic Review* (Treasury's audit quality paper). Support in the public submissions for either the five or seven year period was evenly divided. However, a clear majority of stakeholders informed Treasury that the UK approach involving the audit committee would be an appropriate compromise and would enhance audit quality. The arguments put forward in support of this option are:

- Retention of the core rotation period of five years would keep Australia in line with the important jurisdictions such as Canada, China, South Africa, the UK and the US.

- It is appropriate that the audit committee should have the responsibility of making the decision to extend the rotation period by up to two years where it is necessary to safeguard audit quality because the role of the audit committee is to ensure the integrity of a company's financial reporting and the audit process, including the independence and objectivity of the external auditor.

- The extension of the rotation period by a further two years in appropriate circumstances should in fact enhance audit quality because it would result in the retention of an audit partner's expertise and corporate knowledge without compromising the auditor's independence.

- It would reduce the regulatory burden for audit firms in managing their audit partner rotations, given the geographic

spread of listed entities in Australia and the limited pool of audit partners with relevant industry experience.

1.15 The Bill adopts the UK approach because this option provides the flexibility to enhance audit quality while safeguarding auditor independence.

Summary of new law

1.16 The amendments enable the board of directors of a listed company or a listed registered scheme to grant approval for the extension of the existing five year rotation period for up to two years subject to safeguards to protect audit quality and auditor independence.

1.17 If the listed company or listed registered scheme has an audit committee, the directors must comply with the recommendation of the audit committee where the directors agree to extend the rotation period.

Comparison of key features of new law and current law

New law	*Current law*
The directors will be able to permit an individual (or the lead auditor or review auditor in the case of an audit firm or audit company) who has played a significant role in the audit of a listed company or listed registered scheme for five successive years to continue playing a significant role for up to a further two years provided requirements are satisfied in relation to the safeguarding of audit quality and auditor independence.	An individual (or the lead auditor or review auditor in the case of an audit firm or an audit company) who has played a significant role in the audit of a listed company or listed registered scheme for five successive years, is not eligible to continue to play a significant role in the audit of the company or registered scheme unless the person has not played a significant role for at least two successive financial years (the two year time-out period).

Detailed explanation of new law

1.18 A number of key stakeholders have made representations that the five year rotation period is too short and could be increased to seven years, in line with the rotation period adopted by the EU Statutory Audit Directive and the IFAC *Code of Ethics for Professional Accountants*. It is argued that where audit partners are compelled to rotate off from an audit after five years, this requirement poses a risk that it may

have a detrimental impact on audit quality because of the premature loss of expertise and knowledge about the audit and the audit client.

1.19 While stakeholder support for either the five or seven year period was evenly divided, a clear majority of stakeholders informed Treasury that the UK approach which allows the audit committee or board of directors to extend the five year period by a further two years, would be an appropriate compromise and would enhance audit quality.

1.20 The amendments introduce some flexibility into the existing auditor rotation requirements so that the directors of a listed company or of a listed registered scheme may grant an approval for an individual to play a significant role in the audit of the company or scheme for not more than two successive financial years in addition to the five successive financial years under the existing requirements mentioned in subsection 324DA(1). ***[Schedule 1, Part 1, item 6, section 324DAA]***

1.21 If the company or registered scheme has an audit committee, then the directors must not grant the approval unless:

- the resolution granting the approval is in accordance with a recommendation provided by the audit committee;
- the resolution by the directors granting the approval must set out the reasons why the audit committee is satisfied that the approval:
  - is necessary to safeguard the quality of the audit provided to the company or registered scheme; and
  - would not give rise to a conflict of interest situation as defined in section 324CD of the Corporations Act. ***[Schedule 1, Part 1,item 6, subsection 324DAB]***

1.22 An approval granted by the directors is taken to be made in accordance with a recommendation provided by the audit committee only if:

- the approval is in fact consistent with the audit committee's recommendation;
- the recommendation is endorsed by a resolution passed by the members of the audit committee;
- the recommendation is in writing signed by a member of the audit committee on behalf of the audit committee and given to the directors of the company or scheme; and

- the recommendation states that the audit committee is satisfied that the approval:
  - is necessary to safeguard the quality of the audit provided to the company or scheme;
  - would not give rise to a conflict of interest situation as defined in section 324CD of the Corporations Act. The conflict of interest situation defined in section 324CD constitutes the general standard of independence which was introduced by the CLERP 9 Act (and is similar to the general standard of independence in the rules of the US Securities and Exchange Commission (SEC)); and
- the recommendation sets out the reasons why the committee is satisfied that the extension would safeguard the quality of the audit and would not give rise to a conflict of interest situation. ***[Schedule 1, Part 1, item 6, subsection 324DAB(2)]***

1.23 The directors may decide against granting an extension of the rotation period notwithstanding the fact that the audit committee has recommended that an approval be granted.

1.24 Where a listed company or listed registered scheme does not have an audit committee, the directors may grant an approval to extend the rotation period:

- provided the directors are satisfied that the approval:
  - is necessary to safeguard the quality of the audit provided to the company or scheme;
  - would not give rise to a conflict of interest situation defined in section 324CD of the Corporations Act; and
- the resolution of the directors granting the approval must set out the reasons why the directors are so satisfied. ***[Schedule 1, Part 1, item 6, subsection 324DAB(3)]***

1.25 The directors also must not grant approval for an extension of the rotation period unless the auditor has agreed to the extension:

- in the case of an individual auditor to whom the approval relates who does not act on behalf of an audit firm or company, then the individual auditor must agree in writing to the approval being granted; and

- in the case of an individual auditor to whom the appeal relates who acts on behalf of an audit firm or audit company, then the audit firm or audit company must agree in writing to the approval being granted. ***[Schedule 1, Part 1, item 6, subsection 324DAB(4)]***

1.26 If the directors extend the rotation period in reliance of an approval granted under section 324DAA, the directors' report under section 300 must include details of, and reasons for, the approval. ***[Schedule 1, Part 1, item 2, subsection300(11AA)]***

1.27 If the directors grant an approval to extend the rotation period, they must, within 14 days of granting the approval, give a copy of the resolution granting the approval to:

- ASIC;
- the individual auditor, where the auditor does not act on behalf of an audit firm or audit company; and
- the audit firm or audit company where the individual auditor to whom the approval relates, acts on behalf of the firm or company. ***[Schedule 1, Part 1, item 6, section 324DAC]***

1.28 If the requirements of sections 324DAA, 324DAB and 324DAA are not complied with by the directors, then the purported grant of approval by the directors to extend the rotation period is rendered ineffective by section 324DAD. If an individual auditor to which the purported approval relates relies on the purported extension that has not been properly granted by the directors, the individual auditor, a partner in the audit firm, the audit company or the directors may commit an offence under the current sections 324DB, 324DC and 324DD. ***[Schedule 1, Part 1, item 6, section 323DAD]***

1.29 The obligations contained in sections 324DB, 324DC and 324DD were introduced by the CLERP 9 Act. The obligations in sections 324DC and 324DD impose a form of collective liability and are designed to encourage a 'culture of compliance' across the whole audit firm or audit company. The provisions do contain safeguards for less blameworthy persons. For example under subsections 324DC(1) and 324DD(2) a partner or a director only commits an offence if they are aware that an individual auditor is not eligible to play a significant role in the audit of a company.

1.30 Existing subsections 324DC(2) and 324DD(3) contain strict liability offences against a partner of an audit firm or a director of an audit company but a complete defence is provided if the partner or director has reasonable grounds to believe that the audit firm or audit company had in

place a quality control system that provided reasonable assurance that the firm or audit company would comply with the auditor rotation requirements. The strict offence provision and the statutory defence is designed to provide an incentive across the firm or audit company to establish effective audit quality control systems.

1.31 If the directors of a listed company or listed registered scheme fail to take all reasonable steps to comply with, or to secure compliance with, the provisions relating to the granting of an approval to extend the rotation period, they will contravene subsection 344(1) which is a civil penalty provision. If the directors contravene subsection 344(1) and there is dishonesty involved then under 344(2), the directors will commit a criminal offence. ***[Schedule 1, Part 1, item 8]***

Application and transitional provisions

1.32 There are no transitional provisions because the grant of the approval by the directors to extend the existing rotation period of five successive years must by virtue of subsection 324DAA(2) be made before the end of those five successive years. ***[Schedule 1, Part 1, item 6, subsection 324DAA(2)]***

Consequential amendments

1.33 The heading for subsection 300(11) has been amended to refer to registered schemes as well as listed companies because the auditor rotation requirements apply to both listed companies and listed schemes. ***[Schedule 1, Part 1, item 1]***

1.34 Section 311 of the Corporations Act imposes obligations on an auditor to report to ASIC where the auditor is aware of circumstances that the auditor has reasonable grounds to suspect amount to a contravention of the Act. Subsection 311(5) is amended to pick up a cross reference to the provisions imposing requirements on directors in relation to the granting of an approval to extend the rotation period. ***[Schedule 1, Part 1, item 3]***

1.35 Paragraphs 324DA(3)(a) and (b) are amended to ensure that they also refer to the provisions relating to the granting of an approval by the directors to extend the existing rotation period. ***[Schedule 1, Part 1, items 4 and 5]***

1.36 The heading for section 344 has been amended to refer to the provisions relating to the grant of approval by the directors to extend the existing rotation period. ***[Schedule 1, Part 1, item 7]***

1.37 Section 601HG relates to the audit of a managed investment scheme's compliance plan. The cross-reference in subsection 601HG(11) is amended to refer to the provisions relating to the grant of approval by the directors to extend the existing rotation period. ***[Schedule 1, Part 1, item 9]***

Chapter 2
Annual transparency reports

Outline of chapter

2.1 Part 2 of Schedule 1 of the Bill will insert a Part 2M.4A into the Corporations Act containing requirements for the publication of a transparency report by firms conducting audits of ten or more Australian entities of the following categories: listed companies, listed registered schemes, authorised deposit-taking institutions (ADIs) and insurance companies.

2.2 The broad objective of the requirement is to improve audit quality by enhancing the transparency of audit firms. As Australia's larger audit firms are usually structured as partnerships, minimal information about their ownership, governance, business structure and activities is publicly available. Requiring audit firms to publish a transparency report will assist in addressing this situation by ensuring factual information about firms performing significant audits is available to existing and potential clients.

2.3 Introduction of a requirement for Australian audit firms to publish transparency reports will assist in bringing Australia into line with developments in Europe and North America in relation to the publication of transparency reports by such firms.

Context of amendments

2.4 During the last decade, there has been a move in a number of overseas jurisdictions to require larger audit firms to produce a public annual report.

2.5 In Europe, Article 40 of the EU's Statutory Audit Directive[1] requires statutory auditors and audit firms to publish on their websites, within three months of the end of each financial year, annual transparency reports that contain a range of information about the firm, including:

- a description of the legal structure, ownership and governance structure of the audit firm;

1 Directive 2006/43/EC of 17 May 2006.

- a description of the internal quality control system of the audit firm;
- an indication of when the last quality assurance review of the audit firm took place; and
- a list of 'public interest entities' for which the audit firm has carried out statutory audits during the preceding financial year.

2.6 In the United States (US), a US Treasury Committee report issued in October 2008 made the following recommendation in relation to increased transparency by audit firms:

> Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating (a) information required by the EU's Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VIII of the Report. Further, encourage the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements.

2.7 In framing its recommendation, the US Treasury Committee:

- noted that auditing firms and investors have expressed support for requiring US auditing firms to publish reports similar to the EU's Article 40 Transparency Report;
- believed that information about audit quality indicators could improve audit quality by enhancing the transparency of auditing firms and noted that some foreign affiliates of US auditing firms provide such indicators in public reports in other jurisdictions; and
- noted that auditing firms in the UK now publish annual reports containing audited financial statements pursuant to limited liability partnership disclosure requirements as well as a discussion of those statements, a statement on corporate governance, performance metrics, and other useful information.

2.8 In Australia, there is no statutory requirement under the Corporations Act for auditors to publish information on their websites similar to that required under the EU transparency report. However, in

November 2010, one of the major audit firms voluntarily published a transparency report in relation to its Australian practice.

Summary of new law

2.9 The amendments will require an individual auditor, an audit firm or an authorised audit company conducting audits of ten or more entities of any of the types referred to below to publish a transparency report. The types of audits that trigger the reporting requirements are those of listed companies, listed registered schemes, authorised deposit taking institutions (ADIs) and insurance companies.

2.10 The disclosures to be made in the report will be prescribed in the Corporations Regulations. Disclosure of any information that is likely to result in unreasonable prejudice to the auditor may be omitted from the report (although in these circumstances the report must say that material has been omitted). The amendments also provide that ASIC may relieve the auditor from compliance with all or specified requirements concerning the preparation of the transparency report.

2.11 The report is to be published on the auditor's website within four months after the end of the calendar year to which the report relates and a copy of the report is to be sent to ASIC on or before the day on which it is published. The amendments will allow ASIC to extend the period in which the report must be published.

