Part I: Understanding Auditor Responsibilities

Chapter 2
Corporate Governance and Audits

Learning Objectives:

By studying this chapter, students should be able to:

1. Define corporate governance and identify the parties involved in corporate governance.

2. Describe corporate governance responsibilities and failures of corporate governance leading to enactment of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9 Act).

3. Identify key components of the CLERP 9 Act of 2004 relevant to corporate management and the auditing profession.

4. Describe management's role in preparing and communicating financial and internal control information.

5. Articulate the responsibilities of audit committees.

6. Describe required communications between the audit firm and the audit committee.

7. Analyse the relationship between corporate governance and audit risk.

8. Identify the various types of framework pronouncements that affect the auditing profession and the standards issued within each of the framework categories.

9. Describe the similarities and differences between auditing and assurance standards of the AUSAB and the IAASB.

10. List the fundamental principles of Australian Auditing Standards (ASAs) developed by the AUASB and International Standards on Auditing (ISAs) developed by the IAASB.

11. Articulate a standards-based approach to the audit opinion formulation process.

Teaching Suggestions

The public accounting profession has been widely criticised during the past decade for failing to protect investor interests. While much of the audit profession performed admirably during this time period, the failures were spectacular: HIH Insurance and One-Tel in Australia and in the US Enron and WorldCom. The Australian Government reacted to these failures by enacting extensive legislation affecting the audit profession. The new legislation – the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9 Act) – fundamentally changed the auditor–client relationship and moved the process of setting audit standards from a private–public co-regulatory arrangement to the public sector. But the failures that occurred during the past decade were not solely attributable to failures in the audit profession. They also represented fundamental failures at the very heart of an organisation – failures of the corporate governance structure. The failures in ethical standards and corporate governance continue with significant issues about the governance of the Australian Securities Exchange (ASX), the managed investment scheme industry, disclosure of margin lending and other issues.

The landscape for the auditing profession has changed: new reporting responsibilities, changes in expectations, and a new statutory body responsible for setting audit standards and legal backing for audits conducted pursuant to the *Corporations Act 2001*. This chapter describes the motivation for those changes; describes the differences in responsibilities between auditing listed and unlisted companies, describes generally accepted auditing standards, and presents a brief overview of the audit process as a foundation for understanding recent developments in professional ethics and risk analysis covered in Chapters 3 and 5.

Begin by summarising the events that led up to the CLERP 9 Act 2004. The HIH Insurance and One.Tel examples and more recently ABC Learning, Babcock and Brown, and Centro Properties Group cases certainly provides a rich example of the kind of failure in corporate governance and financial reporting that led to action, but any of the widely publicised corporate accounting scandals could be used. Explain that the failures of the past decade were primarily failures across all parts of the corporate governance structure. They were not just audit failures, or just management failures. Thus, to understand the changes affecting the audit profession, we have to understand how the audit profession fits into the overall corporate governance structure. A broad schematic of the overall governance process can assist in this. As we look at the governance process through the 1990s and early 2000s, there were failures in virtually every part of the governance process. Boards of Directors hired managers, but provided large amounts of share options that ceded enormous power to managers, thus providing incentives to continuously report improved earnings. Managers, in turn, assumed greater responsibilities for involvement in the hiring of external auditors, despite it technically being a shareholder vote, and used their power relationship to too often encourage auditors to find accounting treatments those managers viewed as 'value enhancing' (read increase or better manage earnings).

The storm hit when HIH failed and Enron failed in the US in 2001 both being declared the largest bankruptcies in the respective histories at the time and both audited by Andersen, which subsequently itself failed. In both of these companies, the operational failures were covered up with clever accounting manipulations that were not detected by the public accounting firms. The press, governments, and the general public continued to ask why such failures could have occurred when the public accounting profession was given the sole license to protect the public from financial fraud and misleading financial statements.

Identify and analyse the key components of the CLERP 9 Act 2004 and explain the public implications of that Act. Explain management's role as the key communicator of financial and control information to stakeholders. Discuss the components of CLERP 9 that were intended to highlight management's role in the financial reporting process. Identify the key responsibilities the audit committee has as an important auditor independence mechanism.

Students should know the internationalisation of the framework under which Australian Auditing Standards from the AUASB (and the IAASB) are created. Explain the changes in auditing standards setting resulting from the CLERP 9 Act to incorporate Auditing Standards into the *Corporations Act 2001* in the same way that Accounting Standards are written into that Act.

Describe the overall audit process as a foundation for fulfilling audit responsibilities to the public.

Suggested Homework Problems

Learning Objectives	Review Questions	Multiple-Choice Questions	Discussion and Research Questions	Cases
LO 1 Pp 44-46	2-1, 2-6	2-1	2-37, 2-38, 2-39, 2-52, 2-57, 2-58	2-59
LO 2 Pp 47-49	2-2, 2-3, 2-4, 2-5, 2-6	2-2, 2-3, 2-4	2-40, 2-41	
LO 3 Pp 50-51	2-7, 2-8, 2-9, 2-10, 2-11, 2-12		2-42, 2-47, 2-54, 2-56, 2-57	
LO 4 Pp 51-52	2-13	2-5	2-43, 2-56	
LO 5 Pp 52-53	2-14, 2-15, 2-16, 2-17, 2-18		2-44, 2-45, 2-46, 2-49, 2-52, 2-58,	2-59
LO 6 Pp 54-54	2-19, 2-20	2-6	2-44, 2-45	2-59
LO 7 Pp 54-55	2-21, 2-22, 2-23		2-48, 2-52	
LO 8 Pp 55-56	2-30, 2-31			2-59
LO 9 Pp 56-58	2-26, 2-27, 2-28, 2-29	2-9	2-49	
LO10 Pp 58-61	2-24, 2-25, 2-31, 2-32	2-7,	2-49, 2-50, 2-52, 2-53, 2-64	
LO11 Pp 61-65	2-33, 2-34, 2-35 2-36	2-8, 2-10	2-51, 2-53, 2-55	2-59

Chapter Outline

I. CORPORATE GOVERNANCE AND AUDITING

1. Corporate governance is a process by which the owners and creditors of an organisation exert control and require accountability for the resources entrusted to the organisation. The owners (shareholders) elect a board of directors to provide oversight of the organisation's activities and accountability to stakeholders.

2. Primary parties involved in corporate governance are:
    a. Shareholders
    b. Board of directors
    c. Audit committee as a subcommittee of the Board
    d. Management (financial and operational)
    e. Internal auditors
    f. Self-regulatory organisations (i.e. CPAA, ICAA, IPA)
    g. Other self-regulatory organisations (i.e. ASX)
    h. Regulatory agencies (i.e. ASIC, FRC)
    i. External auditors.

3. Owners want accountability of things such as:
    a. Financial performance
    b. Financial transparency
    c. Stewardship
    d. Composition of the board of directors and their activities.

II. CORPORATE GOVERNANCE RESPONSIBILITIES AND FAILURES:

1. The financial failures of the past decade were not exclusively the fault of the public accounting profession. Rather, the failures represented fundamental breakdowns in the structure of corporate governance. Nor were the failures limited to Australia and the US. Similar failures occurred in major companies located in Italy, France, India, Japan, the UK, and other parts of the world. Greed simply overwhelmed many parts of the system and self-regulatory mechanisms (professional accounting organisations) failed in holding their members to the highest level of corporate accountability. In response, regulations such as the CLERP 9 Act 2004 were enacted, in part to address

fundamental problems in corporate governance. Investment analysts focused on 'earnings expectations' and contributed to the governance problem by relying on management guidance rather than performing their own fundamental analysis.

2. In a famous speech that made international headlines SEC Chairman Levitt cited numerous problems with the profession:
    a. 'Cookie jar reserves' used by firms to manage earnings
    b. Improper revenue recognition
    c. Creative accounting for mergers and acquisitions that did not reflect economic reality
    d. Increased reliance on share-based compensation that put increased pressure on meeting earnings targets.

3. An environment was needed in which auditors would make independent judgements on the economic substance of transactions and require accounting that was consistent with such judgement.

4. There was also concern that the profession was 'cutting corners' to make audits more cost effective and thus allow audit partners to be compensated at levels comparable to their consulting or non-audit service partners. Specifically, there were concerns that:
    a. Analytical procedures were being used inappropriately to replace direct tests of account balances
    b. Audit firms were not thoroughly evaluating internal control and applying substantive procedures to address weaknesses in control
    c. Audit documentation, especially related to the planning of the audit, was not up to professional standards
    d. Auditors were ignoring warning signals of fraud and other problems, and
    e. Auditors were not providing sufficient warning to investors about companies that might not continue as 'going concerns'.

III. THE CLERP 9 Act 2004

Some of the more significant provisions of the Act include:

1) A general statement of principle requiring the independence of auditors (S324CA)

2) Require the auditor to make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Act and the rules of the professional accounting bodies (S307C)
3) Strengthen restrictions on employment relationships between an auditor and audit client. This includes a mandatory period of two years following resignation from an audit firm before a former partner directly involved in the audit of a client can become a director of the client or take a position with the client involving responsibility for fundamental management decisions (S324CI)
4) Impose new restrictions on financial relationships. This covers investments in audit clients and loans between an audit client, and the auditor or their immediate family (S324CH)
5) Require mandatory disclosure in the annual report of fees paid for not just non-audit services (NAS) but, for the first time, the categories of NAS provided (S300(11Ba))
6) Require a statement in the annual report of whether the board of directors is satisfied that the provision of NAS is compatible with auditor independence (S300(11Ba)). This disclosure includes an explanation as to why the following non-audit services, if contracted, do not compromise audit independence:
   (a) Preparing accounting records and financial statements of the audit client
   (b) Valuation services
   (c) Internal audit services
   (d) IT systems services
   (e) Temporary staff assignments
   (f) Litigation support services
   (g) Legal services
   (h) Recruitment of senior management for the audit client
   (i) Corporate finance and similar activities.
7) Make audit lead engagement and review partner rotation compulsory after five years (S324AD); with provision for ASIC (S342A) to grant relief where necessitated by circumstances
8) Require accountants seeking registration as company auditors to meet agreed competency standards, to undertake to abide by an accepted code of

professional ethics and to complete a specialist auditing course prior to registration (S1280A)

9) Requirement that the CEO and CFO certify the financial statements and the disclosures in those statements
10) Partners in charge of audit engagements, as well as all other partners or managers with a significant role in the audit, must be rotated off the engagement every five years
11) Requiring the establishment of an effective 'whistle blowing program' that reports to the appropriate level of the organisation and the audit committee
12) There must be a 'cooling off' period before a partner or manager can take a high-level position in an audit client without jeopardising the independence of the public accounting firm
13) Limiting the non-audit services that audit firms can provide to their audit clients
14) Audit committees be given enhanced responsibilities
15) Auditing Standards to be legally enforced.

The Financial Reporting Council (FRC)

1. The FRC to take oversight responsibility for the setting of Auditing Standards
2. A new statutory Auditing standard setting body established (AUASB)
3. The FRC to establish the strategic direction for the AUASB
4. The FRC delegated responsibility for inspections of audit firms and audit quality to ASIC.

IV. CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTING

A. Management has always had the primary responsibility for the accuracy and completeness of an organisation's financial statements and notes. It is management's responsibility to:
   1. Choose which accounting principles best portray the economic substance of company transactions
   2. Implement a system of internal control that assures completeness and accuracy in financial reporting, and
   3. Ensure that the financial statements contain full and complete disclosure.

B. The CLERP 9 Act also requires management (both the CEO and the CFO) to certify the accuracy of the financial statements and provides for criminal penalties for materially misstated financial statements.

Teaching Note: Mention that management has in turn attempted to push this responsibility further down the organisation by requiring divisional managers and controllers to certify to the correctness of their financial information that is used in developing consolidated statements.

V. ENHANCED ROLE OF AUDIT COMMITTEES

A. Audit committees, where they exist, take on added importance under the CLERP 9 Act. Under the ASX Corporate Governance Guidelines, the audit committee must be composed of 'outside directors'. The audit committee has important oversight roles.

B. The audit committee should:

1. Be apprised of all significant accounting choices made by management
2. Be apprised of all significant changes in accounting systems and controls built into those systems
3. Be involved in the nomination of the external auditor and review the audit plan and audit results with the auditors
4. Have the authority to hire and fire the head of the internal audit function, and set the budget for the internal audit activity and should review the audit plan and discuss all significant audit results
5. Receive all the regulatory audit reports and periodically meet with the regulatory auditors to discuss their findings and their concerns.

C. The audit committee is not intended to replace the important processes performed by the auditors. But, the audit committee must make informed choices about the quality of work it receives from the auditors.

VI. REQUIRED AUDIT FIRM COMMUNICATION TO THE AUDIT COMMITTEE

Auditors are expected to exercise informed judgement beyond simply determining whether the statements reflect Accounting Standards. Auditors should be alert to whether the company may have stretched the limits of Accounting Standards and GAAP in portraying current financial results. The auditor must have a discussion with the audit committee about not only the acceptance of an accounting principle chosen, but whether or not the auditor believes the accounting treatment best portrays the economic substance of the transaction. Auditors must be prepared to bring controversial accounting principles to the audit committee for discussion. The new requirements are a supplement to, not a replacement of, existing communication requirements (ASA 260 and ASA 265).

VII. IMPORTANCE OF GOOD GOVERNANCE TO THE AUDIT

A. Companies with good corporate governance

1. Are less likely to engage in financial engineering
2. Have a code of conduct that is reinforced by actions of top management
3. Have independent board members who take their jobs seriously and have sufficient time and resources to perform their work
4. Take the requirements of good internal control over financial reporting seriously
5. Make a commitment to financial competencies needed.