Comparison of key features of new law and current law

New law	***Current law***
An individual auditor, audit firm or authorised audit company (referred to in the new law as a 'transparency reporting auditor') will be required to publish a transparency report when they audit ten or more entities of any of the following types: listed companies, listed registered schemes, ADIs and insurance companies. An auditor's transparency report is to be published on the auditor's website within four months of the end of the calendar year to which the report relates. An electronic copy of the	There are no equivalent provisions in the current law.

New law	*Current law*
report is to be sent to ASIC on or before the day it is published. The disclosures to be made in the transparency report will be prescribed in the Corporations Regulations. Under the new law, ASIC will have the ability to extend the period of time for publication of the report. It will also have the power to relieve the auditor from compliance with some or all of the requirements relating to the preparation or content of the report. The law also sets out how contraventions of the transparency reporting requirements by an audit firm are to be dealt with.	

Detailed explanation of new law

2.12 The new Part 2M.4A of the Corporations Act will require an individual auditor, audit firm or authorised audit company (collectively referred to in the amending legislation as a 'transparency reporting auditor') ***[Schedule 1, Part 2, item 12, section 332]*** to publish a transparency report for each calendar year in which the auditor conducts audits, under Division 3 of Part 2M.3, of 10 or more bodies of any of the following kinds: listed companies, listed registered schemes, authorised deposit-taking institutions within the meaning of the *Banking Act 1959* and insurance companies. The amendments also permit the Corporations Regulations to be used to add additional kinds of body to the list of bodies that will trigger the transparency reporting obligation. ***[Schedule 1, Part 2, item 12, subsection 332A(1)]***

2.13 An auditor will be required to publish their transparency report on their website within four months of the end of the calendar year to which it relates. In addition, an auditor will be required to send a copy of the report to ASIC on or before the day on which it is published on the auditor's website. ***[Schedule 1, Part 2, item 12, subsections 332A(2) and (3)]***

2.14 The disclosures to be made in the transparency report will be prescribed by the regulations. It is envisaged that these disclosures will include the following:

- information about the auditor's legal structure and ownership;
- where the auditor belongs to a network, information about the network and the legal and structural arrangements in the network;
- information about the auditor's governance structure;
- information about the internal quality control system of the auditor and a statement by the administrative or management body of the auditor on the effectiveness of its functioning;
- details of when the last reviews of the auditor took place, showing separately:
  - audit inspections by ASIC; and
  - quality assurance reviews by each of the professional accounting bodies;
- the names of entities of the kinds listed in proposed subsection 332A(1) for which the auditor conducted audits under Division 3 of Part 2M.3 during the preceding calendar year;
- information about the auditor's independence practices, including details of the last internal review of independence compliance that was conducted;
- the policy followed by the auditor concerning the minimum amount and nature of continuing or other professional education that must be undertaken by professional members of the audit team;
- summary financial information for the auditor, showing total revenue, fees for Corporations Act audits and fees received from audit clients for other assurance services and other non-audit services; and
- a statement of the principles used by the auditor for determining:
  - in the case of an audit firm — partners' remuneration;
  - in the case of an audit company — directors' remuneration. ***[Schedule 1, Part 2, subsection 332B(1)]***

2.15 The amending legislation provides that information may be omitted from the transparency report where its disclosure is likely to cause unreasonable prejudice to the auditor preparing the report. However, in these circumstances the report will have to indicate material has been omitted. ***[Schedule 1, Part 2, item 12, subsection 332B(2)]***

2.16 ASIC will be empowered to extend the period within which an auditor must publish a transparency report and to relieve auditors from all or specified requirements of proposed sections 332A and 332B relating to such reports. A relief order made by ASIC may be expressed to be subject to conditions and the auditor will commit an offence when the conditions are not satisfied. ***[Schedule 1, Part 2, item 12, sections 332C and 332D]***

2.17 The legislation provides that where ASIC is considering an application from an auditor for relief from the requirements of proposed sections 332A and 332B, it must be satisfied that complying with the requirements of those provisions would be inappropriate in the circumstances associated with the preparation of the transparency report or would impose unreasonable burdens on the auditor. For the purpose of deciding whether the preparation of the report would impose an unreasonable burden on the auditor, ASIC is required to have regard to a range of factors, including the expected costs of compliance with the requirements, the expected benefits of that compliance and practical difficulties the auditor would face in complying effectively with the requirements. ***[Schedule 1, Part 2, item 12, section 332E]***

2.18 In conjunction with the introduction of the requirements for the preparation of a transparency report, offence provisions will apply for a failure by an auditor to:

- publish the transparency report (proposed subsection 332A(2));
- send a copy of the report to ASIC (proposed subsection 332A(3)); and
- comply with conditions set by ASIC when making an order either extending the period for publishing the report or providing relief from some or all of the requirements associated with the preparation of the report (proposed subsections 332C(5) and 332D(5)).

2.19 Each of these offences will be one of strict liability, attracting a penalty of 10 penalty units[2] ***[Schedule 1, Part 2, item 13, Schedule 3 (table items***

2 Under section 4AA of the *Crimes Act 1914*, a penalty unit is $110.

116NC-116NF)]. The strict offence provision is designed to provide an incentive across the firm or audit company to foster an effective culture of compliance.

2.20 Where the auditor preparing the transparency report is an audit firm, proposed section 332F imposes a form of collective liability which is designed to encourage a 'culture of compliance' across the whole firm. The section provides that the requirements of Part 2M.4A of the Corporations Act are to apply to the firm as if it were a person, but with the following modifications:

- an obligation that would otherwise be imposed on the firm is imposed on each member of the firm instead, but may be discharged by any of the members; and
- an offence that would otherwise be committed by the firm is taken to have been committed by each member of the firm.

2.21 Under proposed section 332F, a member of the firm does not commit an offence under a provision of Part 2M.4A of the Corporations Act if the member:

- does not know of the circumstances that constitute the contravention of the provision concerned; or
- knows of the circumstances but takes all reasonable steps to correct the contravention as soon as possible after the member becomes aware of those circumstances. ***[Schedule 1, Part 2, item 12, section 332F]***

Application and transitional provisions

2.22 The Bill provides that the transparency reporting requirements will apply in respect of the first calendar year that ends after the commencement of Schedule 1 of the Bill and each subsequent calendar year. For example, if Schedule 1 commenced on 1 December 2011, the requirements would first apply to the calendar year ending on 31 December 2011. However, if Schedule 1 commenced on 31 December 2011, the requirements would first apply to the calendar year ending on 31 December 2012. ***[Schedule 1, Part 3, item 14, section 1527]***

Consequential amendments

2.23 There are no consequential amendments for the provisions in Part 2 of Schedule 1.

Chapter 3
Auditor independence functions

Outline of chapter

3.1 Part 1 of Schedule 2 to the Bill contains amendments to the FRC's auditor independence functions in Part 12 of the ASIC Act.

3.2 The Bill streamlines the auditor independence work of ASIC and the FRC by removing the existing auditor independence function from the FRC and, in its place, giving the FRC a role of providing the Minister and the professional accounting bodies with strategic policy advice and reports in relation to the quality of audits conducted by Australian auditors.

3.3 The FRC's revised functions include giving the Minister and the professional accounting bodies strategic policy advice and reports in relation to the systems and processes used by: Australian auditors to comply with relevant legislative and professional requirements; and professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by such auditors.

3.4 In conjunction with these changes:

- the FRC will be relieved of the requirement to prepare an annual report on the performance of its auditor independence functions. Particulars of any strategic policy advice and reports provided by the FRC as part of its revised functions will be included in the annual report to the Minister on the operations of the FRC; and

- the FRC's information gathering powers will be limited to obtaining information from the professional accounting bodies.

Context of amendments

3.5 A 2001 report by Professor Ian Ramsay proposing new auditor independence requirements for Australia also recommended the establishment of an independent supervisory board to monitor implementation of the new regime, compliance with it, and important international developments in the area of auditor independence.

3.6 Subsequently, as part of the CLERP 9 reforms introduced in 2004, the FRC was given specific functions concerning quality assurance reviews in relation to auditor independence. Under subsection 225(2B) of the ASIC Act, the FRC's functions include monitoring and assessing the nature and overall adequacy of:

- the systems and processes used by Australian auditors to ensure compliance with the auditor independence requirements; and

- the systems and processes used by professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors, to the extent those reviews relate to auditor independence requirements.

3.7 In addition, the FRC has responsibility for giving the Minister and the professional accounting bodies reports and advice about these matters.

3.8 Since 2004, ASIC has developed an audit inspection program that covers all aspects of audit quality (including auditor independence) and, as a consequence, the FRC has been able to perform its auditor independence function by relying primarily on information provided by ASIC. The information provided to the FRC by ASIC is also supplemented by material provided by other bodies, such as the professional accounting bodies and audit firms. In these circumstances, it might be argued that the FRC duplicates the work already being undertaken by others.

3.9 Action is therefore needed to rationalise the FRC's auditor independence function to eliminate duplication with ASIC's audit inspection program.

Summary of new law

3.10 The new law replaces the FRC's existing auditor independence function with a new function of giving strategic policy advice and reports to the Minister and professional accounting bodies concerning the quality of audits conducted by Australian auditors. Matters on which advice and reports can be given by the FRC include:

- the systems and processes used by Australian auditors to comply with: the requirements of the Corporations Act

concerning the conduct of audits; the auditing standards; and codes of professional conduct; and

- the systems and processes used by professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors.

3.11 In conjunction with these changes, the FRC's information gathering powers will be limited to obtaining material from the professional accounting bodies. The FRC's annual reporting obligations also will be amended.

Comparison of key features of new law and current law

New law	***Current law***
Giving strategic policy advice and reports to the Minister and professional accounting bodies in relation to the quality of audits conducted by Australian auditors.	Monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice on those requirements.
Giving strategic policy advice and reports to the Minister and professional accounting bodies in relation to the systems and processes used by: (a) Australian auditors to comply with: the provisions of the Corporations Act dealing with conduct of audits; the auditing standards; and applicable codes of professional conduct; and (b) professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors (and associated follow-up action by the bodies and auditors who have been reviewed).	Monitoring and assessing the nature and overall adequacy of the systems and processes used by: (a) Australian auditors to ensure compliance with auditor independence requirements; and (b) professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors to the extent to which those reviews relate to auditor independence requirements (and associated follow-up action by the bodies and auditors who have been reviewed).
Giving strategic policy advice and reports to the Minister and professional accounting bodies in relation to the investigation and disciplinary procedures of professional accounting bodies as those procedures apply to Australian auditors.	Monitoring and assessing the nature and overall adequacy of the investigation and disciplinary procedures of professional accounting bodies as those procedures apply to Australian auditors.

New law	*Current law*
There is no equivalent requirement in the new law – but ASIC will continue to perform this function.	Monitoring the overall compliance by companies, registered schemes and disclosing entities with the audit-related disclosure requirements of the Corporations Act and the accounting standards.
Giving strategic policy advice and reports to the Minister and professional accounting bodies in relation to the adequacy of Australian requirements in light of international developments in relation to audit quality.	Monitoring international developments in auditor independence and giving the Minister and professional accounting bodies reports and advice on any additional measures needed to enhance the independence of Australian auditors.
Giving strategic policy advice and reports to the Minister and professional accounting bodies in relation to the teaching of professional and business ethics by, or on behalf of, professional accounting bodies to the extent to which the teaching of those subjects relates to auditor quality.	Promoting, and monitoring the adequacy of, the teaching of professional and business ethics by, or on behalf of, professional accounting bodies to the extent to which the teaching of those subjects relates to auditor independence.
Work on the audit quality function will be included in the FRC's annual report.	Preparation of an annual report on the performance of the auditor independence function.

Detailed explanation of new law

3.12 The Bill repeals the FRC's current function of monitoring the effectiveness of auditor independence requirements in Australia and the associated function of giving the Minister reports and advice about these requirements. As part of this change, the Bill inserts new auditor quality functions in place of the current auditor independence functions. ***[Schedule 2, Part 1, items 2 to 5, subsections 225(1) and (2B)]***

3.13 Under proposed subsection 225(2B), the FRC's new auditor quality functions include giving strategic policy advice and reports to the Minister and professional accounting bodies in relation to the quality of audits conducted by Australian auditors. 'Australian auditor' is defined in section 5 of the ASIC Act to mean an individual auditor, an audit firm or an audit company that is conducting, or has conducted, audits undertaken for the purposes of the Corporations Act and includes a registered company auditor who is participating in, or has participated in, an audit of that kind. It is the policy intention that the audit quality functions detailed in subsections 225(2B) and (2C) are to apply only in respect of Corporations Act audits.

3.14 Under proposed subsection 225(2C) the specific matters in respect of which the FRC can give strategic policy advice and reports to the Minister and professional accounting bodies are:

- the systems and processes used by:
  - Australian auditors to comply with: the provisions of the Corporations Act dealing with conduct of audits; the auditing standards; and applicable codes of professional conduct; and
  - professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors (and associated follow-up action by the bodies and auditors who have been reviewed);
- the investigation and disciplinary procedures of professional accounting bodies as those procedures apply to Australian auditors;
- the adequacy of Australian requirements in light of international developments in relation to audit quality; and
- the teaching of professional and business ethics by, or on behalf of, professional accounting bodies to the extent to which the teaching of those subjects relates to auditor quality.

3.15 Subsection 225(2C) provides that this list of matters is not intended to limit the matters in respect of which strategic policy advice and reports can be provided under proposed subsection 225(2B).

3.16 A significant difference between the FRC's current auditor independence functions and the proposed auditor quality functions will be the nature of the FRC's role. At present, the FRC's auditor independence function may be characterised as being of an operational or quasi-operational nature, supported by the FRC's information gathering powers. In contrast, giving strategic policy advice and reports in respect of the auditor quality functions is not intended to be of an operational nature. It is envisaged that the FRC will only be required to take action when it observes, or has brought to its attention, matters in respect of which advice or reports should be provided to the Minister or the professional accounting bodies.

3.17 Proposed subsection 225(2D), which provides that reports to the Minister and the professional accounting bodies under proposed subsections 225(2B) and (2C) are not legislative instruments, has been

included in the Bill to assist readers, as the reports referred to in those subsections are not legislative instruments within the meaning of the *Legislative Instruments Act 2003*. ***[Schedule 2, Part 1, item 15]***

Application and transitional provisions

3.18 The Bill provides that section 235BA, which requires the FRC to prepare in respect of each year a report on the performance of its auditor independence function, will continue to apply to the year in which the FRC's functions are changed. As a result, the FRC will be required to prepare a final report on the performance of its auditor independence functions covering the period commencing on 1 July 2011 and ending on the day on which the amendments to the FRC's functions commence. The Bill also provides that the final report is to be included in the FRC's annual report to the Minister for 2011-12, rather than being provided as a separate report. ***[Schedule 2, Part 4, item 18, section 293]***

Consequential amendments

3.19 In conjunction with the replacement of the FRC's auditor independence function, consequential amendments are being made to sections 5, 225A and 235BA of the ASIC Act.

3.20 The definition of 'auditor independence requirements' in subsection 5(1) will no longer be required and is being repealed. ***[Schedule 2, Part 1, item 1]***

3.21 Section 225A, which contains the FRC's information gathering powers, will be amended to omit the FRC's power to obtain information from auditors, audit firms and audit companies. This amendment will eliminate one area of overlap between the functions of the FRC and ASIC, as ASIC has equivalent information gathering powers. However, the FRC will retain its ability to gather information from the professional accounting bodies in respect of matters on which it is providing advice or reports to the Minister or the professional accounting bodies. ***[Schedule 2, Part 1, items 6 to 13]***

3.22 The requirement for the FRC to prepare a report on the performance of the auditor independence functions is being repealed as it will not be needed with the change to the FRC's functions. Information about any reports and advice the FRC provides to the Minister and the professional accounting bodies about the performance of its auditor quality functions will be included in the annual report prepared by the FRC pursuant to section 235B of the ASIC Act. ***[Schedule 2, Part 1, item 14, section 235BA]***

Chapter 4
Audit deficiency notifications and reports

Outline of chapter

4.1 Part 2 of Schedule 2 to the Bill contains the amendments to the ASIC Act relating to audit deficiency notifications and reports.

4.2 ASIC is the key regulator under the Corporations Act and has responsibility for the surveillance, investigation and enforcement of the financial reporting requirements of the Corporations Act, including the enforcement of auditor independence and audit quality requirements. The scope of ASIC's audit inspection powers was enhanced by the *Australian Securities and Investments Commission Amendment (Audit Inspection) Act 2007*. The amendments introduced by this Act ensured that ASIC's audit inspection and information gathering powers were brought into line with corresponding powers granted to key overseas audit regulators.

4.3 The objective of ASIC's audit inspection program is to promote high quality external audits of financial reports of listed and other public interest entities in Australia so that users can have greater confidence in financial reports. ASIC publishes its generic public inspection reports periodically to better inform all firms, the investing public, companies, audit committees and other interested stakeholders of findings and areas of focus.

4.4 After each inspection, ASIC issues the firm with a confidential inspection report and the firm responds as to how it will deal with the issues which ASIC has identified. ASIC then revisits the firm, generally after around 12 months, to gauge the extent to which the firm has taken remedial action.

4.5 Although there is no legal obligation to report publicly, ASIC's usual practice is to publish on the ASIC website, a public report which sets out key themes and issues identified by ASIC's audit inspection program during the preceding inspection period (which may be up to 15 months). These public reports are prepared on an aggregated basis across firms and are intended to inform stakeholders of systemic themes and issues with the objective of contributing to better audit quality by all firms. These public reports do not attribute specific matters to any firm or audit client of a firm. Section 127 of the ASIC Act prevents ASIC from issuing public individual firm reports without the consent of the audit firm concerned.

4.6 During the course of the preparation of Treasury's audit quality paper, ASIC informed Treasury that in a number of important overseas jurisdictions, the independent audit regulator is permitted to make public disclosure about defects in an individual audit firm's quality control systems, subject to appropriate natural justice protections.

4.7 In the US, the PCAOB is required by the Sarbanes Oxley Act to produce public inspection reports, although portions of the complete report are omitted to comply with confidentiality requirements in the Act. The Sarbanes Oxley Act provides a framework for a remedial process whereby firms have 12 months to remedy defects in their quality control systems to prevent these defects being made public.

4.8 In the UK, the Audit Inspection Unit, part of the UKFRC's Professional Oversight Board, issues a confidential report to the audit firm inspected. In addition to the confidential report, the Audit Inspection Unit publishes both an annual overview report on its audit inspection activities and a high level public report on the inspection of an individual audit firm, detailing findings from reviews of individual audits (without client names) concerning failures to comply with auditing standards or good practice. Criticism (if relevant) of the audit firm's quality control policies and procedures is also made public. Specific reports are also issued to engagement partners of deficiencies in the file reviewed with an expectation that this is shared with the relevant client audit committee or board of directors.

4.9 In Canada, the Canadian Public Accountability Board (CPAB), produces private reports of findings and recommendations to the individual firms inspected. Failure to implement one or more recommendations to CPAB's satisfaction within a prescribed timeframe (generally six months) may result in CPAB making public the relevant portions of the inspection report.

4.10 Treasury discussed the various options for ASIC public reporting on individual audit firms with stakeholders during the consultation process on Treasury's audit quality paper. A majority of stakeholders supported a reporting model along the lines of the more restrictive Canadian approach. This approach would allow ASIC to issue a public report on an individual audit firm only after the firm had failed to take remedial action to address an audit defect identified by ASIC within a prescribed time frame. The following reasons were advanced in favour of this reporting model:

- it should be a significant driver of audit quality because it would provide a strong incentive for an audit firm to take remedial action to address an audit deficiency identified by

ASIC in order to avoid the publication of an adverse public report by ASIC;

- this reporting model would be able to operate in a timely manner;
- it should not impose any significant additional financial/resource burdens on either ASIC or the audit firms; and
- the model could incorporate adequate time for remediation processes by an audit firm.

4.11 The amendments in Schedule 2, Part 2 of the Bill have adopted the more restrictive approach under the Canadian public reporting model. ASIC is given the power to issue an audit deficiency report in relation to specified failures by the audit firm that ASIC has identified during the exercise of its statutory audit functions:

- a failure by the auditor to comply with the auditing standards;
- a failure by the auditor to comply with the auditor independence requirements in the Corporations Act;
- a failure by the auditor to comply with any applicable code of professional conduct; or
- a failure by the auditor to comply with the provisions of the Corporations Act dealing with the conduct of audits.

4.12 ASIC is required to notify the auditor of the identified audit deficiency and to set out any remedial action that ASIC thinks necessary to remedy the deficiency. ASIC must also invite the auditor to make written submissions to ASIC, within six months, about the deficiency and any remedial action taken or proposed to be taken to remedy the deficiency.

4.13 At any time after the end of the six month period, ASIC may prepare an audit deficiency report if ASIC is satisfied that the Australian auditor has not taken appropriate remedial action to remedy the identified audit deficiency. Before preparing the report, ASIC must take into account any submissions received from the auditor and whether or not the auditor has taken any remedial action to remedy the deficiency.

4.14 ASIC may, if it considers it appropriate to do so, publish the report on the ASIC website. ASIC must give a copy of the audit

deficiency report to the Australian auditor at least seven days before publishing the report on its website.

Context of amendments

4.15 The underlying policy rationale for ASIC public reporting on individual audit firm deficiencies is to improve confidence in the capital markets through increased transparency in the audit process. Furthermore, where the reporting model provides the opportunity for an audit firm to correct weaknesses identified in the private confidential report, coupled with the possibility of public disclosure for any failure to take remedial action, it provides a strong incentive for an audit firm to make prompt improvements in overall audit quality.

Summary of new law

4.16 ASIC is given the power to publish an audit deficiency report in relation to specified audit failures by an Australian auditor that have been identified by ASIC. ASIC is required to notify the auditor of the audit deficiency, set out any remedial action that ASIC thinks necessary and ASIC must invite the auditor to make written submissions to ASIC, within six months about any remedial action that the auditor proposes to undertake.

Comparison of key features of new law and current law

New law	***Current law***
ASIC is given the power to prepare and publish an audit deficiency report in relation to an Australian auditor subject to ASIC complying with requirements relating to notification of the audit deficiency to the auditor and providing the auditor a minimum period of at least six months prior to publication to take remedial action to address the audit deficiency.	The confidentiality restrictions in section 127 of the ASIC Act prohibit ASIC from issuing any public report in relation to an Australian auditor about audit deficiencies identified by ASIC during the course of the exercise of ASIC's statutory audit powers.

Detailed explanation of new law

4.17 An audit deficiency in relation to an audit conducted by an Australian auditor consists of any of the following:

- a failure by the auditor to comply with the auditing standards;
- a failure by the auditor to comply with the auditor independence requirements in the Corporations Act;
- a failure by the auditor to comply with any applicable code of professional conduct;
- a failure by the auditor to comply with the provisions of the Corporations Act dealing with the conduct of audits.***[Schedule 2, Part 2, item 16, subsection50A(1)]***

4.18 The new measures apply in circumstances where ASIC identifies an audit deficiency while exercising any of the following functions or powers in relation to audit:

- in relation to audit-related matters (Corporations Act audit requirements) under Chapter 2M or Part 9.2 or 9.2A of the Corporations Act or under other provisions of that Act that relate to that Chapter or that Part;
- for the purposes of ascertaining compliance with Corporations Act audit requirements;
- in relation to:
  - an alleged or suspected contravention of Corporations Act audit requirements;
  - an alleged or suspected contravention of a law of the Commonwealth, or of a State or Territory in this jurisdiction, being a contravention that relates to an audit matter and that either concerns the management or affairs of a body corporate or involves fraud or dishonesty and relates to a body corporate; and
- for the purposes of an investigation under Division 1 of Part 2 of the ASIC Act relating to a contravention referred to in the preceding paragraph. ***[Schedule 2, Part 2, item 16, subsections 50A(1) and (2)]***

4.19 ASIC may, in writing, notify the Australian auditor of the identified audit deficiency. The notice must set out:

- the identified audit deficiency;
- any remedial action that ASIC thinks necessary to remedy the deficiency; and
- such other matters in relation to the deficiency as ASIC thinks fit.

4.20 The notice must also invite the auditor to make written submissions to ASIC, within six months, about the deficiency and any remedial action taken, or proposed to be taken, to remedy the deficiency. ***[Schedule 2, Part 2, item 16, section 50B]***

4.21 ASIC may prepare an audit deficiency report, at any time after the six month period, if ASIC is satisfied that the Australian auditor has not taken appropriate remedial action to remedy the identified audit deficiency. ***[Schedule 2, Part 2, item 16, subsection 50C(1)]***

4.22 The report must set out:

- the identified audit deficiency;
- the remedial action that ASIC thinks necessary to remedy the deficiency;
- if the auditor has taken remedial action to remedy the deficiency, details of the remedial action;
- if the auditor has not taken remedial action, the fact of the failure to take any action; and
- such other matters in relation to the deficiency as ASIC thinks fit. ***[Schedule 2, Part 2, item 16, subsection 50C(2)]***

4.23 Before preparing an audit deficiency report, ASIC is required to take into account:

- any submissions received from the auditor in response to ASIC's invitation under paragraph 50B(2)(b); and
- whether or not the auditor has taken any remedial action to remedy the deficiency. ***[Schedule 2, Part 2, item 16, subsection 50C(3)]***

4.24 Subsection 50C(4) provides that an audit deficiency report is not a legislative instrument. Subsection 50C(4) is included to assist readers of the Bill, as the instrument is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. This provision is not a substantive exemption from the *Legislative Instruments Act 2003* and is merely declaratory of the law. ***[Schedule 2, Part 2, item 16, subsection 50C(4)]***

4.25 ASIC may, if it considers it appropriate, publish the audit deficiency report on its website provided it complies with the following requirements:

- if the audit to which the report relates was conducted by an audit firm or audit company, ASIC may disclose identifying particulars of the audit firm or audit company but must not disclose identifying particulars of any professional member of the audit team involved in the audit;

- if the audit to which the report relates was conducted by an individual auditor who did not act on behalf of an audit firm or audit company, ASIC may disclose identifying particulars of the auditor but must not disclose identifying particulars of any other professional member of the audit team involved in the audit;

- ASIC must not disclose identifying particulars of the audited body; and

- at least seven days before publishing the report on its website, ASIC must give a copy of the report to the Australian auditor to which the report relates. ***[Schedule 2, Part 2, item 16, section 50D]***

4.26 No provision has been made for a review by the Administrative Appeals Tribunal (AAT) of ASIC's decision to publish an audit deficiency report. The audit deficiency report measures are aimed at the very few audit firms that may fail or refuse to cooperate with ASIC in relation to taking remedial action to address concerns identified by ASIC. The great majority of audit firms willingly cooperate with ASIC and see ASIC's activities as contributing positively to improving the quality of the audits that the firms undertake. The threat of publication of an adverse report is a powerful incentive for the few recalcitrant audit firms to take remedial action to remedy any audit deficiencies identified by ASIC.