VIII. AUDIT STANDARD SETTING: A NEW AND OLD MIXTURE

A. Auditing standards that apply to the auditor's task of developing and communicating an opinion on the financial report.

B. Assurance standards that apply to the auditor's task of developing and communicating an opinion on financial information outside of the normal financial statements.

C. An attestation standard is a term used to describe assurance services that involve gathering evidence regarding specific assertions and communicating an opinion on the truth and fairness or fairness of the presentation to a third party.

D. Review standards apply where the board or a user has requested a lower level of assurance than that provided by an audit. In performing these services, the auditor does not gather enough evidence to support a statement as to whether the financial statements are fairly presented, but rather provides negative assurance. Compilation standards provide no assurance.

IX. SIMILARITIES AND DIFFERENCES BETWEEN VARIOUS AUDITING AND ASSURANCE STANDARDS

All of the standards start from fundamental principles on how an audit engagement should be planned and conducted and then how the results should be communicated. An overview of the fundamental principles involved with audit standards is shown in Exhibit 2.5 and for quality control standards is shown in Exhibit 2.6.

X. GENERALLY ACCEPTED AUDITING STANDARDS AND IAASB PRINCIPLES

A. The IAASB developed fundamental principles for auditing standards that serve as a foundation for all subsequent standards. Because the standards are conceptual in nature, an understanding of them provides a foundation on which all the other standards can be interpreted.

B. Quality Control Standards.

1. These guide the profession in selecting and training its professionals to meet the public trust. These standards are represented by the broad concepts underlying technical training and proficiency, independence from the client, and the exercise of due professional care. They form the conceptual foundation for the conduct of audits, and all other standards follow from the basic premises in these standards.

2. Independence is often referred to as the cornerstone of auditing – without independence, the value of the auditor's attestation function would be decreased. Auditors must not only be independent in their mental attitude in conducting the audit (independence in fact) but also must be perceived by users as independent of the client (independent in appearance).

Teaching Note: Stress that an auditor can add value to the client through advice, but in doing so must remain objective or risk becoming irrelevant to shareholders.

3. Due Professional Care.
   The public expects that an audit will be conducted with the skill and care of a professional. Following Auditing Standards is one benchmark for due professional care. However, following Auditing

Standards is not always sufficient. If a 'reasonably prudent person' would have done more, such as investigating for a potential fraud, it is often asserted that the professional should have done at least as much. Public accounting firms use supervision and review of audit work to ensure that audits are conducted with due professional care.

C. Audit Conduct Standards

1. Planning and Supervision.
   The auditor must understand the client's business risks, its processing risk (including computer dependency), and must be able to analyse current financial results and anticipate areas where misstatements are likely in the financial statements and notes. The most visible product of the planning process is the audit program, which lists the audit objectives and the procedures to be followed in gathering evidence to test the accuracy of account balances.
2. Understanding the Entity and its Internal Controls.
   The auditor needs to assess the entity and its environment to help assess the risk of material misstatement (including fraud). Analysis of an organisation's risks and internal controls can yield insight into the types of misstatements (errors or fraud) that might occur without being detected, or alternatively, it might yield insight into the strength of the controls to minimise financial misstatements. An analysis of the accounting system is necessary to determine (a) risks that are not addressed by controls; (b) the potential impact of those risks on the company's financial position, (c), the type(s) of misstatements that could occur and (d) the likelihood that financial misstatements could take place. The auditor's analysis of how a misstatement could occur is important in developing audit procedures to determine its existence.
3. Obtaining Audit Evidence.
   Sufficient (enough) competent (reliable and relevant) evidence must be obtained to evaluate the assertions embodied in the financial statements, including the related notes. More persuasive and extensive testing is required for accounts that are likely to contain material misstatements.

D. Reporting Standards
   1. Presentation in Accordance with Accounting Standards.
      i. The auditor is required to state explicitly whether the financial statements are true and fair for audits under the *Corporations Act 2001* (fairly presented) in accordance with Accounting Standards.
      ii. Consistent
      iii. Disclosures are adequate
      iv. If nothing is mentioned in the auditor's report, the reader can assume that the disclosures in the financial report meet the requirements of authoritative pronouncements.
      v. Opinion.
      vi. If there are reasons why an opinion cannot be issued, inform the reader of all of the substantive reasons why an opinion cannot be issued.

XI. FUNDAMENTAL PRINCIPLES OF IAASB AUDITING STANDARDS

A. The IAASB has taken a broad approach to standard setting that recognises the demand for both assurance and audit services. The IAASB pronouncements require the auditor to determine whether the framework a client uses for financial reporting is appropriate. An overview of the principles for the conduct of an audit is shown in Exhibit 2.5. The standards differ from the 10 GAAS in the following ways:
   1. There is a reference to ethical standards, not just auditor independence
   2. Professional scepticism is important and could be interpreted as either more or less than auditor independence
   3. Reasonable assurance recognises inherent difficulties in conducting an audit, such as the auditor cannot test every transaction, or management may have covered up frauds that are virtually impossible to detect
   4. Audit risk should be minimised to an acceptable level
   5. Materiality is a major concept that affects the design of the audit
   6. The auditor must determine the acceptability of the accounting framework used by the audit client.

B. Standards for Other Audit Engagements
   1. Reasonable assurance engagements
      'Engagements in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.'
   2. Limited assurance engagements
      This is one in which the objective is to provide more limited assurance by doing less work that may be appropriately understood by all three parties. Limited assurance engagements normally result in 'negative assurance' and check to see if anything comes to attention indicating a problem.

C. The IAASB identifies the following elements of an assurance engagement:
   1. A three-party relationship involving a practitioner, a responsible party, and intended users
   2. An appropriate subject matter
   3. Suitable criteria
   4. Sufficient appropriate evidence
   5. A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

XII. ATTESTATION STANDARDS

A. Auditing is a specific and important part of a broader set of services referred to as attestation services. All attestation services, including the financial report audit, involve gathering evidence regarding specific assertions and communicating the attester's (auditor's) opinion on the fairness of the presentation to a third party. Financial report audits are unique in that they are broadly disseminated and have very specific standards developed solely for that service.

B. Future of Audit Standard Setting.
   1. The International Auditing Standards Committee is taking on added importance as the economy becomes increasingly global and companies wish to register on multiple stock exchanges. Finally, the Internal Auditing Standards Board has attained recognition as the

premier standard-setter for the professional practice of internal auditing on a worldwide basis.

XIII. OVERVIEW OF AUDIT PROCESS: A STANDARDS-BASED APPROACH

A. Phase II: Understanding the Client

1. Planning meeting
   Audit planning starts with a meeting with the audit committee, where one exists, and the management of the company being audited. The meeting ensures that the key governance parties, particularly the audit committee, are aware of the audit approach and the responsibilities of each party. While the overall audit approach is shared with management, the details of the plan, including the determination of materiality, is not shared with management although it may be shared with the audit committee.
2. Developing an Understanding of Materiality.
   The audit must be planned to provide reasonable assurance that material misstatements will be detected. The concept of materiality is pervasive and guides the nature and extent of auditing. Materiality guidelines usually involve applying percentages to some base, such as total assets, total revenue, or pretax income. There has been criticism of the accounting profession in the past few years for not sufficiently examining qualitative factors in making materiality decisions. In particular, the profession has been criticised for:
   i. Netting (offsetting) material misstatements and not making adjustments because the net effect may not be material to net income
   ii. Not applying the materiality concept to 'swings' in accounting estimates
   iii. Consistently 'passing' on or waiving individual adjustments that may not be considered material.

Teaching Note: Explain that some transactions, by their very nature, are likely to be more important to some users, so it is important that the auditor and audit committee take into account all the significant stakeholders that may be making decisions based on the financial reports. Although many audit firms have provided guidelines to audit staff for materiality decisions, it is important to note that any guideline is just a starting point that is adjusted for other relevant information.

3. Developing a Preliminary Audit Program
    i. Detailed planning leads to the development of a detailed audit program designed to discover material misstatements, if they exist, in the financial report.
    ii. Planning is the foundation for the audit program and includes the following:
        - Develop an understanding of the client's business and the industry within which it operates.
        - Develop an understanding of risks the company faces and determining how those risks might affect the presentation of a company's financial results.
        - Develop an understanding of management remuneration plans and how those plans may motivate management actions.
        - Develop a preliminary understanding of the quality of the client's internal controls over financial reporting.
        - Build a detailed audit program on audit risk, internal control quality, accounting assertions, and materiality.
        - Develop an understanding of the client's accounting policies and procedures.
        - Anticipate financial report items likely to require adjustment.
        - Identify factors that may require extension or modification of audit tests, such as potential related-party transactions or the possibility of material misstatements.
        - Determine the type of reports to be issued, such as consolidated statements or single-company statements, special reports, or reports to be filed with the regulatory agencies such as APRA.

B. Phases III and IV: Obtaining Evidence
    1. Testing Assertions
    The third and fourth phases of the audit and review opinion formulation process involve obtaining evidence about controls, determining their impact on the financial report audit, and obtaining substantive evidence about specific account assertions. The auditor is required to gather 'sufficient, appropriate audit evidence' in order

to reach a conclusion on the truth and fairness (fairness) of the organisation's financial presentations.

2. Example: Testing Additions to Property, Plant, Equipment
   i. Take the assertion: The equipment shown on the financial statements is properly valued at cost (not to exceed its recoverable value) with applicable allowances for depreciation. This assertion can be broken down into four components:
      - The valuation of assets that were acquired in previous years
      - The valuation of new assets added this year
      - The proper recording of depreciation
      - Potential impairment of the existing assets due to changed economic conditions or management plans regarding the manufacture of some of its products.
   ii. Auditing Additions to PPE
      Generally, the previous year's valuations would have been audited, so the focus is on the current year's additions. The following audit procedure would address the assertion:
      - Take a statistical sample of all additions to property plant and equipment and verify the cost through reference to vendor invoices to determine that cost is accurately recorded and that title has passed to the company.
   iii. Additional Audit Procedure for Company Considered to be 'High Risk
      For the items selected, verify that the asset has been put in production by physically verifying its existence and operation.'

Teaching Note: Describe the major elements in the above audit procedures, which include statistically selecting a sample of items to test, reviewing documentary evidence of cost and title, and physically verifying existence of the asset.

C. Phase V: Wrapping up the Audit and Making Reporting Decisions
   1. Summarise Audit Evidence and Reach Audit Conclusion.
      The remaining task is to summarise the audit evidence related to the assertions tested and reach a conclusion about the truth and fairness (fairness) of the client's financial presentation. If the evidence does not support a fair presentation, the auditor will gather additional

evidence through detailed testing to reach a conclusion about the total misstatement in an account. The additional information gathered will lead the auditor to one of three states:

i. The auditor reaches a conclusion and the client agrees to adjust the financial statements and/or notes to eliminate the misstatement.
ii. The auditor reaches a conclusion, but the client disagrees. The auditor would issue an audit report describing the differences in opinion.
iii. The auditor cannot reach a conclusion and the amounts are so material, the auditor cannot render an opinion. The auditor would issue a statement that the limitation on the work performed will preclude an opinion on the truth and fairness (fairness) of the financial report.

Solutions for Chapter 2

Corporate Governance and Audits

Multiple Choice Questions Online

2-1 (LO 1) All of the following are parts of corporate governance except:

a. Oversight of management by the board of directors.
b. Established processes to provide accountability to stockholders.
c. Whistle-blowing processes.
d. Independent review of financial reports by ASIC.

2-2 (LO 2) Which of the following would *not* be correct regarding corporate governance failures that took place in the past two decades?

a. Boards of directors approved stock option plans that did not align management and shareholder objectives.
b. Audit committees met infrequently, often for only an hour at a time.
c. Boards of directors were often dominated by management.
d. Accounting rules became more specific to address the complexities that existed in new transactions.

2-3 (LO 3) Which of the following is not an ASX Corporate Governance Guideline recommendation for audit committees of the largest 300 listed companies?

a. The audit committee must not be chaired by the chair of the board of directors.
b. Audit committee members must be financially literate.
c. Audit committee members must be independent directors.
d. The audit committee should view itself as the 'client' of the external auditor.

2-4 (LO 2) In which way can it be argued that the public accounting profession contributed to problems that resulted in the Australian Parliament passing the CLERP 9 Act?

a. Failed to detect egregious frauds.
b. Emphasised generating revenues over audit quality.

c. Viewed helping clients find an accounting solution to show increased earnings as value-added auditing.

d. All of the above.

2-5 (LO 4) Which of the following is an *inappropriate* description of management's role in preparing financial reports? Management has the primary responsibility for:

a. Determining the scope of internal and external audit activities.

b. Preparing financial reports that are fairly presented in accordance with accounting standards.

c. Selecting accounting principles that best portray the economic reality of the organisation's transactions and current state.

d. Developing, implementing, and monitoring the internal control processes over financial reporting.

2-6 (LO 6) Which of the following would *not* be required to be communicated to the audit committee by the external auditor?

a. Significant audit adjustments made during the course of the audit.

b. Significant disagreements with management regarding accounting principles.

c. The auditor's knowledge of management's consultation with other public accounting firms regarding the proposed treatment of a controversial accounting item.

d. The extent to which the internal auditors assisted in the conduct of the audit.

2-7 (LO 10) The application of due professional care and skill means that the auditor's work conforms with all of the following except:

a. Current auditing standards

b. The work that a reasonably prudent auditor would have performed in the same situation

c. The work that would have been performed by a reasonable person who was not necessarily trained in auditing

d. The work was at least equal to that which had been performed on the audit engagement during the preceding year.