4.27 The likely delay before an AAT review could be completed, together with the six month period already provided for the audit firm under section 50B to make submissions to ASIC and to take remedial

action, would effectively defeat the purpose of the audit deficiency report measures. Furthermore, the audit firm is also given the opportunity to comment on any proposed deficiency report as ASIC is required to give the audit firm a copy of the report at least seven days prior to publication.

Application and transitional provisions

4.28 The new measures introduced in relation to audit deficiencies identified by ASIC apply to audit deficiencies identified by ASIC after the commencement of these provisions on Royal Assent. ***[Schedule 2, Part 4, item18, subsection 294(1)]***

Consequential amendments

4.29 A definition of an audit deficiency report is included in subsection 5(1) of the ASIC Act and has been given the meaning as described in subsection 50C(1). ***[Schedule 2, Part 2, item 15, subsection 5(1)]***

Chapter 5
Communications with corporations, registered schemes and disclosing entities

Outline of chapter

5.1 During the consultation process on Treasury's audit quality paper, ASIC proposed that it should be able to communicate directly with the audited body (and particularly the entity's audit committee) in relation to significant matters which it identifies during the course of the exercise of ASIC's statutory functions in relation to an audit.

5.2 A significant matter could relate to a matter concerning the audit client's accounting or disclosure practices, or to the conduct of the audit by the audit firm. ASIC has explained that it was placed in a difficult position where it became aware of significant matters affecting the audit of a company during the inspection or surveillance of an audit firm and yet it was unable to disclose this to the audited body or its audit committee. ASIC is prevented from making such disclosures to the audited body or its audit committee without the audit firm's consent because of the confidentiality requirements in section 127 of the ASIC Act.

5.3 The amendments allow ASIC to disclose information to the directors, the audit committee or a senior manager of a company, responsible entity or disclosing entity concerning the conduct of the audit or compliance by the audited body with the requirements in Chapter 2M to prepare financial statements and reports, or with the continuous disclosure requirements of sections 674 and 675 of the Corporations Act. The information that is authorised to be disclosed must have been obtained by ASIC in the course of the exercise of its functions and powers in relation to audit.

Context of amendments

5.4 The objective of the amendments is to remove the current restriction on ASIC under section 127 of the ASIC Act from communicating significant matters to the audited body or its audit committee. The current situation where ASIC is prevented from

communicating information, obtained by ASIC during the exercise of its statutory functions and powers in relation to audit, to the audited body, the directors or its audit committee, constitutes a regulatory failure.

5.5 ASIC has provided the Treasury with the following examples (based on its actual regulatory experience) where the power to communicate with a company, responsible entity of a registered scheme or a disclosing entity (or their directors or audit committee) would have been appropriate and in the public interest:

- A small audit firm conducting an audit improperly where there would be very limited prospect of the audit firm communicating appropriately with the audit committee. While ASIC could refer the individual auditor to the Companies Auditors and Liquidators Disciplinary Board (CALDB), this would be a lengthy process. ASIC's ability to communicate quickly with the audit committee about the defective conduct of an audit would enable the directors to fulfil their obligations.

- Group audits where there are impairment issues involving off shore components of the group which ASIC has become aware of during an audit inspection or through its audit surveillance work where the company does not have the relevant information that ASIC has obtained.

- A situation where ASIC is looking at 'impairment calculation' issues from both the audit point of view and the company's financial reporting point of view. ASIC's concerns arise from information it has obtained from the auditor's working papers. However, the company and the auditor are not communicating with each other. ASIC is of the view that section 127 of the ASIC Act precludes it from raising these concerns with the audit committee because the auditor's working papers are confidential.

- An example relating to concerns that ASIC has about asset values. ASIC cannot obtain the relevant information from the company but it is aware from its audit inspection work that a schedule has been prepared which discloses the calculations used by the company for determining its asset values. ASIC is of the view that section 127 of the ASIC Act prohibits it from referring to this schedule in its discussions with the company.

Summary of new law

5.6 The measures amend section 127 of the ASIC Act to ensure that certain information, obtained by ASIC during the exercise of its functions and powers in relation to audit, which is disclosed to the directors, the audit committee or a senior manager of the audited body, will be treated as authorised disclosure for the purposes of section 127.

Comparison of key features of new law and current law

New law	*Current law*
Certain information which ASIC has obtained while exercising its functions and powers in relation to audit may be communicated to the directors, the audit committee or a senior manager of the audited body as authorized disclosure for the purposes of section 127 of the ASIC Act.	The confidentiality restrictions in section 127 of the ASIC Act prevents ASIC from communicating with an audited body or its audit committee information that ASIC has obtained while exercising its functions or powers in relation to audit.

Detailed explanation of new law

5.7 Subsection 127(2D) of the ASIC Act allows certain information to be communicated to the directors, the audit committee or a senior manager of a company, responsible entity or disclosing entity (as authorised use and disclosure of information for purposes of section 127) if the Chairperson is satisfied that:

- the information has been obtained by ASIC while exercising its functions and powers in relation to audit;
- the information is:
  - about how an audit of a company was conducted by an Australian auditor; or
  - about the company's, scheme's or entity's compliance with the requirements in Chapter 2M of the Corporations Act to prepare financial statements and reports, or with the continuous disclosure requirements of sections 674 and 675 of the Corporations Act; and
- the information should be disclosed to the company, to the responsible entity of the registered scheme or to the

disclosing entity in order to assist the company, scheme or entity to properly manage its affairs. ***[Schedule 2, Part 3, item 17, subsection 127(2D)]***

5.8 The circumstances that must satisfy the ASIC Chairperson relate to information obtained by ASIC while exercising its powers or functions:

- in relation to audit-related matters (Corporations Act audit requirements) under Chapter 2M or Part 9.2 or 9.2A of the Corporations Act or under other provisions of that Act that relate to that Chapter or that Part;
- for the purposes of ascertaining compliance with Corporations Act audit requirements;
- in relation to:
  - an alleged or suspected contravention of Corporations Act audit requirements;
  - an alleged or suspected contravention of a law of the Commonwealth, or of a State or Territory in this jurisdiction, being a contravention that relates to an audit matter and that either concerns the management or affairs of a body corporate or involves fraud or dishonesty and relates to a body corporate; or
- for the purposes of an investigation under Division 1 of Part 2 of the ASIC Act relating to a contravention referred to in the preceding paragraph. ***[Schedule 2, Part 3, item 17, subsection 127(2E)]***

Application and transitional provisions

5.9 The new measures made by Part 3 of Schedule 2 to the Bill apply in relation to information obtained by ASIC after commencement. ***[Schedule 2, Part 4, item 18, subsection 294(2)]***

Consequential amendments

5.10 There are no consequential amendments in relation to the amendments made by Part 4 of Schedule 2 to the Bill.

Chapter 6
Regulation impact statement

Background

Independent verification of financial statements

6.1 All modern systems of company law accept the principle that a reporting entity's financial statements require independent third party verification to ensure their reliability and market credibility. Such third party verification is, in Australia, the traditional role of the registered company auditor.

6.2 There are two key considerations in establishing a reliable and market credible audit:

- the audit must be objective which requires the auditor to be independent of the audit client; and
- a 'quality audit' must be undertaken.

6.3 There is no agreed definition of 'audit quality' but it involves a wide range of inter related factors such as the legal framework relating to audit regulation (including the company auditor registration system, the auditor independence regime in the Corporations Act and the accounting and auditing standards), the ethical standards applying to the members of the professional accounting bodies, the professional qualities and skills of auditors and their staff and the role and activities of ASIC, the independent audit regulator and other bodies involved in the audit review process. There are also other drivers of audit quality that relate to the practices and processes adopted within audit firms, such as the culture within the audit firm and the quality of the firm's audit process, including the experience and technical expertise of the audit team and the audit methodology adopted by the firm.

Audit quality and well-functioning markets

6.4 Audit quality plays an essential role in maintaining an efficient market environment:

- an independent, quality audit underpins confidence in the credibility and integrity of financial statements which is essential for well-functioning markets;

- the Basel Committee on Banking Supervision has highlighted the importance of audit quality for prudential supervision and market confidence; and

- the Financial Stability Board has emphasised the role played by external audit in supporting market confidence and contributing to financial stability.

6.5 External audits performed in accordance with high quality auditing standards can promote appropriate implementation of accounting standards by reporting entities and help ensure that their financial statements are reliable, transparent and useful to the market place, thus enhancing market confidence. Moreover, sound audits can help reinforce strong corporate governance, risk management and internal controls at firms, thus contributing to financial stability.

Audit Quality in Australia: A Strategic Review

6.6 The former Chairman of the FRC released Treasury's consultation paper Audit Quality in Australia: A Strategic Review on 5 March 2010 for a two month consultation period.

6.7 Stakeholders have responded positively to Treasury's paper and to the consultative process that Treasury has undertaken. Stakeholders have recognised the timeliness of the paper because:

- the global financial crisis has presented new complexities, risks and uncertainties for auditors, such as the opinion an auditor must make whether it is appropriate for the financial statements to have been prepared on a 'going concern' basis and the uncertainties around valuation during periods of market stress. Treasury's paper provided an opportunity to examine the impact of the uncertain economic environment on audit quality in Australia, including a 'stress test' on the robustness of the audit regulation framework and the performance of the audit profession; and

- it is now more than six years since the CLERP 9 audit reforms were enacted in 2004 and the Treasury paper provides an opportunity to make a measured assessment whether Australia's audit regulation framework remains in

line with best international standards and is consistent with recent international trends in relation to auditor oversight.

6.8 Treasury received 18 written submissions on its paper which have been placed on the Treasury website (except for one confidential submission). The Australian Prudential Regulation Authority (APRA) decided not to provide a formal submission but submitted confidential comments to Treasury on several key issues raised in the paper.

6.9 Stakeholders have endorsed Treasury's key finding that Australia's audit regulation framework is robust and stable, that the framework is in line with international best practice and that no fundamental changes to the framework are required. The audit environment however is complex and dynamic and Treasury's consultation process has identified a number of specific issues that may warrant legislative reform.

6.10 Ensuring that Australia's audit regulation framework remains in line with international best practice standards provides important benefits for Australian stakeholders:

- Auditing has increasingly taken on an international focus because many significant Australian and foreign business entities now operate on a trans-national basis. Similar auditing regimes in different jurisdictions results in cost savings for business entities and their auditors. Trans-national audits can also be undertaken more efficiently and effectively which could be expected to enhance the quality of an audit.

- ASIC, as the key audit regulator, is able to undertake its responsibilities more effectively, particularly where cooperation with foreign regulators is necessary. The fact that Australia's regulatory framework has been judged to be in line with overseas requirements has facilitated mutual recognition arrangements which benefit both auditors and regulators:

  – ASIC entered into a joint audit inspection arrangement in 2007 with the US PCAOB which results in significant cost savings for Australian audit firms registered with the PCAOB because one joint audit inspection is undertaken rather than ASIC and PCAOB conducting two separate inspections; and

  – the European Commission (EC) concluded in February 2011 that Australia's systems, including our audit firm

inspection arrangements, are equivalent to those in the EU. The EC decision means that EU audit regulators will be able to rely on ASIC audit firm inspections rather than carrying out their own inspections of Australian audit firms that audit Australian companies in Europe or Australian subsidiaries of European companies. This will result in significant savings for audit firms and companies covered by these arrangements made between ASIC and EU member states. In making its decision the EC commented on the need for extensive international cooperation between audit regulators, given the global reach of corporations and their auditors.