2-8 (LO 10) The auditing standards require the auditor to do all of the following except:

a. Understand the business and the risks affecting the preparation of the financial report.
b. Gather sufficient, appropriate audit evidence to provide the basis for an opinion on the financial report.
c. Perform analytical procedures that compare the entity with others in the industry to identify potential misstatements in the financial report.
d. Obtain an understanding of internal control over financial reporting and assess the potential for misstatements.

2-9 (LO 9) The following describes a situation in which an auditor has to determine the most appropriate standards to follow. The audited company is headquartered in Australia but has substantial operations within the US (60% of all operations) and has securities registered with the SEC and traded on the New York Stock Exchange. The company uses IFRS for its accounting framework. What would be the most appropriate set of audit standards to follow?

a. AUASB and PCAOB or AICPA
b. AASB
c. IASB
d. IAASB.

2-10 (LO 11) The auditor uses the following audit procedure as part of the audit of long-lived assets that included material additions during the year: 'take a *statistical sample* of all additions to property plant and equipment and trace to invoices received from the vendor.' Which of the following outcomes would most likely alert the auditor to the possibility of a misstatement of the account balance?

a. Most of the items chosen are small in dollar amount even though the invoices are typical of items that last three to five years.
b. About one-third of the items chosen are large-dollar items that are traced to journal entries, but there are no underlying purchase documents.
c. About one-fourth of the items are from the same vendor and relate to the equipment purchased for a new factory.

d. Vendor invoices cannot be located for a number of purchases. However, all the items for which the invoices cannot be found relate to purchases from a related company.
e. All of the above.
f. (b) and (d) only.

Multiple Choice Answers:

2-1. d. (LO 1, pp 44-46)
2-2. d. this is part of the profession's problem, but not a cause of the failure. (LO 2, pp 47-49)
2-3. d. (LO 3, pp 50-51)
2-4. d. (LO 2, pp 47-49)
2-5. a. (LO 4, pp 51-52)
2-6. d. (LO 6, pp 54)
2-7. d. (LO 10, pp 58-61)
2-8. b. (LO 10, pp 58-61)
2-9. a. (LO 9, pp 56-58)
2-10. f. (LO 11, pp 61-65).

Review Questions:

2-1. (LO 1, pp 44-46) Corporate governance is defined as:

> 'a process by which the owners and creditors of an organisation exert control and require accountability for the resources entrusted to the organisation. The owners (shareholders) elect a board of directors to provide oversight of the organisation's activities and accountability back to its stakeholders.'

The key players in corporate governance are the shareholders (owners), board of directors, audit committees, management, regulatory bodies, and both internal and external auditors.

2-2. (LO 2, pp 47-49) In the past decade, all parties failed to a certain extent. For detailed analysis, see Exhibit 2.2 in the chapter and repeated here:

Corporate Governance Responsibilities and Failures

Party	***Overview of Responsibilities***	***Overview of Corporate Governance Failures***
Shareholders	**Broad Role:** Provide effective	Focused on short-term prices,

	oversight through election of board members, auditor appointment, approval of major initiatives such as being taken over, annual reports on management compensation from the board	failed to perform long-term growth analysis, abdicated most responsibilities to management and analysts as long as share price increased
Board of Directors	**Broad Role:** The major representative of shareholders to ensure that the organisation is run according to the organisation's constitution and that there is proper accountability	Inadequate oversight of management Approval of management compensation plans, particularly share options that provided perverse incentives, including incentives to manage earnings
	Specific activities include: Selecting management Reviewing management performance and determining compensation Declaring dividends Approving major changes, e.g. mergers Approving corporate strategy Overseeing accountability activities	Directors often dominated by management Did not spend sufficient time or have sufficient expertise to perform duties Continually repriced share options when market price declined
Management	**Broad Role:** Operations and accountability. Manage the organisation effectively; provide	Earnings management to meet analyst expectations

	accurate and timely accountability to shareholders and other stakeholders	Fraudulent financial reporting
		Utilising accounting concepts to achieve reporting objectives
	Specific activities include:	Created an environment of greed, rather than one of high ethical conduct
	Formulating strategy and risk management	
	Implementing effective internal controls	Too often acted as client of the auditor
	Developing financial and other reports to meet public, stakeholder, and regulatory requirements managing and reviewing operations	Audit opinion shopping
	Implementing an effective ethical environment	
Audit Committee of the Board of Directors	**Broad Role:** Provide oversight of internal and external audit function and the process of preparing the annual financial report	Similar to board members – did not have expertise or time to provide effective oversight of audit functions
	Specific activities include:	Were not viewed sufficiently by auditors as a potential support
	Nominating external audit firm	
	Signing off to board that non-audit work performed by the audit firm does not compromise independence	
	Selecting and/or approving the appointment of the head of	

	internal audit position Reviewing and approving the scope and budget of the internal audit function Discussing audit findings with internal auditor and external auditor and advising the board (and management) on specific actions that should be taken	
Self-Regulatory Organisations: CPAA, ICAA, IPA	**Broad Role:** Discipline members Lobbying on behalf of members Thought leadership Specific roles include: Implementing quality control processes to ensure audit quality Educating members on audit and accounting requirements	Peer reviews that were not always transparent Inadequate enforcement of existing auditing standards Members could resign and then disciplinary action could not be enacted Auditing standard setting in profession's rather than public's interest Profession more oriented to pushing the rules rather than enforcing concepts
Other Self-Regulatory Organisations: ASX	**Broad Role:** Ensure the efficiency of the financial markets including oversight of trading and oversight of companies that are allowed to trade on the exchange **Specific activities** include: Establishing listing requirements	Conflicts of interest because ASX Ltd is a private company listed on its own exchange

	– including governance requirements	
Regulatory Agencies: ASIC	**Broad Role:** Ensure the accuracy, timeliness and fairness of public reporting of financial and other information for companies	Identified problems but was not granted sufficient resources to deal with the issues
	Specific activities include:	
	Reviewing filings with the ASX	
	Facilitating Standard Business Reporting (SBR) filed financial reports	
	Conducting quality review inspections of audit firms	
	Identifying corporate frauds, investigate causes and suggest remedial actions	
	Monitoring trading activities	
External Auditors	**Broad Role:** Perform audits of company financial reports to ensure that the statements are free of material misstatements including misstatements that may be due to fraud	Helped companies utilise accounting concepts to achieve earnings objectives Became economically dependent on some clients Promoted personnel based on ability to sell 'non-audit products'
	Specific activities include:	Replaced direct tests of

	Audits of financial reports	accounting balances with inquiries, risk analysis, and analytics
	Other services such as tax or consulting	Failed to uncover basic frauds because fundamental audit procedures were not performed
Internal Auditors	**Broad Role:** Perform audits of companies for compliance with company policies and laws, audits to evaluate the efficiency of operations, and periodic evaluation and tests of controls	Focused efforts on 'operational audits' and assumed that financial auditing was addressed by the external audit function
	Specific activities include:	Reported primarily to Management with little reporting to the audit committee
	Reporting results and analyses to management (including operational management) and audit committees	In some instances did not have access to the corporate financial accounting records
	Evaluating internal controls	

2-3. (LO 2, pp 47-49) The board of directors is often at the top of the list when it comes to responsibility for corporate governance failures. Some of the problems with the board of directors included:

- Inadequate oversight of management
- Approval of management remuneration plans, particularly share options that provided perverse incentives, including incentives to manage earnings
- Non-independent, often dominated by management
- Did not spend sufficient time or have sufficient expertise to perform duties.

2-4. (LO 2, pp 47-49) (LO 2, pp 47-49) Some of the alleged ways the auditing profession was responsible were:

- Too concerned about creating 'revenue enhancement' opportunities for their public accounting firm, and less concerned about their core services or talents
- Willing to 'push' accounting standards to the limit to help clients achieve earnings goals
- Began to use more audit 'shortcuts' such as inquiry and analytical procedures instead of direct testing of account balances
- Relied on management representations instead of testing management representations
- Were too often 'advocates' for management rather than protectors of users.

2-5. (LO 2, pp 47-49) Cookie jar reserves are essentially liabilities or contra-assets that companies have overestimated in previous years to use when times are tougher to smooth earnings. The rationale is that the funds are then used to 'smooth' earnings in the years when earnings need a boost. 'Smooth' earnings typically are looked upon more favourably by the share market.

An example of a cookie jar reserve would be over-estimating an allowance account, such as allowance for doubtful accounts. The allowance account is then written down (and into the income statement) in a bad year. The result is to increase earnings in the subsequent year.

2-6. (LO 2, pp 47-49) Users should expect auditors to have the expertise, independence, and professional scepticism to render an unbiased and justified opinion on the financial report. Auditors are expected to gather sufficient applicable evidence to render an independent opinion on the financial report.

2-7. (LO 3, pp 50-51) The CLERP 9 Act was designed to enhance the independence of the audit profession and create more credible and transparent financial reporting. The overall intent was to encourage better corporate governance (in the end the ASX took responsibility for this); to enhance the role of the audit committee; encourage the independence and oversight of the audit standard setting board, and improve the independence of the external audit profession. There were certainly many factors that led to the CLERP 9, but the failures at HIH and One.Tel in Australia and Enron and WorldCom in the US with the demise of Andersen, will probably be pointed to in the future as the major factors that led to the Act being passed when it was. The Government intended to modify the financial reporting process to provide just cause for the public to again trust financial reports and the audit processes leading up to the audit opinion.

2-8. (LO 3, pp 50-51) Under the CLERP 9 Act, the AUASB is a statutory body charged with setting auditing standard in the public interest, using, at the strategic direction of the Financial Reporting Council, the International Standards on Auditing (ISAs) developed by the International Auditing and Assurance Standards Board (IAASB) and any other standards as appropriate.

The Financial Reporting Council also delegated to the Australian Securities and Investments Commission (ASIC) responsibility for inspections of audit firms as an audit quality control mechanism. ASIC administers the *Corporations Act 2001* and registers company auditors under that Act – this is not a CLERP 9 initiative but a long-standing arrangement.

2-9. (LO 3, pp 50-51) Management has always been responsible for the truth and fairness, completeness, and accuracy of financial statements and notes, but the CLERP 9 Act goes a step further by requiring the CEO and CFO to certify the accuracy of the financial report with criminal penalties as a punishment for materially misstated statements. The CEO and CFO must assume responsibility for the truth and fairness (fairness) of the financial presentations. It thereby encourages organisations to improve their financial reporting functions.

2-10. (LO 3, pp 50-51) Whistle blowing enables violations of a company's ethical code or serious breaches of societal norms to be reported to appropriate levels in an organisation, including the audit committee. Because of its presence, potential violators know that there is a real possibility and simple avenue by which inappropriate actions may be revealed. As such, it contains a preventive component that is indirectly helpful to the audit committee in fulfilling its corporate governance role.

2-11. (LO 3, pp 50-51) There are a number of provisions that are designed to increase auditor independence. First, for listed clients certain non-audit services need to be explained in the annual report by the board of directors as not compromising auditor independence. Second, the Auditing Standards, including ASA 102 received legal backing under the *Corporations Act 2001*. Third, audit partners are required to rotate every five years. Finally, the auditors are expected to follow fundamental principles of independence that have been enacted under the *Corporations Act 2001* (more details in Chapter 3).

2-12 (LO 3, pp 50-51)

	The CLERP 9 Act 2004 and ASX Corporate Governance Principles and Recommendations	***Sarbanes-Oxley Act 2002***
Similar (CLERP 9)	Establishing the Auditing and Assurance Standards Board (AUASB) as a statutory body under the strategic direction of the Financial Reporting Council (FRC)	Establishing the Public Company Accounting Oversight Board (PCAOB) with broad powers, including the power to set auditing standards for audits of public companies
Same	Requiring that the CEO and CFO	Requiring that the CEO and

(CLERP 9)	*certify* the financial report and the disclosures in those statements	CFO *certify* the financial statements and the disclosures in those statements
Different	No similar requirement No public reporting on internal controls is required by either management or the auditor	Requiring management of public companies to provide a comprehensive report on internal controls over financial reporting
Different	No similar requirement	Requiring management to certify the correctness of the financial statements, its disclosures and processes to achieve adequate disclosure, and the quality of its internal controls. Auditor provides assurance on this management report
Different (CLERP 9)	Shareholders (members) remain the audit client. Auditors must be nominated and accept nomination and be appointed by members at GMs. Audit firms cannot be terminated or resign other than with the permission of ASIC. The board of directors must include in the annual financial report a statement to the effect that non-audit services (NAS) provided by the audit firm do not compromise auditor independence	Empowering audit committees to be the formal 'audit client', with responsibilities to hire and fire its external auditors and pre-approve any non-audit services provided by its external auditors; audit committees must also publicly report their charter and issue an annual report on their activities
Somewhat similar (ASX)		Requiring that audit committees have at least one person who is a financial expert and to disclose the name and characteristics of that individual; other members must be knowledgeable in financial accounting as well as internal control
Similar (CLERP 9)	Requiring individual auditor, audit firm, audit company or director of an audit company who plays a significant role in the audit to rotate off the engagement after five	Requiring partners in charge of audit engagements, as well as all other partners or managers with a significant role in the audit, to be rotated off public company

	successive financial years. ASIC has the power to grant relief from these requirements	engagements every five years
Different	No similar requirement, but accounting standards have disclosure requirements	Increasing the disclosure of all 'off-balance-sheet' transactions or agreements that may have a material current or future effect on the financial condition of the company
Somewhat similar (CLERP 9)	Whistleblower protection under *Corporations Act 2001* for private sector	Requiring the establishment of an effective 'whistle-blowing program' whereby important violations of the company's ethical code (including those related to accounting transparency) are reported to the appropriate levels of the organisation and the audit committee
Similar (CLERP 9)	For other than small proprietary companies, persons who were professional members of the audit team and who are retiring from the audit firm cannot be an officer of the previous audit client within a period of two years. A lead or review partner who ceases employment with the audit firm similarly cannot be an officer of the previous audit client within a period of two years	Requiring a 'cooling-off' period before a partner or manager can take a high-level position with an audit client; without the cooling-off period, it is presumed that the independence of the public accounting firm is jeopardised
Some restrictions, but less restrictive than SOX (CLERP 9)	Explanation required by directors as to how auditor provision of the following non-audit services does not compromise independence: preparing accounting records and financial statements of the audit client, valuation services, internal audit services, IT systems services, temporary staff assignments, litigation support services, legal services, recruitment of senior management for the audit client, corporate finance and similar	Limiting the non-audit services that audit firms can provide to their audit clients to only tax services

	activities. These types of services are not permitted for auditors under ethical standards either. There is also a maximum hours test of 10 hours for provision of non-audit services by the auditor	
Different	No similar requirement	Mandating analyses of audit firm competition and the potential need for audit firm rotation
CLERP 9	Disclosure of NAS fees by category	No such requirement
CLERP 9	Force of law for auditing standards	No such requirement
CLERP 9	Audit reports signed in both firm and individual auditor's name	Audit reports signed in audit firm name only

2-13. (LO 4, pp 51-52) Management is responsible for issued financial statements. Although other parties may be sued for what is contained in the statements, management is ultimately responsible. Ownership is important because it establishes responsibility and accountability. Management must set up and monitor financial reporting systems that help it meet its reporting obligations. It cannot delegate this responsibility to the auditors.