- The development of international accounting and auditing standards is also a very significant development for investors and regulators because of the global activities of so many buseiness and investment entities. Australia adopted International Financial Reporting Standards (IFRS) from 1 January 2005 and the clarity Auditing Standards adopted by the Auditing and Assurance Standards Board from 1 January 2010 are based on the clarith standards issued by the International Auditing and Assurance Standards Board.

6.11 Ensuring that Australia's audit regulation framework remains in line with international best practice standards provides important benefits for Australian stakeholders:

6.12 After Treasury had undertaken its analysis of the submissions, Treasury completed its consultations with key stakeholders by holding roundtable discussions with stakeholders in Sydney on 2 November 2010 and in Melbourne on 3 November 2010.

6.13 Treasury has now finalised a report to the Parliamentary Secretary to the Treasurer on the outcomes of the consultative process which includes recommendations seeking policy approval for a number of legislative reforms designed to enhance audit quality.

The methodology adopted in Treasury's paper

6.14 The Treasury paper identifies the key drivers of audit quality in Australia and assesses whether any measures should be taken to address any real or perceived threats to these drivers of audit quality.

6.15 The key drivers of audit quality identified in Treasury's paper are:

- Australia's audit regulation framework

  – The ASIC Act and the Corporations Act including the establishment of the statutory institutional framework:

  :ASIC (the key corporate regulator and independent audit oversight body);

  :the FRC;

  :the two standard setters, the Australian Accounting Standards Board and the Auditing and Assurance Standards Board; and

  :the Companies Auditors and Liquidators Disciplinary Board.

  – The three professional accounting bodies (CPA Australia, The Institute of Chartered Accountants in Australia and the National Institute of Accountants) and the ethical standards applying to their members made by the Accounting Professional and Ethical Standards Board.

- Audit firm arrangements and processes

  – The culture within the firm.

  – The skills and personal qualities of individual auditors and their staff.

  – The effectiveness of the audit process within the firm:

  :well structured audit methodology, sound audit quality control procedures, high quality technical support, adherence to ethical standards, and efficient procedures for collection of audit evidence and documentation.

- The reliability and usefulness of audit reporting

  – Audit report addresses the needs of users of financial statements.

  – Auditor communicates effectively with audit committee and users of financial statements.

- Factors outside the control of auditors

  – Corporate governance and an effective audit committee.

- Adequate supply of registered company auditors.
- Auditor liability.

Implementation and review

6.16 It is proposed that the proposals will be implemented by amendments to the ASIC Act and the Corporations Act which will be included for comment in an exposure draft of the Bill. Stakeholders will be consulted on the exposure draft of the Bill prior to its introduction into Parliament. The proposals will be subject to ongoing review after they have been enacted by Parliament through regular stakeholder consultation arrangements with Treasury.

Identification of options, impact analysis, conclusions and recommendations

Auditor Rotation

Background

6.17 The length of a relationship between senior audit personnel and an audit client presents clear risks in relation to auditor independence. Mandatory audit partner rotation requirements for audits of listed companies and listed registered schemes have been introduced in Australia and many overseas jurisdictions to address the familiarity threat arising from a long association between an audit partner and a client. The *Code of Ethics for Professional Accountants* issued by the IFAC also contains auditor rotation requirements.

6.18 The key policy issue in determining an appropriate rotation period is to strike a balance between auditor independence and objectivity on the one hand and the retention of knowledge and experience relating to the audit of the client on the other hand. While mandatory audit partner rotation addresses the familiarity threat and brings a fresh mind to the financial report and audit, it can also result in a significant loss of knowledge held by the rotating partner about the audit client. While knowledge should be retained through the working papers, continuing engagement team members, and a handover to the new partner, audit firms have expressed concerns over possible negative impacts on audit quality.

6.19 The *Review of the Independence of Australian Company Auditors* (the Ramsay report, October 2001) recommended that there should be mandatory rotation of an audit partner responsible for the audit of a listed company after a maximum of seven years and that there should be a period of at least two years before the partner can again be involved in the audit of a client.

6.20 The CLERP 9 Act introduced a rotation period of five years in relation to the lead engagement and review partners for the audit of a listed company which brought the Australian rotation period into line with the new requirements in the UK and in the US under the Sarbanes Oxley Act of 2002. The CLERP 9 Act retained the two year time-out period recommended by the Ramsay report rather than the more onerous time-out period of five years adopted in the UK and US. Canada, also introduced a five year rotation period with a five year time-out period. China, Singapore and South Africa have each adopted a five year rotation period with a two year 'time-out' period.

6.21 In key finding 2 of the audit quality paper, Treasury said that it considered that the existing five year rotation period and the two year time-out period constituted an appropriate balance between continuity, the familiarity threat and audit quality.

6.22 Treasury emphasised the importance of retaining the five year rotation period in line with the requirements in Canada, the UK and the US, although the paper noted that the UK had recently introduced some flexibility by permitting a company's audit committee to extend the rotation period from five to seven years where the committee is satisfied that the extension is necessary to safeguard audit quality.

6.23 Treasury's paper noted that the EU Statutory Audit Directive had adopted a seven year rotation period with a two year time-out period. This is also the position adopted by IFAC in the *Code of Ethics for Professional Accountants*. New Zealand has also adopted the seven year rotation period and two year time-out model.

6.24 Treasury also suggested that if any change were to be made to extend the existing five year rotation period, this would raise the question of whether the existing two year time-out period should also be increased.

Problem

6.25 A number of key stakeholders have made representations to the Government that the five year rotation period is too short and could be increased to seven years, in line with the rotation period adopted by the

EU Statutory Audit Directive and the IFAC *Code of Ethics for Professional Accountants*. It is argued that where audit partners are compelled to rotate off from an audit after five years, this requirement poses a risk that it may have a detrimental impact on audit quality because of the premature loss of expertise and knowledge about the audit and the audit client. In support of their representations, these stakeholders note that:

- the increase in the rotation period to seven years is unlikely to be a threat to auditor independence given that it would be in line with the rotation period adopted by the EU and IFAC;
- increasing the rotation period from five to seven years is likely to enhance audit quality because the audit team would retain the expertise of the lead auditor or review auditor for a further two years; and
- it will reduce the regulatory burden for the large and mid-tier audit firms in managing their audit partner rotation arrangements.

6.26 Some stakeholders have raised similar concerns but suggested that the same outcomes could be achieved by adopting the approach recently adopted in the UK which retains the five year core rotation period but gives the audit committee the power the rotation period by a further two years where it considers that this is necessary to safeguard audit quality.

Evidence

6.27 The policy rationale for an audit partner rotation regime has been well established and recognised in Australia and in most important overseas jurisdictions. There are, however, different views as to whether the existing core rotation period in Australia of five years should be retained or extended to seven years and whether the existing time-out period of two years should be extended to five years.

Policy objective

6.28 The broad objectives of this proposal would be to:

- enhance current auditor rotation requirements to further enhance audit quality;

- reduce the regulatory burden on audit firms in managing their audit partner rotation systems; and
- ensure that Australia's auditor rotation requirements remain in line with international best practice standards.

Implementation options

Option A: Status quo

6.29 Under this option, the existing five year rotation period and the existing two year time out period would be retained.

Option B: Audit committee's discretion to extend the five year auditor rotation period

6.30 Under this option, the audit committee (or board of directors where the listed entity has no audit committee) would be given the power to extend the core rotation period of five years to up to seven years provided the audit committee is satisfied that the extension of the rotation period is necessary to safeguard the quality of the audit and the audit firm agrees. In addition, the audit committee's decision would need to be:

- endorsed by the board of directors;
- notified to ASIC; and
- the decision would be required to be explained in the directors' report under s 300 of the Corporations Act.

6.31 The existing time out period of two years would also be retained under this option rather than extending the separation period to five years (see cost benefit considerations in relation to a two year or five year time out period discussed below in relation to Option A).

Option C: Extend existing rotation period of five years to seven years

6.32 Under this option, the mandatory core audit partner rotation period would be extended from five years to seven years.

6.33 The existing time out period of two years would also be retained under this option rather than extending the separation period to five years (see cost benefit considerations in relation to a two year or five year time out period discussed below in relation to Option A).

Assessment of impacts

Impact group identification

6.34 Affected groups:

- audit firms;
- companies (particularly directors, audit committees and shareholders); and
- government and regulators.

Analysis of costs/benefits

Option A: Status quo

6.35 The current audit partner rotation regime was introduced in the CLERP 9 Act reforms in 2004 in response to the perceived market and regulatory failures arising from the familiarity threat to auditor independence where there is a long association between an audit partner and an audit client.

6.36 Auditor independence is fundamental to the credibility and reliability of auditors' reports and in turn independent audits perform an important function in terms of capital market efficiency. The EC has described auditor independence as the 'bedrock of the audit environment' in its Green Paper *Audit Policy: Lessons from the Crisis* which was released in October 2010.

6.37 The Ramsay report and the HIH Royal Commission both recommended that a statutory audit partner rotation regime should be included in the Corporations Act. The benefits of mandatory rotation were perceived to outweigh the costs in terms of the loss of expertise and knowledge in relation to a particular audit partner who is rotated off the audit of a client.

6.38 The existing five year rotation period which was adopted in the CLERP 9 Act is in line with the core rotation period in Canada, China, Singapore, South Africa, the UK and the US (although the UK has recently introduced some flexibility for the period to be extended — see Option B below).

6.39 While not taking issue with the underlying policy rationale of an audit partner rotation regime, some stakeholders, notably the audit firms and the professional accounting bodies, have argued that audit quality

would be enhanced by an extension of the rotation period to seven years or by adopting the flexible approach recently introduced in the UK.

6.40 An important element in the design of an audit partner rotation regime is the time out or separation period which prohibits an audit partner who is 'rotated-off' an audit of a particular client from becoming involved again in the audit of the audit client for a specified mandatory period. The existing time-out period in the Corporations Act is two years. China, Singapore and South Africa have also adopted a two year time-out period. However, it is noted that Canada, the UK and the US have adopted a more onerous time-out period of five years.

6.41 The Ramsay report recommended that it would be appropriate for Australia to adopt a time-out period of two years.

6.42 As part of the consultation on its audit quality paper, the Treasury specifically raised with stakeholders the question whether it might be appropriate for the existing two-year time-out period to be extended to five years. Treasury concluded that, having regard to the relatively smaller market for the audit of listed companies (compared to the UK and the US) and the more limited depth of audit expertise in Australia, it would be appropriate to retain the two year time-out period. In this context, the following advice from stakeholders informed Treasury's conclusion on this issue:

- Treasury was informed that as a general rule in the major audit firms, once an audit partner was rotated off an audit, it would be most unlikely that the partner would return to the audit of the entity after the two year time-out period. Treasury was also advised that an exception to this rule was that in some industries where specialist knowledge was required, such as in banking and life insurance, partners tended to return to the audits because of the demand for their expertise and the fact that so few auditors had the required specialist knowledge. Treasury concluded that there was a legitimate concern that the adoption of a five year time-out period may have an adverse impact on audit quality in relation to these complex, large audits having regard to the limited number of audit partners with the necessary specialist industry expertise and knowledge.

- In its discussions with the mid-tier audit firms, Treasury was advised that it was usual in the mid-tier firms for partners rotated off an audit to return to the audit after the time-out period. This reflected the fact that these firms are much smaller than the Big Four and they did not have as many registered company auditors. In these circumstances, it was

considered that an extension of the existing time-out period from two to five years would have a significant adverse impact on mid-tier and other smaller firms without any corresponding positive effect on audit quality.

Option B: Audit committee's discretion to extend the five year auditor rotation period

6.43 It has been argued that Option B would be an appropriate compromise in light of the following considerations:

- Retention of the core rotation period of five years would keep Australia in line with the important jurisdictions such as Canada, China, South Africa, the UK and the US.

- It is appropriate that the audit committee should have the responsibility of making the decision to extend the rotation period by up to two years where it is necessary to safeguard audit quality because the role of the audit committee is to ensure the integrity of a company's financial reporting and the audit process, including the independence and objectivity of the external auditor.

- The extension of the rotation period by a further two years in appropriate circumstances should in fact enhance audit quality because it would result in the retention of an audit partner's expertise and corporate knowledge without compromising the auditor's independence.

- It would reduce the regulatory burden for audit firms in managing their audit partner rotations, given the geographic spread of listed entities in Australia and the limited pool of audit partners with relevant industry experience.

Option C: Extend existing rotation period of five years to seven years

6.44 The representations made in support of extending the existing statutory rotation period of five years to seven years have framed their arguments in terms of the following costs and benefits:

- The current mandatory five year period does not represent the optimal balance between managing the familiarity threat and maintaining audit quality, particularly in relation to audits of larger and more complex entities.

- The geographic spread of listed entities in Australia, as well as the pool of available registered company auditors,

provides particular challenges outside of Melbourne and Sydney under the current five year requirement. There is a concern that it is sometimes difficult to assign the most qualified audit partner to the engagement and that the current requirements actually lead to a decrease in audit quality.

- There is a general recognition that in the audit of large, complex and highly regulated entities, it would typically take two to three years for an audit partner to achieve optimal effectiveness and to rotate the partner off after five years involves a significant loss of expertise and knowledge. In this context, it is argued that the current five year rotation period may result in a decrease in audit quality.

- The IFAC *Code of Ethics for Professional Accountants* and the EU Directive on Statutory Audits provide for a maximum rotation period of seven years. New Zealand has also adopted a rotation period of seven years.

Consultation

6.45 Support in the public submissions for either the five or seven year period was evenly divided. However, a clear majority of stakeholders informed Treasury that the UK approach involving the audit committee would be an appropriate compromise and would enhance audit quality. For example, the Group of 100 (G100) said that while these requirements are less than the seven year rotation period in the EU's Directive, a similar outcome would be achieved if a company had the discretion to extend the appointment of an audit partner for an additional two years provided that the reasons for doing so are explained in the annual report and approved at the annual general meeting.

6.46 A number of stakeholders supported the retention of the existing five year rotation period (Option A). These include submissions from the Australian Institute of Company Directors (AICD), Deloitte Touche Tohmatsu (Deloitte), the G100, Hermes Equity Ownership Services UK and Pitcher Partners. However, some of these bodies qualified their support for the retention of the existing rotation period. The AICD said that there may be merit in considering the extension of the period to seven years for Australia's largest listed companies or where businesses have particularly complex business structures or financial arrangements. The G100 indicated that the UK approach, giving the company the discretion to extend the period by two years would also be acceptable, 'provided this action is explained in the annual report and approved at an annual general meeting'. Pitcher Partners raised concerns that, from a mid-tier firm's

perspective, whenever an audit partner rotation is required, the audit client will often go out to tender and this is giving the Big Four audit firms an opportunity to wrest audit work away from the mid-tier firms.

6.47 Another group of stakeholders (Deloitte, Ernst & Young (E&Y), G100, the three professional accounting bodies and KPMG) indicated that Option B would be an acceptable compromise to either Option A or Option C. In addition, the Australian Public Policy Committee (APPC) supported this option because it considered that it would bring an appropriate focus onto the audit committee which is the right mechanism to monitor and assess the appropriate balance between auditor independence and quality.

6.48 Option C was preferred by a number of stakeholders. BDO Kendalls supported a seven year rotation period on the grounds that the depth of the Australian audit profession is not that of the UK or US and that therefore, there are situations where the five year requirement impacts negatively on audit quality.

6.49 The three professional accounting bodies made a joint submission arguing that there was no indication from the outcomes of inspection processes that increasing the rotation period to seven years would cause the quality of audit to suffer.

6.50 Three of the Big Four audit firms were supportive of Option C. E&Y also based its support for a seven year period on the limited professional resources in Australia. E&Y also believed that an audit partner usually reaches their peak effectiveness at about the five year mark and that there was a need to maximise this potential benefit to audit quality by allowing an audit partner to continue as the lead engagement or review partner for a further two years. PricewaterhouseCoopers (PwC) was of the view that the current rotation period did not represent the optimal balance between management of the familiarity threat and maintaining audit quality, particularly on audits of larger and more complex entities. KPMG was also supportive of an increase to seven years.

Conclusion and recommended option

6.51 Treasury received a consistent message both from the written submissions and from discussions with stakeholders (particularly the audit firms and professional accounting bodies) that it often takes audit partners at least two or three years to settle into the audit of a listed company and that it is usually at about the five year mark that an audit partner achieves optimal effectiveness in terms of knowledge of the client's operations and

authority and influence in relation to the client's management. A significant number of the stakeholders argued that it was sensible in terms of the quality of the audit to allow audit partners to remain on an audit as either the lead engagement or review partner for a further two years.

6.52 There was a general consensus among stakeholders that after seven years, it was appropriate for an audit partner to rotate off an audit.

6.53 Treasury has been persuaded that the UK approach, involving the audit committee (Option B), would be the appropriate option to adopt. This option would address the problems raised by stakeholders in relation to the existing requirements and would also meet the Government's objective's outlined above. The following considerations have informed Treasury's view that Option B is the most appropriate option to adopt in relation to the mandatory audit partner rotation:

- Treasury acknowledges that there is a far more rigorous audit regulation regime in place, than was the case when the existing CLERP 9 Act rotation requirement was introduced in 2004. This includes ASIC's ongoing audit inspection program and the fact that there is no evidence in ASIC's audit inspection reports that a more flexible approach would have an adverse effect on audit quality;

- Treasury considers that the argument that a more flexible approach could in fact improve audit quality is persuasive. Many stakeholders argued that in the audit of large, complex or highly regulated entities it would typically take two or three years for an audit partner to achieve optimal effectiveness and to rotate the partner off after five years involves a significant loss of expertise and knowledge;

- retaining the basic core rotation period of five years, would keep Australia in line with the position in Canada, the UK and the US but it would also introduce flexibility, through the audit committee so that the rotation period could be increased to seven years; and

- it is appropriate that the role of the audit committee in relation to its participation in enhancing audit quality should be strengthened.

6.54 Treasury's consideration of the issue whether the existing time-out period of two years should be extended has also been informed by our discussions with the audit firms during the consultation period:

- The Big Four audit firms informed Treasury that, as a general rule in those firms, once an audit partner was rotated off an audit it would be most unlikely that the partner would return to the audit of the company after the time-out period. The exception to this rule was that in some industries where specialist knowledge was required, such as in banking and life insurance, partners tended to return to the audits because so few auditors had the required specialist knowledge.

- The mid tier audit firms informed Treasury that it was usual in their firms for partners rotated off an audit to return to the audit after the time-out period. This occurred because these firms were much smaller than the Big Four and did not have as many registered company auditors.

6.55 In light of this feedback from the large and mid-ties audit firms and the advice the Treasury has received from stakeholders in relation to the nature of the audit market in Australia (the geographic spread of listed entities in Australia and the pool and geographic spread of available registered company auditors), Treasury considers that the retention of the existing two-year time-out period can be justified on compelling audit quality grounds.

FRC Auditor Independence function

Background

6.56 In conjunction with the 2001 recommendations proposing new auditor independence requirements in Australia, the Ramsay report also recommended the establishment of an independent supervisory board to monitor implementation of the new regime, compliance with it, and important international developments in the area of auditor independence.

6.57 Subsequently, as part of the ninth phase of the Corporate Law Economic Reform Program (CLERP 9), the FRC was given specific functions concerning quality assurance reviews in relation to auditor independence. Under subsection 225(2B) of the ASIC Act, the FRC's functions include monitoring and assessing the nature and overall adequacy of:

- the systems and processes used by Australian auditors to ensure compliance with the auditor independence requirements; and

- the systems and processes used by professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors, to the extent those reviews relate to auditor independence requirements.

6.58 The FRC also has responsibility for giving the Minister and the professional accounting bodies reports and advice about these matters.

6.59 Following CLERP 9, ASIC also developed a wide ranging and ongoing audit inspection program which encompasses all aspects of audit quality, including auditor independence.

6.60 As a result, the FRC has performed this function by obtaining information from ASIC under the terms of a Memorandum of Understanding (MOU) with that body, by reviewing reports published by the ICAA and the former Audit Quality Review Board (AQRB) and by requesting information from the professional accounting bodies under the terms of its MOUs with those bodies.

Problem

6.61 Since 2001, corporate regulators and the accounting profession in Australia and elsewhere have come to regard auditor independence as one, albeit important, factor that contributes to the performance of a quality audit. As the FRC's statutory function is limited to monitoring auditor independence issues, the FRC is not able to consider the broader issue of audit quality.

6.62 Since 2004, ASIC has developed an audit inspection program that covers all aspects of audit quality and, as a consequence, the FRC has been able to perform its auditor independence function by relying primarily on information provided by ASIC. The information provided to the FRC by ASIC is also supplemented by material provided by other bodies, such as the professional accounting bodies and audit firms. In these circumstances, it might be argued that the FRC adds minimal value to the work already being undertaken by others.

6.63 Accordingly, action is needed to improve the efficiency of government administration by eliminating, or minimising, the duplication of work performed by the FRC and ASIC.

Evidence

6.64 The FRC's monitoring and policy advisory role in relation to auditor independence was appropriate immediately after the introduction of the comprehensive auditor independence regime under CLERP 9, particularly during the period of the 'bedding down' of the new legislative regime. However, ASIC's ongoing audit inspection program, which began in 2005 and encompasses all aspects of audit quality including auditor independence, has overtaken the need for the FRC's auditor independence function.

Policy objective

6.65 The broad objective of this proposal would be to rationalise the FRC's auditor independence function in order to eliminate duplication with ASIC's audit inspection program.

Implementation options

Option A: Status quo

6.66 This option would see the FRC retain its functions relating to auditor independence under subsection 225(2B) of the ASIC Act.

Option B: Remove function from FRC

6.67 This option would see the streamlining of the auditor independence work of ASIC and the FRC by removing the auditor independence function from the FRC.

Option C: Remove function but have FRC retain high level advisory policy role in relation to audit quality and auditor independence

6.68 This option would see the streamlining of the auditor independence work of ASIC and the FRC by removing the existing auditor independence function from the FRC and giving the FRC a high level policy advisory role in relation to audit quality and auditor independence.

Assessment of impacts

Impact group identification

6.69 Affected groups:

- audit firms;
- companies; and
- government and regulators (particularly ASIC and the FRC).

Analysis of costs/benefits

6.70 Treasury has estimated the annual administrative costs incurred by the FRC, including the FRC Secretariat, in carrying out the FRC's auditor independence function to be approximately $280,000. These costs would not be incurred if the FRC's auditor independence function was abolished.

6.71 The FRC's auditor independence function involves the Chairman of the FRC and the Secretary to the FRC meeting with key stakeholders (ASIC, APRA, audit firms, professional accounting bodies, and the ASX) to discuss auditor independence issues. The costs incurred by stakeholders in relation to their respective meetings with the FRC would also not be incurred if the FRC's auditor independence function was removed.

Consultation

6.72 In key finding 11 of the audit quality paper, Treasury proposed exploring with ASIC and the FRC whether there is scope to streamline the work of the two bodies in relation to auditor independence in order to eliminate any duplicated effort.

6.73 The Treasury paper identified two options that should be explored:

- A number of submissions (Deloitte, KPMG, Pitcher Partners and PwC) expressed a sentiment that, as ASIC's audit inspection program is fully in place (and covers auditor independence), there is no need for similar oversight by the FRC.

- Another submission, Hermes Equity Ownership Services, observed that aligning the monitoring of auditor independence with the overall work assessing audit quality will ensure that it is placed in its appropriate context.

6.74 As noted above, there was broad support by stakeholders for the Treasury proposal to streamline the work of ASIC and the FRC by removing the auditor independence function from the FRC (Option B).

6.75 At roundtable discussions that Treasury held with stakeholders in November 2010, stakeholders strongly supported the removal of the FRC's auditor independence function and replacing it with a high level strategic policy advisory role on audit quality and auditor independence (Option C). Stakeholders considered that this option would remove the duplication between the 'operational' nature of the FRC's existing function and ASIC's audit inspection program. In supporting this option, stakeholders considered that the proposed strategic policy advisory function that would be given to the FRC under Option C would draw on the depth and diversity of expertise of the members of the FRC.

Conclusion and recommended option

6.76 In light of the strong stakeholder support for Option C, Treasury recommends that the existing FRC function in relation to auditor independence be abolished and replaced with a high level strategic policy advisory role in relation to audit quality and auditor independence.

Audit deficiency reports and asic communication with audit committees

Background

6.77 ASIC is the key regulator under the Corporations Act and has responsibility for the surveillance, investigation and enforcement of the financial reporting requirements of the Corporations Act, including the enforcement of auditor independence and audit quality requirements. The scope of ASIC's audit inspection powers was enhanced by the *Australian Securities and Investments Commission Amendment (Audit Inspection) Act 2007*. The amendments introduced by this Act ensured that ASIC's audit inspection and information gathering powers were brought into line with corresponding powers granted to key overseas audit regulators.

6.78 The objective of ASIC's audit inspection program is to promote high quality external audits of financial reports of listed and other public interest entities in Australia so that users can have greater confidence in financial reports. ASIC publishes its generic public inspection reports periodically to better inform all firms, the investing public, companies, audit committees and other interested stakeholders of ASIC's findings and areas of focus.

6.79 ASIC commenced its ongoing audit inspection program in 2005. In that year it inspected the Big 4 firms. In subsequent years, ASIC continued to inspect the Big 4 firms but also began inspecting mid-tier firms and smaller firms. In 2007, ASIC inspected 19 firms, of which nine were inspected for the first time, six were inspected for the second time (being the six mid-tier firms inspected in 2006) and four were inspected for the third time (that is, the Big 4). As part of the 2007 audit inspection program, ASIC reviewed 101 audit engagements. ASIC also began conducting joint inspections with the US PCAOB. Since signing their cooperative arrangement, ASIC and the PCAOB have conducted five joint inspections of Australian audit firms.