2-14. (LO 5, pp 52-53) An audit committee is a subcommittee of the board of directors that is composed of independent, outside directors. The audit committee has oversight responsibility (on behalf of the full board of directors and shareholders) for the outside reporting of the company (including the annual financial report); risk monitoring and control processes; and both internal and external audit functions.

2-15. (LO 5, pp 52-53) An outside director is not a member of management, legal counsel, a major vendor, outside service provider, former employee, or others who may have a personal relationship with management that might impair their objectivity or independence.

The audit committee, where it exists, is responsible for assessing the independence of the external auditor and involvement in nomination only of auditors it believes are independent. Auditors are appointed by shareholders in Australia. The intent is to make auditor accountability more congruent with shareholder and third-party needs.

2-16. (LO 5, pp 52-53) The primary point of this question is for students to understand that the audit committee's role is one of oversight rather than direct responsibility.

For example, directors are responsible for the truth and fairness (fairness) of the financial report. Auditors are responsible for their audit and independent assessment of financial reporting. The audit committee is not designed to replace the responsibility of either of these functions. The audit committee's oversight processes are to see that the management processes for financial reporting are adequate and the auditors carry out their responsibilities in an independent and competent manner.

2-17. (LO 5, pp 52-53) In the case of the internal audit function, the audit committee, where one exists, often has the ability to hire and fire the head of internal audit as well as set the audit plan and budget. The audit committee does not control regulatory auditors, but should meet with regulatory auditors to understand the scope of their work and to discuss audit findings with them. In terms of the external auditor, audit committees often become involved with the nomination of the auditor to be voted on at the annual general meeting. They have oversight responsibility for the external audit.

2-18. (LO 5, pp 52-53) In Australia, only the top 500 companies by market capitalisation have to have an audit committee, as per the ASX Listing Rules. No regulation requires non-listed companies to have audit committees. However, that is not to say that it does not happen or is not a good idea. Most stakeholders want an independent party to ensure that their interests are being considered.

2-19. (LO 6, p 54) The external auditor should discuss any controversial accounting choices with the audit committee, where one exists, and must communicate all significant adjustments made to the financial statements and/or notes during the course of the audit. In addition, the processes used in making judgements and estimates as well as any disagreements with management should be communicated. Other items that need to be communicated include:

- All adjustments that were not made during the course of the audit
- Difficulties in conducting the audit
- The auditor's assessment of the accounting principles used and overall truth and fairness (fairness) of the financial presentation
- The client's consultation with other auditors
- Any consultation with management before accepting the audit engagement
- Significant deficiencies in internal control.

2-20. (LO 6, p 54) The board of directors needs to ensure that the auditor is independent with respect to the annual audit. In order to ensure that independence, the board must consider all other services that might be performed by the external auditor and approve any such services in advance and make a statement in the entity's annual report to the effect that auditor provided non-audit services have not compromised auditor independence. Often this task is undertaken by the audit committee, where one exists, and a recommendation is made to the board.

Howeve, under CLERP 9 it is the board that takes responsibility for the final decision.

2-21. (LO 7, pp 54-55) Good governance is important to the external auditor for a number of reasons, including, but not limited to the following. Good governance:

- Usually leads to better corporate performance
- Reflects a commitment to a high level of ethics, integrity, and sets a strong tone for the organisation's activities
- Requires a commitment to financial reporting competencies and to good internal controls
- Reduces the risk that the company will have materially misstated financial statements.

If a client does not have good governance, there are greater risks associated with the client. For example, their poor performance may lead to financial failure and lack of payment of the audit fee. Or their poor governance may lead to improprieties in financial reporting, which puts the auditor at risk in terms of litigation (if the improprieties go undetected by the auditor).

2-22. (LO 7, pp 54-55) The auditor might utilise the following procedures in determining the actual level of governance in an organisation:

- Observe the functioning of the audit committee by participating in the meetings, noting the quality of the audit committee questions and responses
- Interactions with management regarding issues related to the audit, e.g.
    - providing requested information on a timely basis
    - quality of financial personnel in making judgements
    - accounting choices that tend to 'push the limits' towards aggressiveness or creating additional reported net income
    - the quality of internal controls within the organisation.
- Review the minutes of the board of directors meetings to determine that they are consistent with good governance
- Review internal audit reports and especially determine the actions taken by management concerning the internal auditor's findings and recommendations
- Review the compensation plan for top management
- Review management expense reimbursements to determine (a) completeness of documentation, (b) appropriateness of requested reimbursement, and (c) extent of such requests
- Review management's statements to the financial press to determine if they are consistent with the company's operations.

2-23. (LO 7, pp 54-55) Good corporate governance is correlated with increased corporate performance as measured by return on equity, or return on capital. Generally, good corporate governance reduces audit risk as it is less likely that the organisation will suffer from problems of management integrity, or would have an environment that might allow or permit fraud. Less audit risk implies that the amount of work to render an opinion on the financial report would also be less than that required for a company with poorer corporate governance.

2-24. (LO 10, pp 58-61) Auditing Standards issued by the AUASB cover all audits and members of the professional bodies are bound to follow them when conducting an audit. Additionally, for audits conducted pursuant to the *Corporations Act 2001*, Auditing Standards (ASAs) have the backing of law. That is the standards are legally enforceable post the CLERP 9 Act. Auditors can be fined and even jailed if found guilty of breaches of the Auditing Standards for audits performed subject to the *Corporations Act 2001*.

2-25. (LO 10, pp 58-61) Due professional care is the expectation that an audit will be conducted with the skill and care of a professional. The standard of due professional care plays a role in litigation against auditors. Plaintiffs will try to show that the auditor did not do what a reasonably prudent auditor would have done in the circumstances. To evaluate the standard, a third-party also decides whether someone with similar skills in a similar situation would have acted in the same way.

2-26. (LO 9, pp 56-58) There are two important dimensions identified in Exhibit 2.4:

- Scope of information on which assurance is provided
- Nature of organisations on which assurance is provided,

Standard Setters	***IAASB***	***PCAOB***	***AICPA (American Institute of Certified Public Accountants)***
Scope of Applicability of Standards	Audits in countries for which international standards are Required (including Australia)	Audits of all public US companies – referred to as registered accounting firms	Audits of non-public US entities, **except** governmental units, for which standards are set by the GAO (Government Accountability Office)
Objective of Audit Standards	Form an opinion on whether the financial statements are prepared, in all material aspects, in conformity with the applicable	Form an opinion on the financial statements whether they are in accordance with US GAAP or IFRS, and an opinion on the quality of	Form an opinion on whether the financial statements are prepared in accordance with US GAAP

	reporting framework	an organisation over financial reporting	

Commonalities Among the Standards

All are principles-based supplemented by more detailed guidance. Standards are similar in key areas such as:

- Planning the Audit to Minimise Risk
- Auditor Documentation
- Audit Evidence
- Due Professional Care or Reasonable Care
- Nature of the Audit Report
- Independence (US) vs Professional Scepticism (IAASB)
- PCAOB standards parallel most of the AICPA standards

Key Differences:

Opinion and Communication	Required to form an opinion on the appropriateness of the accounting framework used by the company. Criteria are presented to determine the appropriateness of the framework	Required to form an opinion on whether the most appropriate accounting treatment was used and to convey that opinion to management and the board when another acceptable accounting treatment was used	GAAP is acceptable. The communication beyond SAS No. 61 covered earlier is optional
Internal Control	Reports on internal control are addressed when required by governing unit	Specific audit standard on the audit of internal control over financial reporting	Internal control audits are covered under separate attestation standards
Convergence	Committed to international convergence on	As a new regulatory body, the PCAOB does not have a mandate for	The AICPA is committed to international

	auditing standards	international convergence	convergence and works with the IAASB in developing many standards
Assurance Standards	Assurance standards are built into the international auditing standards framework	Does not issue assurance standards, as it is not part of its mandate	The AICPA issues assurance and attestation standards, but they are issued by other bodies within the AICPA
Independence and Professional Scepticism	More focus on professional scepticism with fewer specifics on independence	Major focus on independence and implementation of principles on independence promulgated by the SEC	A very rules-based approach to auditor independence

2-27. (LO 9, pp 56-58) Since AUASB Auditing Standards are based on IAASB Standards there are very few differences. Only changes required for differences in the legal framework or terminology are found. For instance, in Australia auditors cannot withdraw from engagements without the permission of the regulator, ASIC. Regulatory permission is not common among other countries adopting International Standards on Auditing and so changes to accommodate this Australian requirement need to be made.

2-28. (LO 9, pp 56-58) The IAASB Audit Standards are quite consistent with those of the AUASB. They are very similar in the following ways:

- Requirement of independence
- Gathering and evaluation of sufficient evidence
- Documentation of audit work
- Audit designed to minimise audit risk
- Due professional care vs reasonable assurance
- Nature of the audit report.

2-29. (LO 9, pp 56-58) The notion of reasonable assurance in the context of an audit engagement applies to the development of an opinion on an organisation's financial report. It is planned that the financial report will be used by third parties who do not have direct access to client data. The audit engagement is a form of 'positive assurance' in which an opinion must be rendered, i.e. the item being attested to is either properly presented, or is not properly presented.

A review engagement differs from an audit in a number of important dimensions:

- It can apply to almost any assertion that management wants to make as long as there is agreed-upon criteria by which to test management's assertion. It is preferable that the criteria are generally accepted.
- It provides limited assurance in the form of a negative expression of an opinion.
- The effort required in gathering evidence to provide a review conclusion is less than that required in an audit engagement. For a review of a financial report, generally the evidence gathering procedures involve inquiries of management and analytical procedures, unless something comes to the auditor's attention requiring other additional procedures.

2-30. (LO 8, pp 55-56)

- *Auditing Standards ASAs* apply to the auditor's task of developing and then communicating an opinion on financial statements and, where applicable, independent opinions on the quality of an organisation's internal control over financial statements to the board, management, and outside third parties.
- *Assurance Standards ASAEs* apply the auditor's task of developing and communicating an opinion on financial information outside of the normal financial statements, or on non-financial information to management, the board, and outside third-parties. Assurance services are engagements in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users about the outcome of the evaluation or measurement of a subject matter against criteria.
- *Review Standards ASREs* apply to review engagements which provide only limited assurance. In Australia, they are most commonly used for statutory half-year reviews of financial reports. However, they can be used for any review engagement.
- *Quality Control Standards (ASQCs)* apply to firm-level engagement quality control.

2-31. (LO 8, pp 55-56; LO 10 pp 58-61) Independence means objectivity and freedom from bias. The auditor can favour neither the client nor the third party in evaluating the truth and fairness (fairness) of the financial report The auditor must be independent in fact and in appearance. Independence in fact means the auditor is unbiased and objective. An auditor could be independent in fact if he or she owned a few ordinary shares in an audit client, but might not appear independent to a third party. Independence in appearance means that a third party with knowledge of the auditor's relationship with the client would consider the auditor to be independent.

Professional scepticism, as used in the standards promulgated by the AUASB (and IAASB), has a broader meaning in that it refers to all of the factors that would affect an auditor's ability to exercise proper scepticism in an audit engagement. The factors to be considered vary from those associated with the individual, such as objectivity, to those associated with the structure of the firm. These are similar to the independence standards that emphasise both audit firm relationships to the client as well as objectivity. However, the IAASB emphasis on professional scepticism goes a bit further: an auditor could be objective, but not necessarily exercise professional scepticism, i.e. being open to potential explanations of events that are not consistent with the auditor's prior experiences. Professional scepticism appears to be a broader term than independence.

2-32. (LO 10 pp 58-61)

AUASB

– sets auditing standards for all audits

IAASB

– sets standards for financial statement audits on an international basis. Right now, the international standards are being increasingly accepted by all political jurisdictions, but particularly in Europe and many developing countries. Harmonisation with US will continue to be an objective.

IASB

– sets standards for the professional practice of internal auditing around the world. Incorporates other standards by reference where applicable.

2-33. (LO 11, pp 61-65) An audit program follows good corporate governance in the following way: Good governance is critical to the development of sound internal controls in an organisation. The stronger the controls, the less risk that the financial report will be misstated.

The development of audit programs follows the standards in determining that sufficient evidence is gathered in order to evaluate the assertions being addressed in the audit engagement. Further, the gathering and evaluation of that evidence must be done by auditors who are independent of the client – in both fact and in appearance. Finally, the work must be carried out by auditors who understand the standards and exercise due professional care in the conduct of the audit engagement.

2-34. (LO 11, pp 61-65) The major planning steps are:

- Meeting with the audit client
- Developing an understanding of the client's business and industry
- Develop an understanding of the client's financial reporting processes and controls
- Develop an understanding of materiality
- Develop a preliminary audit program that identifies the audit objectives defined in Chapter 1.

2-35. (LO 11, pp 61-65) Materiality is defined as follows:
'Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial report. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.' (Australian Accounting Standards Board, AASB 1031 Materiality, (2009) Appendix Defined Term.)

Materiality guidelines usually involve applying percentages to some base, such as total assets, total revenue, or pretax income and consideration of qualitative factors such as the impact on important trends or ratios. The base should be a 'stable' account however, making total assets a better choice than pretax income.

2-36. (LO 11, pp 61-65) The auditor would take a sample of all additions to PP&E and verify the cost through reference to vendor invoices to determine that cost is accurately recorded and that title has passed to the company. If the company was considered high risk, the auditor might choose to physically verify the existence of the asset.

Discussion and Research Questions:

2-37. (LO 1, pp 44-46)

a. The auditor might use the following approaches to determine whether a corporate code of ethics is actually followed:

- Observe corporate behaviour in tests performed during the audit, e.g. approaches the company takes to purchasing goods, promoting personnel, and so forth
- Observe criteria for promoting personnel; for example, does performance always take on greater importance than how things are done?
- Observe corporate plans to communicate the importance of ethical behaviour; for example, webcasts, emails, and so forth to communicate the importance of ethics
- Review activity on the client's whistle-blowing website, or a summary of whistle-blowing activities reported by the internal auditor
- Read a sample of self-evaluations by corporate officers, the board, and the audit committee and compare with the auditor's observations of behaviour
- Examine sales transactions made during the end of quarters to determine if the sales reflect 'performance goals' as opposed to the company's code of ethics.

b. Are auditors equipped to make subjective judgements? This should be a great discussion question because many young people are attracted to the accounting profession because there are rules and relative certainty as to how things are done. However, as the profession is evolving, more judgements are required in both auditing and accounting. Audit personnel need to be equipped to make judgements on whether the company's governance structure operates as intended and whether there are deficiencies in internal control when it does not operate effectively. The profession believes that auditors can make such judgements.

c. Assessing the competence of the audit committee can occur in a number of ways. Fortunately, the most persuasive evidence comes from the auditor's direct interaction with the audit committee, where one exists, on a regular basis. The auditor can determine the nature of questions asked, the depth of understanding shared among audit committee members, and the depth of items included in the audit committee agenda. Many audit committees have self-assessment of their activities. The auditor should also review the minutes of the audit committee meetings and determine the amount of time spent on important issues.

An external auditor should be very reluctant to accept an audit engagement where the audit committee is perceived to be weak. There are a number of reasons including:

- The lack of good governance most likely influences the organisation's culture and is correlated with a lack of commitment to good internal control.
- The auditor has less protection from the group that is designed to assist the auditor in achieving independence.
- The company may be less likely to be fully forthcoming in discussions with the auditor regarding activities that the auditor might question.

d. Internal auditing is an integral part of good corporate governance. It contributes to corporate governance in three distinct ways:

- It assists the audit committee in its oversight role by performing requested audits and reporting to the audit committee.
- It assists senior management in assessing the continuing quality of its oversight over internal control throughout the organisation.
- It assists operational management by providing feedback on the quality of its operations and controls.

2-38. (LO 1, pp 44-46)

a. Corporate governance is defined as:

> 'a process by which the owners and creditors of an organisation exert control and require accountability for the resources entrusted to the organisation. The owners (shareholders) elect a board of directors to provide oversight of the organisation's activities and its accountability to stakeholders.'

The key players in corporate governance are the shareholders (owners), board of directors, audit committees, management, regulatory bodies, and auditors (both internal and external).

b. In the past decade especially, all parties failed to a certain extent. For detailed analysis, see Exhibit 2.2 in the chapter and reproduced in response to Q 2.2 above in this document.

c. There is an inverse relationship between corporate governance and risk to the auditor (i.e. the better the quality of corporate governance, the lower the risk to the auditor). This relationship occurs because lower levels of corporate governance imply two things for the auditor:

- There is more likelihood that the organisation will have misstatements in its financial statements because the commitment to a strong organisational structure and oversight is missing.
- There is greater risk to the auditor because the governance structure is not designed to prevent/detect such misstatements, and will likely not be as forthcoming when the auditor questions potential problems.

2-39.(LO 1, pp 44-46)

Element of Poor Corporate Governance	**Audit Activity to Determine if Governance is actually Poor**	**Risk Implication of Poor Governance**
The company is in the financial services sector and has a large number of consumer loans, including mortgages, outstanding	This is not necessarily poor governance. However, the auditor needs to determine the amount of risk that is inherent in the current loan portfolio and whether the risk could have been managed through better risk management by the organisation	The lack of good risk management by the organisation increases the risk that the financial statements and/or notes will be misstated because of the difficulty of estimating the allowance for loan losses. The auditor will have to focus increased efforts on estimating loan losses, including a comparison of

Element of Poor Corporate Governance	Audit Activity to Determine if Governance is actually Poor	Risk Implication of Poor Governance
		how the company is doing in relation to the other companies in the financial sector
The CEO and CFO's compensation is based on three components: (a) base salary, (b) bonus based on growth in assets and profits, and (c) significant share options	This is a rather common compensation package and, by itself, is not necessarily poor corporate governance. However, in combination with other things, the use of 'significant share options' may create an incentive for management to potentially manage reported earnings in order to boost the price of the company's shares. The auditor can determine if it is poor corporate governance by determining the extent that other safeguards are in place to protect the company	The auditor should carefully examine if the company's reported earnings and share price differs broadly from companies in the same sector. If that is the case, there is a possibility of earnings manipulation and the auditor should investigate to see if such manipulation is occurring
The audit committee meets semi-annually. It is chaired by a retired CFO who knows the company well because she had served as the CFO of a division of the firm before retirement. The other two members are local community members – one is the President of the Chamber of Commerce and the other is a retired executive from a successful local manufacturing firm	There is a strong indicator of poor corporate governance. If the audit committee meets only twice a year, it is unlikely that it is devoting appropriate amounts of time to its oversight function, including reports from both internal and external audit There is another problem in that the chair of the audit committee was previously employed by the company and would not meet the definition of an independent director Finally, the problems with	This is an example of poor governance because (1) it signals that the organisation has not made a commitment to independent oversight by the audit committee, (2) the lack of financial expertise means that the auditor does not have someone independent that they can discuss controversial accounting or audit issues that arise during the course of the audit. If there is a disagreement with management, the audit committee does not have the expertise to make independent judgements on whether the auditor or

Element of Poor Corporate Governance	Audit Activity to Determine if Governance is actually Poor	Risk Implication of Poor Governance
	the other two members is that there is no indication that either of them have sufficient financial expertise	management has the appropriate view of the accounting or audit issues
The company has an internal auditor who reports directly to the CFO, and makes an annual report to the audit committee	The good news is that the organisation has an internal audit activity	The bad news is that a staff of one is not necessarily as large or as diverse as it needs to be to cover the major risks of the organisation. The external auditor will be more limited in determining the extent that his or her work can rely on the internal auditor
The CEO is a dominating personality – not unusual in this environment. He has been on the job for six months and has decreed that he is streamlining the organisation to reduce costs and centralise authority (most of it in him)	A dominant CEO is not especially unusual, but the centralisation of power in the CEO is a risk that many aspects of governance, as well as internal control could be overridden. The auditor should look at policy manuals, as well as interview other members of management and the board – especially the audit committee members	The centralisation of power in the CEO is a risk that many aspects of governance, as well as internal control could be overridden. This increases the amount of audit risk
The company has a loan committee. It meets quarterly to approve, on an ex-post basis, all loans that are over $300 million (top 5% for this institution)	The auditor should observe the minutes of the loan committee to verify its meetings. The auditor should also interview the chairman of the loan committee to understand both its policies and its attitude towards controls and risk	There are a couple of elements in this statement that carries great risk to the audit and to the organisation. First, the loan committee only meets quarterly. Economic conditions change more rapidly than once a quarter, and thus the review is not timely. Second, the only loans reviewed are (a) large loans that (b) have already

Element of Poor Corporate Governance	Audit Activity to Determine if Governance is actually Poor	Risk Implication of Poor Governance
		been made. Thus, the loan committee does not act as a control or a check on management or the organisation. The risk is that many more loans than would be expected could be delinquent, and need to be written down
The previous auditor has resigned because of a dispute regarding the accounting treatment and fair value assessment of some of the loans	The auditor should contact the previous auditor to obtain an understanding as to the factors that led the previous auditor to either resign or be terminated. The auditor is also concerned with who led the charge to get rid of the auditor	This is a very high risk indicator. The auditor would look extremely bad if the previous auditor resigned over a valuation issue and the new auditor failed to adequately address the same issue Second, this is a risk factor because the organisation shows that it is willing to get rid of auditors with whom they do not agree. This is a problem of auditor independence and coincides with the above identification of the weakness of the audit committee. This action confirms a generally poor quality of corporate governance

2-40. (LO 2, pp 47-49)

a. External auditors are supposed to perform audits of financial statements to ensure that the statements are free of material misstatements. They work for each of the parties to a certain extent and since they are independent, they will not favour any party over the other. The auditors are an independent and objective attestor that evaluates the quality of financial reporting and conveys an opinion to all parties involved in corporate governance.

b. Some of the ways the accounting profession was responsible were allegedly:

- Too concerned about creating 'revenue enhancement' opportunities, and less concerned about their core services or talents
- Willing to 'push' accounting standards to the limit to help clients achieve earnings goals
- Began to use more audit 'shortcuts' such as inquiry and analytical procedures instead of direct testing of account balances
- Relied on management representations instead of testing management representations.

c. The term 'public watchdog' implies that auditors will look over the business world and stop bad things from happening. In terms of financial statements, Arthur Levitt, former Chairman of the SEC said, 'We rely on auditors to put something like the good housekeeping seal of approval on the information investors receive.' The term 'public watchdog' places a great deal of responsibility on the shoulders of auditors to protect the public's interests.

2-41. (LO 2, pp 47-49)

ab&c. **Cookie jar reserves** are essentially funds that companies have 'stashed away' to use when times get tough. The rationale is that the reserves are then used to 'smooth' earnings in the years when earnings need a boost. 'Smooth' earnings typically are looked upon more favourably by the share market. An example of a cookie jar reserve would be over-estimating an allowance account, such as allowance for doubtful accounts. The allowance account is then written down (and into the income statement) in a bad year.

Auditors may have allowed cookie jar reserves because they are known to smooth earnings, and smooth earnings are rewarded by the market. On the flip side, fluctuating earnings are penalised, and present more risk to the company of bankruptcy or other problems.

The CLERP 9 Act addressed the issue by creating CFO and CEO certification of the truth and fairness of the financial report.

Allowing improper revenue recognition is one thing that auditors may have done in their unwillingness to say 'no' to clients. For example, companies shipped out goods to customers at the end of the year for deep discounts and allowed returns at the beginning of the next year. This practice is known as channel stuffing. Since the goods had a great chance of being returned, it would be improper to recognise all as revenue.

Again, auditors were unwilling to say 'no' to clients. Greed is probably the reason here. If companies claim more revenue, their share price would grow in the short-term, making management richer, and making management more willing to give higher fees to their auditors.

With the establishment of stronger audit committees and certification of financial statements and notes, this kind of accounting trickery should decrease.

Creative accounting for M&A included the use of inappropriate values that then gave rise to inappropriate goodwill valuations. The creative accounting also shielded the income statement from charges that would have otherwise hit income including: goodwill amortisation, depreciation, and depletion expenses.

Greed, the same reasons as the revenue recognition issue, was most likely the motivation for this creative accounting.

Discussion between an educated audit committee and auditor plus certification of financial statements required by the CLERP 9 Act should address this issue.

Assisting management to meet earnings. Too often, auditors confused 'financial engineering' with value adding. In other words, auditors often sought to add value to their clients by finding ways to push accounting to achieve earnings objectives sought by management. These earnings objectives then played a major role in escalating share prices – all desired because of the heavy emphasis of management compensation on share options.

Incentives were misaligned. Most of management compensation came in the form of share options.

Better audit committees, increased auditor responsibility, identification of shareholders as the client of the auditor, and management certification of financial statements and notes should address the issue via requirements of the CLERP 9 Act.