6.80 ASIC released its public report on its audit inspection program for 2008-09 on 11 March 2010. This report sets out key themes and issues identified by ASIC's audit inspection program for 2008-09.

- ASIC reviewed audit engagement files across 19 firms, focusing on the substance of the auditor's work and whether sufficient and appropriate audit evidence was documented to support the conclusions reached in relation to key audit judgements.

- While ASIC concluded that Australia's audit regime compares well internationally, ASIC's inspections identified a number of cases requiring improvements in audit quality in most areas related to the global financial crisis, such as the appropriate use of experts in testing asset valuations.

- ASIC indicated that future inspections would focus on compliance with auditing standards, paying particular attention to those auditing standards impacted more by the effects of the global financial crisis and those that were not appropriately applied in previous years. ASIC also indicated that it will focus on audit quality for new or existing audits where audit fees appear low or appear to have been reduced for reasons other that changes in the underlying business of the entity being audited.

6.81 ASIC focuses on audit quality by promoting compliance with the requirements of the Corporations Act, Australian Auditing Standards and professional and ethical standards. ASIC's inspection program is designed to:

- confirm ASIC's understanding of the design of each audit firm's system of quality control. It covers the following elements of quality control as set out in ASA 220 *Quality Control for Audits of Historical Financial Information* and ASQC 1 *Quality Control for Firms that perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements*:
  - leadership responsibilities for quality within the firm (executive leadership/tone at the top);
  - ethical requirements (independence);
  - acceptance and continuance of client relationships and specific engagements;
  - human resources;
  - engagement performance (audit quality); and
  - monitoring.
- test the effectiveness of the implementation of each firm's system of quality control that provides reasonable assurance that:
  - the firm complies with the audit independence requirements in Division 3 of Part 2M.4 of the Corporations Act (independence); and
  - the firm's audit methodology facilitates the conduct of its audits in accordance with the auditing standards as required in Division 3 of Part 2M.3 of the Corporations Act (audit quality).

6.82 After each inspection, ASIC issues the firm with a confidential inspection report and the firm responds as to how it will deal with the issues which ASIC has identified. ASIC then revisits the firm, generally after around 12 months, to gauge the extent to which the firm has taken remedial action. In accordance with a MOU between ASIC and the FRC, ASIC provides the FRC, for the purposes of the FRC's auditor independence function, with a generic report on its audit inspection

program for the previous period, particularly noting any systemic issues identified. ASIC's usual practice is to also issue at about 18 month intervals on the ASIC website, a public report which sets out key themes and issues identified by ASIC's audit inspection program during the preceding inspection period.

6.83 By working with the profession, ASIC has assisted in raising the standard of audit quality and auditor independence. ASIC has noted the following as some of the improvements as a result of its inspection activities:

- creation of quality control policies and procedures;
- employment of dedicated technical resources;
- employment of external experts to conduct monitoring activities;
- changes of auditor in relation to a small number of listed audit clients; and
- registration by partners on specified training courses.

6.84 Although there is no legal obligation to report publicly, ASIC issues public reports on systemic themes and issues identified during the audit firm inspections. These public reports are prepared on an aggregated basis across firms and are intended to inform stakeholders of key themes and issues with the objective of contributing to better audit quality by all firms.

Problem

6.85 The problem with ASIC's existing audit reporting model is that s 127 of the ASIC Act:

- prevents ASIC from issuing public individual audit firm reports without the consent of the audit firm concerned; and
- prevents ASIC from informing the audit committee (or the company) of significant matters that ASIC becomes aware of during the exercise of its statutory duties in relation to the audit.

Evidence

6.86 ASIC has informed Treasury that in a number of important overseas jurisdictions, the independent audit regulator is permitted to make public disclosure about defects in an individual audit firm's quality control systems, subject to appropriate natural justice protections.

- In the US, the PCAOB is required by the Sarbanes Oxley Act to produce public inspection reports, although portions of the complete report are omitted to comply with confidentiality requirements in the Act. The Sarbanes Oxley Act provides a framework for a remedial process whereby firms have 12 months to remedy defects in their quality control systems to prevent these defects being made public.

- In the UK, the Audit Inspection Unit (AIU), part of the Professional Oversight Board (POB) of the UK Financial Reporting Council (UKFRC), issues a confidential report to the audit firm inspected. In addition to the confidential report, the AIU publishes both an annual overview report on its audit inspection activities and a high level public report on the inspection of an individual audit firm, detailing findings from reviews of individual audits (without client names) concerning failures to comply with auditing standards or good practice. Criticism (if relevant) of the audit firm's quality control policies and procedures is also made public. Specific reports are also issued to engagement partners of deficiencies in the file reviewed with an expectation that this is shared with the relevant client audit committee or board of directors.

- In Canada, the Canadian Public Accountability Board (CPAB), produces private reports of findings and recommendations to the individual firms inspected. Failure to implement one or more recommendations to CPAB's satisfaction within a prescribed timeframe (generally six months) may result in CPAB making public the relevant portions of the inspection report.

6.87 The underlying policy rationale for the individual firm public reporting models in Canada, the UK and the US, is to improve confidence in the capital markets through increased transparency in the audit process. Furthermore, where the reporting model provides the opportunity for an audit firm to correct weaknesses identified in the private confidential report, coupled with the possibility of public disclosure for any failure to take remedial action, it provides a strong incentive for an audit firm to make prompt improvements in overall audit quality.

6.88 ASIC has also proposed that it should be able to communicate directly with the audit committee (and the company) in relation to significant matters which it identifies during the course of the exercise of ASIC's statutory functions in relation to an audit. ASIC has explained that it was placed in a difficult position where it became aware of significant matters arising from the audit of a company during the inspection or surveillance of an audit firm and yet it was unable to disclose this to the audit committee (these matters could relate to the accounting practices of the company or the conduct of the audit). At present, ASIC is of the view that it is prevented from making such disclosures to the audit committee because of the confidentiality requirements in s 127 of the ASIC Act. If given the ability to communicate matters to companies, ASIC said that it envisaged that it would only exercise this ability in exceptional circumstances.

6.89 ASIC's inability at present to provide such information to an audit committee (or the company), which would assist the directors in fulfilling their responsibilities in relation to the preparation of the company's financial statements and the audit of those financial statements would appear to constitute a regulatory failure. If this issue is not addressed, then there is the risk that ASIC's inability to communicate quickly to the audit committee about defects in either the conduct of the audit or matters relating to the company's accounting or disclosure practices prevents the audit committee (and the board of directors) from fulfilling their obligations.

Policy objective

6.90 The broad objectives of the proposal would be to:

- enhance ASIC's ability to issue public reports about audit deficiencies which it identifies during the course of its statutory functions in order to increase transparency in the audit process and to provide an incentive for an audit firm to make improvements in its audit quality systems; and

- remove the current restriction under s 127 of the ASIC Act which prevents ASIC from informing the audit committee (or the company) of significant matters that ASIC becomes aware of during the exercise of its statutory duties in relation to the audit.

Implementation options

Option A: Status quo

6.91 Retain the status quo.

Option B: Status quo but give ASIC the ability to communicate with the audit committee

6.92 This model would not give ASIC a power to issue a public report on an individual audit firm inspection but it would remove the current restriction under s 127 of the ASIC Act which prevents ASIC communicating with the audit committee (or the company) in relation to significant matters that ASIC becomes aware of during the exercise of its statutory functions in relation to an audit.

Option C: A restrictive public reporting model based on Canadian approach

6.93 This model draws on the approach adopted in Canada by the CPAB. This is the most restrictive public reporting model because it contemplates ASIC only releasing a public report after the audit firm has failed to take steps to address an audit deficiency identified by ASIC in the course of exercising its statutory functions within a prescribed time period after advising the audit firm of the deficiency.

6.94 The model would also remove the current restriction under s 127 of the ASIC Act which prevents ASIC communicating with the audit committee (or the company) in relation to significant matters that ASIC becomes aware of during its regulatory activities in relation to an audit.

Option D: A more expansive public reporting model based on the UK approach

6.95 This option would permit the release by ASIC of a high level report on an individual audit firm inspection. The option is based on the approach adopted in the UK by the POB, one of the operating bodies within the UKFRC, which has overall responsibility for audit regulation in the UK. The POB is also responsible, through the Audit Inspection Unit (AIU), for monitoring directly the quality of the auditing of economically significant entities. ASIC would only be permitted to exercise this power where the release of the high level report on an individual audit firm inspection is part of an audit inspection program undertaken by ASIC.

6.96 The distinction between Options C and D is that under Option C, ASIC's ability to issue a public report is more in the nature of a residual power to be used when an audit firm that has been inspected fails to address an audit deficiency identified by ASIC, while under the Option D model, ASIC would issue a high level public report on each audit firm that ASIC had inspected.

6.97 The model would also remove the current restriction under s 127 of the ASIC Act which prevents ASIC communicating with the audit committee (or the company) in relation to significant matters that ASIC becomes aware of during the exercise of its regulatory activities in relation to an audit.

Option E: a combination of options C and D

6.98 It would be possible to combine Options C and D. This would allow ASIC to implement the Canadian reporting model immediately and to introduce a high level public reporting regime at a later time without the need to amend the ASIC Act.

6.99 The model would also remove the current restriction under s 127 of the ASIC Act which prevents ASIC communicating with the audit committee (or the company) in relation to significant matters that ASIC becomes aware of during the exercise of its regulatory activities in relation to an audit.

Assessment of impacts

Impact group identification

6.100 Affected groups:

- audit firms;
- users of publicly available audited financial reports;
- companies, and particularly audit committees; and
- government and regulators.

Analysis of costs/benefits

Option A: Status quo

6.101 Audit firms would not incur any additional administrative costs.

6.102 There would be no transparency benefits arising from the publication of information by ASIC in relation to an individual audit firm.

6.103 The ability of ASIC to communicate with the audit committee would remain restricted where the information was obtained by ASIC during the exercise of its statutory duties in relation to an audit.

Option B: Status quo but give ASIC the ability to communicate with the audit committee

6.104 Audit firms would not incur any additional administrative costs.

6.105 There would be no transparency benefits arising from the publication of information by ASIC in relation to an individual audit firm.

6.106 The model would enhance communication between ASIC and audit committees. Any costs incurred by an audit committee receiving information from ASIC would only arise where the audit committee considered that it should take appropriate action to ensure that the directors or the company carried out their duties and responsibilities in relation to the preparation of the company's accounts and the integrity of the external audit.

Option C: a restrictive public reporting model based on Canadian approach

6.107 The benefits of this model are:

- it would provide a strong incentive for the audit firm to address an audit deficiency identified by ASIC; and
- costs would only be incurred by the audit firm that had failed to take remedial action to address the audit deficiency identified by ASIC.

6.108 The model would also enhance communication between ASIC and audit committees. Any costs incurred by an audit committee receiving information from ASIC would only arise where the audit committee considered that it should take appropriate action to ensure that the directors or the company carried out their duties and responsibilities in

relation to the preparation of the company's accounts and the integrity of the external audit.

Option D: a more expansive public reporting model based on the UK approach

6.109 The main benefit that has been identified with this model is the increase in transparency resulting from the publication by ASIC of a high level public inspection report on each individual audit firm that had been inspected by ASIC.

6.110 The model would, however, impose considerable resource burdens on ASIC and the individual audit firms. There are also concerns that the large number of reports that ASIC would be required to prepare and settle with each audit firm could result in significant delays in the publication of the reports which would significantly reduce any benefits relating to improved audit quality or transparency because of the staleness of the information.

Option E: a combination of options C and D

6.111 This option would aggregate the costs and benefits described above in relation to options C and D.

Consultation

6.112 In key finding 7 of its audit quality paper, Treasury said that ASIC's audit inspection program is in line with the methodologies and best practice standards adopted by audit oversight bodies in the major developed economies. ASIC's role as an independent oversight regulator with clear statutory powers is an important feature of the Australian system. Treasury noted that the reliance that the US PCAOB has been prepared to place on the Australian audit regulation system for purposes of its joint audit inspection process with ASIC is testament to the high regard it has placed on ASIC's performance as an independent statutory audit regulator.

6.113 In light of the international developments in relation to the publication by audit oversight bodies of reports on audit inspections of individual audit firms, Treasury said in key finding 8 that it proposed, in conjunction with ASIC, to seek the views of key stakeholders on whether ASIC's audit inspection reporting model should be brought into line with the reporting models adopted in Canada, the UK and the US in relation to public reports on individual audit firm inspections.

6.114 Treasury stated that it wished to explore with stakeholders the following issues:

- the costs and benefits of introducing a reporting model which would enable ASIC to issue public individual audit firm reports, without a firm's consent, but subject to appropriate natural justice protections which would include remedial opportunities with ASIC prior to release of public information by ASIC;

- the costs and benefits of a process which would require audit firms to communicate significant matters identified by ASIC in its confidential audit inspection report to a firm to the audit client's audit committee and/or board of directors; and

- the scope of any amendments required to the ASIC Act, including s 127, to achieve an appropriate public individual firm reporting model.