2-42. (LO 3, pp 50-51)

a. Some ways that the impact of the CLERP 9 Act affects the external audit profession:
- The granting of legal backing for Auditing Standards

- CFO and CEO certification of the financial reporting standards
- Auditors should now feel more comfortable taking issues to the audit committee
- Audit partners must rotate off every five years. This will create a difficult transition at every client every five years
- With the cooling off period, audit partners or managers cannot take jobs with clients as easily.

b. The ASX Corporate Governance Guidelines encourage effective internal audit functions for all listed companies.

c. This could be argued either way. On one side, the legislation clearly creates a 'watchdog' of the accounting industry, which decreases the power and prestige as the profession is no longer self-regulated. On the other hand, the Act and recent business press has brought a lot of attention to the accounting industry, which has educated the world about the role of accountants in the economy, and possibly increased their power and prestige.

Now, there may be an increased feeling that the public accounting profession has re-established itself as a watchdog for investors. Overall, the consensus seems to be that the profession has regained a great deal of its prestige.

2-43. (LO 4, pp 51-52)

a. The Sarbanes-Oxley Act changed responsibilities of management in the following ways:
- Requirement that CEO and CFO certify the financial statements and disclosures
- Requirement to implement whistle-blowing mechanisms.

b. Under the *Corporations Act 2001*, management is not the 'client', but rather the shareholder. This was the case long before the CLERP 9 Act and differs from the US where the audit committee is the client. The auditor works closely with the audit committee, where one exists, which is independent of management. With these changes, the auditor should be able to be 'tougher' on management because the audit committee will be demanding it. However, the auditor still has to work with management to gain access to needed information, as well as understanding management intent as management intent drives some accounting treatments.

c. The CEO and CFO, as members of management, are ultimately responsible for the financial statements and notes. The chair of the audit committee and the external auditor are then responsible to a certain extent, probably more in the minds of the public than in reality. Finally, the

Director of Internal Audit is the least responsible of the group, as he or she is essentially an employee of management and the audit committee.

2-44. (LO 5, pp 52-53; LO 6, pp 54)

a. The audit committee should be comprised of 'outside' independent directors, who should be financially literate. In addition, the audit committee sets the scope for and hires internal auditors. It should review the work of both internal and external auditors.

b. In Australia the shareholder is the client. In the US, the audit committee certainly has taken on much more responsibility. Audit committees should be much more informed about the audit function and financial reporting processes within their company than was the case previously. The auditor should report all significant problems to the audit committee. For auditors, the reporting relationship should reinforce the need to keep the third-party users in mind in dealing with reporting choices.

c. The audit committee is basically in a position of mediator, but not problem solver. All members should be well versed in the field. This financial knowledge can help the audit committee to understand the disagreement. Ultimately, the auditor has to be able to form an audit opinion. If the auditor believes a certain accounting treatment to be wrong, the auditor does not give a clean opinion. In this way, neither the audit committee nor management can necessarily solve a dispute.

d. The accounting choice is acceptable, and thus, the financial report is true and fair (fairly presented) in accordance with Accounting Standards. The fact that the auditor believes there is a better treatment should be communicated to important parties as follows:

- *Management* – the communication should be made directly, and the rationale for the auditor's opinion should be explained to management and documented in the working papers. The working papers should also include the client's rationale for the chosen accounting treatment.
- *Audit Committee* – Both management's chosen treatment and the auditor's preferred treatment should be communicated to the audit committee. Preferably the communication would include both verbal communication and written communication. The rationale for accepting management's accounting treatment should also be communicated.
- *Users of the Financial Report* – There is no required communication to the outside users of the financial report as long as the auditor has concluded that the financial report is fairly presented in accordance with Accounting Standards.

2-45. (LO 5, pp 52-53; LO 6, pp 54)

a. An **audit committee** is a subcommittee of the board of directors; it is responsible for monitoring audit activities and serves as a surrogate for the interests of shareholders. Audit committees should preferably be composed of outside or non-executive members of the board; that is, members who do not hold company management positions or are closely associated with management.

b. The following information should be discussed with the audit committee:

- A summary of the auditor's responsibilities under Auditing Standards. Auditor responsibilities change over time as new standards are issued. The audit committee should always be aware of the nature of the audit function within the organisation.
- Initial selection or major changes in *significant accounting policies* that could have a material effect on financial report presentation. The audit committee needs to know how the choice may affect both current reports and future financial reports as well as the rationale for the choice because it is presumed that companies select the accounting principles that best reflect the economic substance of their transactions and are thus changed only when dictated by standard-setting bodies or when the economics of the situation change.
- The process utilised by management to make *significant estimates* and other management judgements such as loan loss reserves in banks and savings and loans and insurance reserves in insurance companies.
- *Significant audit adjustments* that may reflect on the stewardship and accountability of management, even if management agreed to make the adjustments.
- The auditor's review of and responsibility for *other information* contained in an annual report (outside of the audited financial statements).
- All major *accounting disagreements with management,* even if such disagreements are eventually resolved to the auditor's satisfaction.
- The auditor's knowledge of *management's consultation with other auditors* regarding accounting or auditing issues.
- Any significant accounting or auditing *issues discussed with management prior to the acceptance of the audit engagement* – in particular, any positions taken regarding the proper accounting of controversial areas should be disclosed.

- Any *difficulties encountered* in performing the audit, especially any activities undertaken by management that might be considered an impairment of the audit function.
- *Internal audit plans and reports* and management's responses to those reports.
- The extent to which the client has implemented a comprehensive *plan of risk assessment* and the organisation's plans to mitigate, share, control, or otherwise address those risks.
- Any known *internal control weaknesses* that could significantly affect the financial reporting process.

The rationale for this communication is that the board of directors through its audit committee is responsible for the client's financial reporting and a thorough discussion of these issues will help them fulfil that responsibility.

c. Although they do not have shareholders, non-listed entities would still want to have audit committees comprised of independent members. No matter what the organisation, there are always stakeholders that want to make sure the company is being run properly. In the example of a school, taxpayers and parents want to know what is happening with public funds. Without an audit committee, the stakeholders would be trusting management to do everything properly, and in their best interests. There is a need for accountability and independent reporting for charities, governmental agencies, and other public-interest organisations. Audit committees help fill that role.

2-46. (LO 5, pp 52-53)

a. This is intended to be an open-ended discussion. There are a number of factors that have been mentioned in the discussions regarding auditor independence. The following is representative of some issues discussed:

- The audit firm's policy for rotating auditors in charge of the engagement
- Whether or not the client has hired personnel from the audit firm for significant financial or management positions in the company, such as the Chief Financial Officer having been the former partner in charge of the audit engagement
- The nature of non-audit services provided by the audit firm
- The existence of any social or other relationships with management
- Audit committee experience with the audit firm in other situations, such as the auditor provides services for other entities with which the audit committee member has an association
- The existence of any charges brought against the auditing firm by ASIC
- The audit firm's involvement in significant lawsuits where auditor judgement has been questioned
- The amount of fees charged by the auditing firm. If the audit fees are too low, the audit committee should question the thoroughness and

independence of the work. If fees from non-audit work are high, the audit committee will want to question that relationship and possible effect on judgements made by the auditor

- The manner in which individual audit partners are compensated by the public accounting firm. For example, if an audit partner's compensation is determined significantly by whether or not a client is retained, then there might be questions about what the auditor would do to retain the client.
- The general reputation of the firm
- The firm's policies and procedures for attracting and retaining talented audit personnel
- The process of assigning personnel to an audit
- The firm's expertise in the industry.

b. The main way that the audit committee can influence the independence of the internal audit department is by choosing who is in charge of the department. The 'tone at the top' in the internal audit department will go a long way. Further, the audit committee ought to approve the scope of the internal audit charter, approve annual audit plans, as well as annual budgets.

c. 1. **Tax Return for Company:** *Approval argument*. The auditor is already aware of all the information, so can efficiently prepare the return. Tax accounting is different than audit accounting, so accounting treatments can be different in both settings and will not affect each other.

Non-Approval: On the other hand, some argue that tax preparation is a consulting activity (i.e. the auditor would need to be a client advocate and thereby should not prepare the tax return.

2. **Tax Return for Management and Board Members:** *Approval:* The auditor is an expert. The services can be viewed as a benefit for management and the board.

Not Approve: Performance of the tax services too closely aligns the auditor with management and the board. The auditor has to be a client advocate in developing the tax returns. This may mentally conflict with the auditor's need to be objective in all other work involving the client.

3. **Tax Return paid for by Managers, not company:** *Approval:* This is an independent service not paid for by the company.

Not Approve: The argument is the same as #2 above. Although paid for by the individuals, there is still the possibility of conflict.

4. **Overseas Assistance for Internal Audit Department:** *Do not approve*. It is the responsibility of management to prepare a review of internal control, and the auditor does an independent analysis. Further, the performance of internal audit work is one of the areas that have been explicitly prohibited by the SEC.

5. **Security Audit of Information Systems:** *Approve*. This is not a conflict of interest as it is an audit or assurance service.

6. **Train Operating Personnel on Internal Controls:** *Approve*. Auditors are experts on this area. There is no direct conflict with the performance of the audit. Better trained personnel should imply better internal controls – beneficial for both management and the auditor.

   Not Approve. The PCAOB is explicit that management has the responsibility to design, implement, and evaluate internal control. Thus, training personnel is a management task that cannot be performed by the auditor. It could, however, be performed by a different public accounting firm.

7. **Perform Internal Audit Work for the Company:** *Do not approve*. It is the responsibility of management to prepare a review of internal control, and the auditor does an independent analysis. Usually internal audit is responsible for 'management's' end of assessing internal controls. The audit of effectiveness and efficiency is akin to consulting and would be interpreted by most people as compromising the auditor's independence.

8. **Provide, at no cost, Seminars to Audit Committee Members.** *Approve.* The audit committee can make a decision as to whether a particular member will attend the seminar. It is one way that an audit committee member can keep up on the profession. The only potential problem would occur if the audit committee only relied on the audit firm for updates on accounting and audit issues.

9. **Seminars for both Audit and Non-Audit Clients.** *Recommend Approval.* The key is whether the audit committee feels that it may lose some of its objectivity in performing its oversight role.

2-47. (LO 3, pp 50-51)

a. To protect the public interest, the Australian Government apparently felt that the profession was no longer capable of setting its own standards.

b. ASIC administers the *Corporations Act 2001*, which includes many requirements related to the audit function and auditors. The Companies

Auditors and Liquidators Disciplinary Board, responsible for the disciplining of auditors was strengthened with the enactment of CLERP 9. ASIC is responsible for the administration of registering company auditors. It is has been delegated by the Financial Reporting Council with responsibility for inspection of audit firms and of their audits as a quality control mechanism. Its inspections and subsequent reports provide insight into the degree of compliance with Auditing Standards. It tests quality control guidelines for public accounting firms engaged in audit activity. The inspection process keeps the public accounting profession acutely alert to its responsibilities of assuring audit quality (i.e., the threat of inspection should lead to more consistently high audit quality on all engagements even though not all engagements will actually be inspected). ASIC is also responsible for giving approval for changes of audit firm.

c. The rationale for the requirement is to get people from diverse disciplines to comprise the AUASB with a focus on the public interest. In this way, more thoughts are generated and the tendency for 'group think' and vested interests to dominate.

d. This needs to be answered by looking at the AUASB website at http://www.auasb.gov.au and then looking for the current membership.

e. Yes, although only audits pursuant to the *Corporations Act 2001* provide legal backing to the auditing standards.

2-48. (LO 7, pp 54-55)

AUASB	IAASB	PCAOB	AICPA Auditing Standards Board
12 members plus Chairman appointed by the Government, other members appointed by the Financial Reporting Council. One member is an internal auditor, two are public sector auditors, one is an independent consultant and the remainder are in public practice, with all but one from the Big 4	18 members, with 10 nominated by IFAC members (2 of which are US), 3 public members, and 5 from major firms, including all of the Big 4 plus Grant Thornton. Has less substantial legal authority	5 members, of which only 2 can be US CPAs, and the CPAs do not necessarily have to have audit experience. All are appointed by the SEC since the PCAOB is a quasi-regulatory organisation. Has more substantial legal authority	19 members, including one academic, a representative from each of the Big 4 firms, and a wide representation from other audit firms. All US CPAs. Members are appointed by the AICPA. Has less substantial legal authority

b. The AUASB Standards differ from the IAASB Standards in mostly minor ways connected to the differences in legal regime in Australia compared with most countries. For example, Australian Auditing Standards have legal backing. Australian auditors cannot withdraw from an audit engagement without ASIC permission.

c. The following are some of the major ways in which they differ:

- Requirement to comment on the appropriateness of the accounting standard that serves as a criteria for fair presentation
- A greater emphasis on professional scepticism as a fundamental concept of auditing
- Includes assurance standards as well as audit standards
- Has less specified standards on audits of internal control over financial reporting (standards only apply when user or regulator requires such a report).
- The US Standards include a separate standard on the audit of internal control over financial reporting.

d. The IAASB standards are purposefully broader regarding the proposed accounting framework criterion because many companies (in spite of the movement to global convergence) still have unique aspects to their accounting rules or principles. In addition, there are other frameworks that exist besides accrual-based accounting, e.g. the cash basis or the tax based statements. Thus, the auditor is required to communicate as to whether the framework in which the management prepared the financial statements is appropriate. Then, the auditor opines on whether the financial statements are fairly presented in accordance with that framework.

In the US, the appropriate accounting standards have been recognised as Generally Accepted Accounting Principles (GAAP), as promulgated by the Financial Accounting Standards Board (FASB) or its designees. The auditor does have a responsibility to communicate to management and the audit committee their view of the application of the accounting principles to the financial statements and whether the auditor believes that an alternative approach would more fairly present the financial statements – even if the chosen alternative falls within the range of acceptable GAAP.