6.115 The responses in the public submissions to key finding 8 from audit firms and the professional accounting bodies, with one exception (Pitcher Partners), have given in principle support to the concept of some form of public reporting of individual audit firm inspections, subject to further consultation with Treasury. This group of stakeholders qualified their in principle support to the extent that they raised concerns on issues such as the timeliness of reports, resolution of disputes between ASIC and an audit firm prior to the issuing of a public report, the impact of criticism of a firm and the risks of undermining a firm's reputation.

6.116 The AICD expressed reservations whether publicly releasing individual audit firm reports generally, or where there have been failures by the audit firm to take remedial action, would assist audit quality.

6.117 Treasury prepared a written options paper for discussion at the stakeholder roundtable meetings in Sydney and Melbourne on 2 and 3 November 2010. Treasury's paper identified four options for consideration:

- Option 1: retain the status quo.

  – Only the AICD indicated support for this option because it maintained its reservations whether any form of public reporting would improve audit quality.

- Option 2: a restrictive public reporting model based on Canadian approach.

– A number of the public submissions supported the adoption of the Canadian model. The following reasons for supporting this model were provided:

:it should be a significant driver of audit quality because it would provide a strong incentive for an audit firm to take remedial action to address an audit deficiency identified by ASIC in order to avoid the publication of an adverse public report by ASIC;

:this reporting model would be able to operate in a timely manner;

:it should not impose any significant additional financial/resource burdens on either ASIC or the audit firms; and

:the model could incorporate adequate time for remediation processes by an audit firm.

– There was general support for the option B model based on the Canadian approach at both the Sydney and Melbourne roundtable discussions. ASIC also supported an approach modelled on option B.

- Option 3: a more expansive public reporting model based on the UK approach.

  – A number of the public submissions raised quite strong reservations about the more comprehensive reporting models adopted in the UK. These concerns related to the additional cost burdens that would be imposed on both ASIC and the audit firms, the delays in reporting that had been experienced in the UK. Furthermore, the submissions questioned whether the additional cost incurred would result in a commensurate increase in the quality of information being conveyed to the market. The stakeholders noted that the US has also adopted a more expansive public reporting model under the Sarbanes-Oxley Act and similar criticisms have been made about the US model in relation to cost and delays experienced in public reports being released which does not assist in improving audit quality.

  – One of the major audit firms at the Melbourne roundtable meeting noted that while it was attracted to the UK model, it conceded that it would require significant resource and

time commitment on the part of both ASIC and the audit firms and without such a commitment, there could be significant delays in reporting with adverse implications in relation to the quality of the information released to the market.

- Option 4: a combination of options 2 and 3.

  – Stakeholders generally did not support this option because of:

  :the reservations noted above about the UK model in relation to additional cost/resource implications for both ASIC and the audit firms and concerns about the timeliness of reports; and

  :the likelihood that once a permissive power is given to ASIC in the ASIC Act to issue high level public reports, it raises an expectation that high level public reports on each individual audit firm inspection conducted by ASIC should be released.

Conclusion and recommended option

6.118 Option C, the more restrictive public reporting model based on the Canadian approach, is the preferred option because of the benefits identified above relating to the incentive it would provide to improve audit quality within a firm, the fact that it would not result in delays in the publication of reports by ASIC and the expectation that it should not impose any significant costs or resource burdens on either ASIC or the audit firms.

6.119 Option C would also provide ASIC with the ability to communicate significant matters to the audit committee which ASIC had identified during the course of the exercise of its statutory functions in relation to an audit. Giving ASIC the ability to communicate directly with the audit committee would address a regulatory failure that currently exists because of the restrictions imposed on ASIC under s 127 of the ASIC Act.

6.120 Option C is also supported by the majority of key stakeholders who were consulted. Some stakeholders were concerned that the proposed amendment to s 127 of the ASIC Act to enable ASIC to communicate with audit committees should be carefully drafted to ensure that there were no unintended consequences.

Annual Audit Firm Transparency Reports

Background

6.121 During the last decade, there has been a move in a number of overseas jurisdictions to require larger audit firms to produce a public annual report.

6.122 In Europe, Article 40 of the EU's Statutory Audit Directive requires statutory auditors and audit firms to publish on their websites, within three months of the end of each financial year, annual transparency reports that include at least the following:

- a description of the legal structure, ownership and governance structure of the audit firm;
- where the audit firm belongs to a network, a description of the network and the legal and structural arrangements in the network;
- a description of the internal quality control system of the audit firm and a statement by the administrative or management body on the effectiveness of its functioning;
- an indication of when the last quality assurance review of the audit firm took place;
- a list of 'public interest entities' for which the audit firm has carried out statutory audits during the preceding financial year;
- a statement concerning the audit firm's independence practices which also confirms that an internal review of independence compliance has been conducted;
- a statement on the policy followed by the audit firm concerning the continuing education of statutory auditors;
- financial information showing the importance of the audit firm, such as the total turnover divided into fees from statutory audits and fees charged for other assurance services and other non-audit services; and
- information concerning the basis for partner remuneration.

6.123 In the UK, the transparency report requirements in the EU's Statutory Audit Directive were implemented by the Statutory Auditors (Transparency) Instrument 2008.

6.124 A US Treasury Committee report issued in October 2008 made the following recommendation in relation to increased transparency by audit firms:

> Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating (a) information required by the EU's Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VIII of this Report. Further, encourage the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements.

6.125 In framing its recommendation, the US Treasury Committee:

- noted that auditing firms and investors have expressed support for requiring US auditing firms to publish reports similar to the EU's Article 40 Transparency Report;
- believed that information about audit quality indicators could improve audit quality by enhancing the transparency of auditing firms and noted that some foreign affiliates of US auditing firms provide such indicators in public reports in other jurisdictions; and
- noted that auditing firms in the UK now publish annual reports containing audited financial statements pursuant to limited liability partnership disclosure requirements as well as a discussion of those statements, a statement on corporate governance, performance metrics, and other useful information.

6.126 Subsequently, in September 2009, IOSCO released a consultation paper, Transparency of Firms that Audit Public Companies, as part of a study to determine whether enhancing the transparency of audit firms' governance, audit quality indicators, and audited financial statements may serve to maintain and improve audit quality and the availability and delivery of audit services.

6.127 In Australia, there is no statutory requirement under the Corporations Act for auditors to publish information on their websites similar to that required under the EU transparency report. However, KPMG, one of the Big 4 audit firms, voluntarily prepared and published, a transparency report in relation to its Australian practice in November 2010.

Problem

6.128 When a company or other entity is considering the appointment of an auditor, it is the usual practice to seek information from selected audit firms about: the quantum of fees for the audit services to be provided; and the activities of the firm that gives the entity that requires the audit services confidence that the audit firm has the strength and ability to provide services of a high quality.

6.129 As Australia's larger audit firms (including each of the Big 4 firms) are structured as partnerships in which the liability of members is unlimited, minimal information about the ownership, governance, business structure and activities of firms is publicly available (for example, ASIC, the corporate regulator, has no publicly available information about Australia's audit firms).

6.130 While many audit firms now have established internet websites, the information published on those sites is often of a promotional nature — effectively, advertising the services the firm offers — and, as a consequence, provides little guidance to an entity that is considering whether to reappoint its auditor or appoint a new auditor.

6.131 The introduction of a requirement for audit firms to prepare a transparency report would resolve the current lack of information by ensuring that factual information about firms is available to existing and potential clients. To ensure this objective is achieved, a transparency report would need to provide existing and potential clients with information on the audit firm's audit quality control systems, key financial and human resource data, the legal structure of the firm and its governance arrangements. The availability of such information would also lead to a better understanding by the firm's clients and the public of the firm's audit process and its management, in turn assisting in providing confidence within the market about the quality of the audits undertaken by the firm.

Evidence

6.132 In key finding 14 of the audit quality paper, Treasury proposed holding discussions with stakeholders to ascertain whether they saw value in the Corporations Act being amended to require audit firms that undertake an audit for the purposes of the Corporations Act, to publish on their websites an annual transparency report in line with the requirement under the EU's Statutory Audit Directive and the Quality Control Reports (QCRs) published by the Big 4 audit firms in accordance with the AQRB arrangements. The publication of such reports may also assist in bridging

the audit expectations gap. This proposal would bring the Australian audit regulation framework into line with corresponding developments in the EU, the UK and the US.

Policy objective

6.133 The broad objectives of this proposal would be to improve audit quality by enhancing the transparency of audit firms and bringing Australia into line with developments in leading overseas jurisdictions in relation to the publication of transparency reports by audit firms.

Implementation options

Option A: Status quo

6.134 This option would see the status quo retained whereby audit firms are able to produce a public annual transparency report on a voluntary basis only.

Option B: Use the EU's Article 40 as a platform for developing a report for Australian audit firms

6.135 This option would see the requirements of the EU's Article 40 (content of a transparency report) be used as the platform for developing a report for Australian audit firms.

Assessment of impacts

Impact group identification

6.136 Affected groups:

- audit firms;
- users of publicly available audited financial reports;
- companies; and
- government and regulators.

Analysis of costs/benefits

6.137 The costs and benefits associated with a requirement to publish a transparency report have been difficult to quantify. However, Treasury was advised by stakeholders that compliance costs would be low because the information required would already be available to each of the firms. The costs will vary depending on the size of the firm, the structure under which the firm operates in Australia (for example, national partnership or a network of associated firms) and the ability of the firm to draw on the resources of international associates when preparing the report.

6.138 The preparation of a transparency report can be expected to benefit an audit firm and its clients by contributing to the enhancement of audit quality within the firm. This is because the firm would have to focus more closely on how it manages its audit quality and would be required to articulate in the report its approach to audit quality, including providing information about the firm's audit quality control systems.

6.139 An audit firm will incur administrative costs in connection with the preparation of its transparency report, although these costs are unlikely to be significant once a firm has prepared and published its initial report. Costs associated with the proposal will also be contained when the firm is able to adapt a template developed by an international associate for the Australian report. Costs directly associated with the proposal may also be off-set by savings through not having to prepare information for individual clients or prospective clients.

Consultation

6.140 Eleven submissions commented on key finding 14. Of these, eight submissions were supportive of transparency reporting, two raised concerns about aspects of the finding and one informed Treasury that IOSCO recently consulted on transparency reporting by audit firms and recommended that regard should be given to any IOSCO findings.

6.141 Of the submissions supportive of transparency reporting, three supported using or exploring EU Article 40 as the framework on which Australian disclosures are based (E&Y, KPMG and APPC); three suggested using the QCR published in accordance with the former AQRB arrangements as the basis for the Australian disclosures (Deloitte, PwC and Joint Accounting Bodies); while the other two expressed no views on the preferred platform to be used for an Australian disclosure regime (BDO and Hermes).

6.142 Concerns raised in two of the other submissions were:

- requiring audit firms that undertake an audit for the purposes of the Corporations Act to prepare a transparency report would go further than the EU Directive, which applies only to those firms that audit listed entities, credit institutions and insurance undertakings (AICD); and

- requiring the preparation of a transparency report could be problematic to mid-tier firms where the structure and organisation of the firm is not centred on audit (Pitcher Partners).

6.143 At the time this document was written, IOSCO had not released its final report concerning transparency reporting by audit firms.

6.144 Treasury held roundtable discussions with key stakeholders in November 2010 to consider the comments concerning the preparation of transparency reports by Australian audit firms.

6.145 Having regard to the public comments that were received on this issue, Treasury proposed to stakeholders that:

- the requirements of the EU's Article 40 (content of a transparency report) be used as the basis for developing a report for Australian audit firms;

- an Australian requirement should apply only to auditors of listed and other public interest entities (broadly along the lines of the European model); and

- an auditor should be required to perform a minimum number of audits before the obligation to prepare a transparency report is triggered.

6.146 There was broad support among stakeholders for the Treasury proposals.

6.147 Specific observations made by stakeholders during discussion of this issue included:

- the need to start the transparency reporting requirements at a modest level, then refine as necessary;

- there will be a need to ensure consistency in the reports, with the objective of having the reports provide information that will enhance audit quality rather than act as a public relations vehicle for the firm preparing the report;

- agreement with the notion that the policy setting for preparing a transparency report should be one based on the number of public interest audits undertaken; and

- a need for validation of the information included in a transparency report.

Conclusion and recommended option

6.148 Option B is the preferred option.

6.149 Treasury recommends that:

- the requirements of the EU's Article 40 (content of a transparency report) be used as the platform for developing a report for Australian audit firms;

- the Australian requirement should apply only to auditors of listed and other public interest entities (such as ADIs and insurance companies subject to prudential supervision by the Australian Prudential Regulation Authority); and

- the obligation to prepare a transparency report should be triggered where an Australian audit firm audits not less than ten listed or other public interest entities.

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