2-49. (LO 5, pp 52-53; LO 9, pp 56-58; LO 10, pp 58-61)

a. On the 'pro' side, having the same standards makes audits more comparable for the public and the auditors. Nobody has to go through the trouble of reconciling differences in audits. On the 'con' side, standards that seem appropriate for listed clients may require more time and effort than necessary to gain comfort with a non-listed company's financial report. Auditors should be able to work in the most efficient way if they are going to be profitable.

b. Examples could include the following: (1) listed companies might have audit standards that are more applicable to larger and more complex entities, (2) non-listed companies might have audit standards that adjust for weaker internal controls (e.g., lack of segregation of duties), (3) listed companies might have audit standards that are geared toward more remote and less-informed users (e.g., shareholders) rather than less remote and better-informed users (e.g., bankers).

c. The main authority and standards come from the AUASB's Auditing Standards as they are applicable to both public and private sector audits.

d. The audit committee should not play any role in this determination. This is up to the auditor's judgement.

2-50. (LO 10, pp 58-61)

Auditing Standards	Holmes' Failure to Comply with Auditing Standards
Technical Training and proficiency as an auditor	The college students did not have the proper training and proficiency and were not properly supervised
Independence	Holmes lacked independence because of the financial interest in whether the bank loan is granted to Ray
Due professional care	Holmes failed to follow the fieldwork and reporting standards as a reasonably prudent auditor would have done. He did not critically review the work done or the judgements of the assistants
Planning and supervision	Holmes accepted the engagement without first considering the availability of qualified staff. He also failed to supervise the assistants and plan the work adequately
Understanding internal control structure	Holmes and the assistants did not obtain an understanding of the business, industry, or its internal control system
Sufficient, competent evidence	Holmes gathered no evidence to corroborate the information in the financial report. The work performed was more an accounting service than an audit service
Reporting standards: Adherence to Accounting Standards	The report made no reference to Accounting Standards. Because Holmes did not do a proper audit, no opinion should have been expressed as to the fairness of the financial statements in accordance with Accounting Standards
Identification of circumstances in which such principles have not been consistently observed	Holmes was not in a position to determine whether the accounting principles had been consistently observed due to the lack of evidence
Informative disclosures	There were no notes to the financial statements. At a minimum, the significant accounting policies should be described. Disclosures were obviously inadequate, but the audit report did not mention this
Opinion	Even though an opinion was expressed, it is not based on the results of a proper audit. A disclaimer should have been issued because Holmes failed to conduct an audit in accordance with Auditing Standards

2-51. (LO 11, pp 61-65)

a. The standard of due professional care plays a role in litigation against auditors. Plaintiffs will try to show that the auditor did not do what a reasonably prudent auditor would have done in the circumstances. To evaluate the standard, a third party also decides whether someone with similar skills in a similar situation would have acted in the same way.

b. Independence is vitally important to the auditing profession. Auditors exist to create confidence in the public that financial reports are free from material misstatement. When auditors are not independent, the public cannot necessarily trust that the statements and notes are free from material misstatement, because they could have incentives to allow misstatements. Independence was a primary concern under the CLERP 9 Act because the auditing profession was rapidly losing the public trust that had taken decades to build. The Australian Government saw the need to begin rebuilding this public trust through legislation, since self-regulation has proved inadequate in its estimation.

c. The question becomes one of how to remain sceptical despite continued indications that there are no major problems at the client. There are three fundamental approaches that are often taken:

- Continuous training and especially reinforcement of the importance of professional scepticism
- Supervisory review throughout every aspect of an audit
- A personal commitment from each auditor.

d. According to the *Corporations Act 2001* and the Auditing Standards on audit reporting, the auditor does not have the option of simply walking away from the audit. The auditor is required to render an opinion if the auditor has developed sufficient evidence to render an opinion. Further, the auditor cannot withdraw from an engagement without the permission of ASIC.

2-52. (LO 1, pp 44-46; LO 5, pp 52-53; LO 7, pp 54-55; LO 10, pp 58-61)

a. Good corporate governance is important to both auditors and investors because: (a) it is highly correlated with better organisational performance, and (b) it creates an atmosphere where it is less likely that there will be problems with the company's annual financial statements, or other financial reports.

b. Good corporate governance includes dual components of trust and accountability. Thus, a commitment to good corporate governance is also a commitment to excellence in accountability, including financial reports.

In addition, well-run companies are generally well-run on multiple dimensions, e.g., corporate governance and operational performance.

c. There are a multitude of risks to the auditor if an organisation is not committed to high quality corporate governance. Among the most important risks are:

- Potential lack of management integrity and trustworthiness regarding important accounting issues such as making estimates
- Lack of commitment and support of the audit function, and especially important, a lack of support for audit independence and competence from the audit committee
- Less emphasis on high quality internal controls resulting in more errors made in financial reports
- Lack of transparency in all reporting to external bodies.

All of these combine into a situation that makes it much more likely that an auditor might be sued when materially misstated financial statements are issued.

d. The audit committee, where one exists, is a subcommittee of the board of directors and has oversight responsibilities relative to both the internal and external audit functions.

e. It is important to have directors that are fully independent of management in order to provide an objective evaluation of the work of management, and to ensure that the board pushes back against management when members of management propose actions that may be in management's best interests, but not in the best interests of the organisation's shareholders or other stakeholders. This is all the more important in an environment in which management is compensated through share options.

f. It is hard to recommend accepting an engagement when the company has poor corporate governance – for all of the reasons identified above. Stated differently, performing an audit on a company that does not have good corporate governance increases the probability that there will be misstatements in the financial statements and/or notes and the auditors may be sued. On the other hand, an auditor may accept an engagement for a company with less than good corporate governance when the auditor:

- believes the company is committed to improving corporate governance

- believes the deficiencies in corporate governance, while important, are not so major that they will routinely lead to misstatements in the financial report

- structures the audit engagement with adequate work to obtain sufficient audit evidence to address the risks that are apparent (i.e., the auditor knows that he or she will have to perform more audit work on the client than would otherwise be necessary).

g. The standards are designed to protect the auditor from poor corporate governance in the following ways:

- Highlighting the need to control audit risk

- Emphasising that more audit evidence needs to be gathered when there is higher risk of material misstatement

- Increasing the responsibility to interact with the audit committee, where one exists

- Requiring the auditor to evaluate the competence and integrity of management.

2-53. (LO 10, pp 58-61; LO 11, pp 61-65)

a. Materiality is defined as follows:

> 'Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial report. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.' (Australian Accounting Standards Board, AASB 1031 Materiality, (2009) Appendix Defined Term.)

Materiality is used in both accounting and auditing to help guide decisions about the magnitude of problems in the financial statements and/or notes that must be fixed prior to issuance of an unqualified audit opinion; materiality is also used to guide decisions about areas that are considered key to the focus of the audit.

b. In the past when audit committees were not independent, materiality would not normally have been discussed with audit committees or management. Now, materiality should be discussed with the audit committee to determine what an appropriate level of materiality might be for that audit. The audit committee can help to determine stakeholders and their decision-making criteria.

Some argue that management should be unaware of materiality. If members of management know the amount, they might feel free to misstate up to that level in many different accounts, which could add up to a significant number (and fraud). Management would also have the ability to focus on only having good control of high dollar transactions, possibly compromising control over smaller transactions which can add up in a hurry. With this in mind, the audit profession is on alert for offsetting material misstatements, swings in accounting estimates, or consistent immaterial adjustments.

That said, materiality is a guideline that is well understood in the profession. As long as the auditor indicates that there is both a quantitative and qualitative component of materiality then a general discussion with management and the audit committee does not do any harm. In some cases, management or the audit committee may want the auditor to look at some areas with a lower level of materiality.

c. Materiality guidelines usually involve applying percentages to some base, such as total assets, total revenue, or pretax income as a starting point. The base should be a 'stable' account, however, making total assets a better choice than pretax income.

In determining the amount to set for materiality, the auditor should consider the riskiness of the audit, qualitative factors such as the effect on trends and ratios, as well as the stakeholders who will be making decisions based on the financial statement presentation.

2-54. (LO 3, pp 50-51)

The goal of this research assignment is to have students read the latest literature on these topics and discuss in class.

2-55. (LO 11, pp 61-65)

a. Construction equipment is an asset. That is the amount that the equipment was purchased for originally. The accumulated depreciation account is a summation of all the depreciation taken on the construction equipment. \$1,278,000 – \$386,000 = \$892,000 is the current carrying value of the equipment. Around 25% has been depreciated to date. By the end of the useful life of the equipment, the carrying value will be zero (fully depreciated). The leased equipment represents assets that are rented and not owned.

b. The equipment held by the company could be characterised as fairly new. Only about 25% of the equipment value has been depreciated to date.

c. If the number of leased equipment pieces is small, examine each lease agreement.

d. Randomly select invoices for new pieces of equipment and check that the total amount paid for the equipment is reflected in the total amount. Review the invoice to make sure the equipment was bought and not leased.

e. The auditor should question the method and calculations for the current year depreciation entries and make an assessment as to whether the method, the number of years of useful life, and the calculations, are reasonable. The auditor should also determine whether there is an impairment in the value of the equipment.

f. First, the auditor can review past transactions and useful lives. If the company often recognised gains on trade-ins of assets, then the useful life was too short (the opposite if the company recognised losses). The auditor can also review management plans, industry usage, and industry practice for other insight on the useful life. Finally, the auditor can audit the internal controls on the system that calculates depreciation, and can utilise verbal inquiry for an explanation of useful life.

2-56. (LO 3, pp 50-51; LO 4, pp 51-52) The following are excerpts from the research study Houghton, Jubb, Kend and Ng (2010).

i. **Legal backing for auditing standards**

ii. **'10.0 Regulatory reforms to audit: their impact**

Purchasers were split between whether or not legal enforceability was a positive initiative for the Australian economy. Some purchasers suggested that it could be worthwhile, while others were concerned that legal enforceability would result in auditors withdrawing from offering opinions and judgements and moving to fulfil compliance requirements. One purchaser lamented the loss of intellectual property rights for the profession. This purchaser also observed that the government had no-one to blame but itself and its own processes if and when there was another round of corporate failure. Few purchasers suggested there was a clear increase in confidence in the capital market, and suppliers also shared the scepticism that the market would be any different to that which had preceded it. In terms of audit quality, some purchasers felt that while the audit might not change much of what was done, the current regulatory requirements added considerable robustness to the audit, which might not have been present before. A number of purchasers suggested that, fundamentally, the audit they observed had not changed with recent amendments to regulatory requirements; however, it had driven up costs. Few purchasers were able to identify how the audit had been changed or whether the auditors provided new and valuable insights into the business. Those who were able to make direct comparisons between Australia's current position and the Sarbanes-Oxley legislation in the United States spoke favourably of the Australian position and somewhat harshly of the more prescriptive and compliance-driven US position.

Standard setters took the view that legal enforceability was good because it would give rise to improved quality. One regulator indicated that it would give substance and support and a more clarified approach than had previously been the case.

Users, purchasers and suppliers all acknowledged that costs had risen as a consequence of these changes. For users who were somewhat sceptical of the value-adding capacities of an audit, these added costs only intensified their irritation. Purchasers also acknowledged that costs had risen, but there appeared to be some acceptance of these costs being passed on – at least in part. Suppliers acknowledged increased costs and that in some instances margins had been squeezed. While recognising there was going to be a cost gravitation upwards with respect to legally backed auditing standards, some standard setters commented that this came about because of changes in the international standards, which called for higher levels of documentation. One standard setter also made the observation that the change to legally enforceable auditing standards could in fact substantially increase the threshold costs of becoming an auditor to the corporate sector – thereby limiting competition.

Related to but not directly connected with the increase to operating costs of conducting an audit under the new regulatory environment is the issue of the costs or potential costs to auditors of litigation risk. One regulator took the view that the presence of legally backed auditing standards would change the environment in only a relatively minor way – adding another legal pathway to enhance auditor accountability.'

Executive Summary Section 10.0, Houghton, K, C. Jubb, M. Kend and J. Ng *The Future of Audit: Towards a National Strategy in Keeping Markets Efficient*. 2010.

iii. **'9.1 Inferences from interview findings: rotation**

The issue of mandated partner rotation is one of the few issues on which there is agreement among stakeholders. A large number of purchasers and suppliers as well as a number of users, regulators and standard setters articulated the desirability of having a 'fresh pair of eyes' and the 'diversity of view' that audit partner rotation could bring. Purchasers noted that rotation was practised by many audit firms before the current regulatory framework, but that the period was typically longer than five years. Purchasers also expressed some degree of uncertainty about the quality of any partner rotating in. Among the purchasers representing companies within the top 50 or so listed companies on the ASX, there was deep-rooted concern about the speed of rotation. Purchasers also expressed concern that when senior partners rotated off, the next logical client could be a major competitor in the same industry.

Suppliers also agree with the principle of rotation but have concerns. Suppliers noted a significant trade-off between independence – real and perceived – and the erosion of client knowledge. It was common to suggest that a five-year period was too short, particularly for large, complex or highly regulated (particularly APRA-regulated) companies. One supplier noted that there was no similar requirement for directors to rotate off. Suppliers to larger clients observed that large clients felt they had the power to demand any particular partner of their choice. Consequently, there is increased pressure on the most expert partners and less ability to train more junior partners.

Some suppliers noted that the five-year rotation was a 'tipping point' for clients in a decision to put the auditor to tender; it was also a tipping point for some individual partners to reconsider their own careers. Suppliers also noted the time and energy needed to manage the partner rotation process with the need for 'shadow' partners for some complex clients in the year or more before rotation. The authors note the anomaly of this situation in terms of bringing a 'fresh pair of eyes'.

Regulators, standard setters and users agreed in principle with rotation, but also acknowledged a substantial trade-off between knowledge of the client and independence. Suppliers and standard setters recognised that, generally, the initial-year audit quality was lower than the quality of an audit where the partner had been engaged with the client for three or more years. The authors note that the balance between engagement time and perceived independence might need to be crafted conditionally on the size, complexity or regulatory framework within which the auditee operates.'

Executive Summary Section 9.1, Houghton, K, C. Jubb, M. Kend and J. Ng *The Future of Audit: Towards a National Strategy in Keeping Markets Efficient*. 2010.

2-57. (LO 1, pp 44-46; LO 3, pp 50-51)

The purpose of this project is to get students out into the business community and acquaint them with the process of gathering evidence about corporate governance and evaluating the effectiveness of corporate governance. Another alternative is to discuss what students have observed in their part-time jobs.

2-58. (LO 1, pp 44-46; LO 5, pp 52-53)

The goal of this exercise is to allow the student to see how audit committees really function in the 'real world'. The differences between the various companies will prove that all audit committees, charters, and company goals are different. The latter part of the assignment will serve as a chance to hear student opinions on a yet unsettled issue.

Cases:

2-59 .(LO 1, pp 44-46; LO 5, pp 52-53; LO 6, pp 54-54; LO 8, pp 55-56; LO 11, pp 61-65)

a. Any individual on the board of directors can serve on the audit committee. It would be preferable to have individuals with some financial knowledge.
b. Financial and operational knowledge and a willingness to challenge management and interact with the external auditors.
c. The answer to this question will, of course, vary by company.

ADVANCED ENGINE COMPONENTS LTD (AEC) AND ADVANCED BRAKING TECHNOLOGY LTD (ABV)
INTRODUCTION AND CORPORATE GOVERNANCE

Note to Instructor: Using these instructional resources based on Advanced Engine Components Ltd and Advanced Braking Technology Ltd, students will have the opportunity to apply the concepts from each chapter within the context of two actual companies.

1a. Describe the history of Advanced Engine Components, it's current business, operating sectors, and reportable segments.

Advanced Engine Components Ltd was incorporated in Western Australia on 5.12.1983 and listed on the ASX on 21 February 2000. At the time of writing it is suspended from the ASX. It lies in the Consumer Discretionary GICS Sector and in the Automobiles and Components industry group within that sector. It is headquartered in Western Australia. It specialises in research, development and production of patented electronic fuel injection and engine management technologies that enable vehicle engines to run on natural gas. Its principal activity is the sale of patented Natural Gas Vehicle Systems, natural gas engines incorporating Natural Gas Vehicle Systems and associated components and spare parts. Its key markets are India, where it has agreements with Tata Motors, and China, where it has agreements with Norinco Equipment Co. Thailand, Indonesia and France are also countries with which it does business. In Australia, its sales are related to services, spares and consumables.

Its controlled entities (100% owned) according to the 30 June 2010 annual report include:
AEC China Holdings Ltd incorporated in the British Virgin Islands
AEC China Ltd incorporated in China
AEC Vehicle Technology Pty Ltd incorporated in Australia
Transcom NGVS Research Pty Ltd incorporated in Australia

1b. Describe the factors affecting Advanced Engine Component's profitability and factors affecting the automotive industry in general.

Factors affecting profitability include: wholesale unit volumes, margins on vehicles sold (which is affected by the mix of products sold, component costs, incentives and other marketing costs, warranty costs, and safety/emission/fuel economy technology costs), and a high level of fixed costs, including labour costs.

Factors affecting the auto industry in general include: (a) a competitive industry with many producers, none of whom are the dominant producer; (b) seasonality, whereby results of the third quarter are less favourable than those of other quarters because of high spring and summer demand; (c) raw materials costs and acquisition uncertainty; (d) low backlogs, (e) intellectual property that is difficult to develop, defend, and maintain, (f) and high potential warranty costs.

1c. Compare the nature of Advanced Engine Component's history, business sectors, and reportable segments to those of Advanced Braking Technology.

Both companies are in the Consumer Discretionary GICS Sector and in the Automobiles and Components industry group within that sector. Advanced Braking Technology Ltd was listed on 28.5.2002. It uses the Wet Brake concept developed in the early 1980s. The primary activity is the design, manufacture and distribution of vehicle braking systems using a patented technology, Sealed Integrated Braking System (SIBS). The Company's manufacturing and assembly operations are located in Thailand, and its products are sold directly in Australia and through resellers in Canada and South Africa. The Sealed Integrated Braking System is a fully enclosed, single rotor, enclosed wet braking system designed for harsh operating conditions or with heavy or frequent braking applications. The Company offers a range of Sealed Integrated Braking System on-road and off-road light, medium and heavy commercial vehicle applications for use in the mining industry. Its product portfolio includes special-purposed brake designs and brakes for Toyota Landcruiser, Toyota Hilux, Mitsubishi Canter and the Isuzu NPS300. Presently, ABV is developing a new brake design for garbage trucks used in the waste collection industry. The Garbage Truck development program has entered into its Production Validation phase, a final stage before commercialisation, after entering into the Pre-Production Contract with Brake Developments Pty Ltd in 2010. The Segment Note 23 in 2010 shows that 16% of revenue was attributable to Engineering Services and 84% was attributable to Mining Brakes.

The mining brake sector manufactures and sells a variety of Sealed Integrated Braking Systems (SIBS) for use in the mining sector. All models of brakes are similar in nature and are sold to similar types of customers. The manufacturing and sales process extends to installation of the brakes where required, support of the products and the sale and supply of replacement parts. The engineering and development sector undertakes research and development of Sealed Integrated Braking Systems for a variety of uses. This sector is also engaged in creating customised braking solutions for various customers.

The history of Advanced Engine Components appears above. Its Segment Note 8 in 2010 shows that it uses a geographic basis for segment reporting whereas ABV uses operating segments. Australia is the source of 45% of Advanced Engine Components' revenue and China 55%.

Company History as per http://www.advancedbraking.com/company_history.htm accessed 21 November 2011:

1991 Invention of fully enclosed, oil immersed brake.

1992 First prototype developed for applications where ordinary braking systems under-perform and require excessive maintenance.

1996 Winner of International Society of Automotive Engineers – Most Innovative Ideas in Engineering.

2000 Safe Effect product concepts evolved into the maturely developed Sealed Integrated Braking Systems

2002 Safe Effect publicly listed on ASX .

2005 **Product**
Multiple products have been developed, with the Light Commercial Vehicle (LCV) series of brakes be
ready for the market.

Intellectual Property

The Company has developed an extensive patent portfolio. It covers high-speed sealed disc, drum, sec
cooled braking systems, and various others.

Business Development

The Company has formulated a global commercialisation strategy. With the current focus on Australia
North America marketing, the Company has been actively selecting and negotiating reseller arrangem
with the view to establish distribution network worldwide.

Manufacturing

Manufacturing facility was moved from Melbourne, Australia to Laem Chabang, Thailand. The Comp
established its wholly owned manufacturing subsidiary aiming at supplying the Australian and interna
market. .

2006 Safe Effect Technologies has been assessed and certified as meeting the requirements of AS/NZS ISO
9001:2000. For the following activities: Research and Development, Design, Testing and Servicing of
Systems.

2a. Which of the board members for both companies met the ASX Corporate Governance Guidelines (2007) as independent? Is there gender or other types of diversity discernible among directors?

The ASX Corporate Governance Principles and Recommendations 2nd Edition (2007:16-17) state that:
'An independent director is a non-executive director who is not a member of management and who is free of any business or other relationship that could materially

interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgement. Relationships which may affect independent status are set out in Box 2.1. Directors considered by the board to be independent should be identified as such in the corporate governance statement in the annual report. The board should state its reasons if it considers a director to be independent, notwithstanding the existence of relationships listed in Box 2.1, and the corporate governance statement should disclose the existence of any such relationships. In this context, it is important for the board to consider materiality thresholds from the perspective of both the company and its directors, and to disclose these.'

Box 2.1: Relationships affecting independent status
'When determining the independent status of a director the board should consider whether the director:

1. is a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company
2. is employed, or has previously been employed in an executive capacity by the company or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the board
3. has within the last three years been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided
4. is a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer
5. has a material contractual relationship with the company or another group member other than as a director.'

Given the above definition of 'independence' as it pertains to directors, the next step is to examine the description of each director for both companies and also the related parties notes and top 20 shareholder lists to determine whether any of the criteria in Box 2.1 above is breached. Below are extracts from the respective annual reports describing the directors. It is important to note that 'non-executive' directors do not necessarily meet the criteria for 'independent' directors.

In terms of board diversity, both companies have all male boards, although Advanced Braking Technology has ethnic diversity which does not appear to be the case for Advanced Engine Components.

Directors of Advanced Engine Components
David Humann *Chairman*
Mr Humann is a Fellow of the Institute of Chartered Accountant, A Fellow of the Institute of Certified Practicing Accountants and Fellow of the Australian Institute of Company Directors. He was Chairman and Senior Partner of Price Waterhouse (Hong Kong and China firm) from 1986 until 1994. Mr Humann was also the Managing Partner of Price Waterhouse, Asia Pacific Region, and a member of the World Board of Price Waterhouse and of the global firm's World Executive Committee based in London and

New York. He was formerly a member of the Australian and New Zealand firm's Executive Policy Committee. Mr Humann is a member of the boards of a number of public and private companies. Appointed 28 August 2006.

Professor Malcolm Richmond *Non-Executive Director*
Professor Richmond is currently visiting Professor of Business and Professor of Engineering at the University of Western Australia and Adviser Technology Commercialisation at Curtin University. Currently, he is a Director of MIL Resources Limited, Strike Resources Ltd, SMS Ltd and was formerly Chairman of Territory Iron Limited. He is a metallurgist by profession whose career spanned 26 years with CRA/Rio Tinto Group where he worked in a number of positions including: Vice President – Strategy and Acquisitions; Managing Director – Research and Technology; Managing Director – Development of Hamersley Iron Pty Limited. He was recently Vice Chairman of the Australian Mineral Industries Research Association and a member of the Murdoch University Senate. Appointed 28 August 2006.

Mr Ken Johnsen *Executive Director and CEO*
Mr Ken Johnsen joined the Company as Chief Executive Officer on 9 September 2005. Mr Johnsen has over 31 years experience in the development and licensing of advanced technology for the automotive industry. He has held senior management roles in both Australia and the USA with Orbital Corporation Ltd and served on the Orbital board for 13 years. Since joining Advanced Braking Technology Ltd, Mr Johnsen has led the recapitalisation and relisting of the Company, as well as the commercialisation of the Company's products. Appointed 30 April 2007.

David Slack *Non-Executive Director*
Mr Slack is the Managing Partner and Chief Investment Officer, Investment Manager – Small Companies for Karara Capital Limited. Over the past 30 years Mr Slack has made a significant contribution to the Australian funds management industry. Notably he was the co-founder and Joint Managing Director of Portfolio Partners, which had $5.3 billion in funds under management when it was sold to Norwich Union in 1998. Prior to that, Mr Slack was a founding executive director of County NatWest Investment Management, where he was Head of Australian Equities. He was formerly a non-executive director of the Victorian Funds Management Corporation and until recently its deputy Chairman and Chair of the Board Investment Committee. David has a Bachelor of Economics degree with Honours and is a Fellow of FINSIA. Appointed 9 September 2009.

Source 2010 Annual Report Advanced Braking Technology p. 19-20.

In terms of Advanced Braking Technology director independence, the 2010 Annual Report page 11 states:

'Independence of Directors
The Board has reviewed the position and associations of all non-executive Directors in office at the date of this report and considers that all the Directors are independent. In considering whether a Director is independent, the Board has regard to the independence criteria in ASX Best Practice Recommendations Principle 2 and other facts, information and circumstances that the Board considers relevant. The Board assesses the

independence of new Directors upon appointment and reviews their independence, and the independence of the other Directors, as appropriate. The Board considers that all Directors meet the criteria in ASX Principle 2. They have no material business or contractual relationship with the Company, other than as Directors and Shareholders, and no conflicts of interest which could interfere with the exercise of independent judgement. Accordingly, they are considered to be independent.'

Note 25. RELATED PARTY TRANSACTIONS Advanced Braking Technology
Transactions between related parties are on normal commercial terms and conditions except inter company loans which are provided at no interest and are treated by the Parent Entity as an investment in the subsidiary. The following related party transactions took place during the year ended 30 June 2010:

	Economic Entity		**Parent Entity**	
	2010	**2009**	**2010**	**2009**
	$'000	**$'000**	**$'000**	**$'000**
a) Associated Companies				
Loan to Safe Effect (Thailand) Co. Ltd	-	-	-	-
Loan to Advanced Braking Pty Ltd	-	-	9,824	8,024
Total Loans	-	-	9,824	8,024

The loans to subsidiary companies are at call and are interest free and are treated by the Parent as an investment in subsidiaries. The loans have been carried at the Directors estimate of fair value. Refer Note 9.

b) Directors and Key management personnel
2010
During the year to 30 June 2010 ordinary shares were issued to Mr Humann, Professor Richmond and Mr Slack in satisfaction of Directors fees. These Director transactions were approved by shareholders in General Meeting on 2 November 2009. The transactions were as follows:

- On 24 July 2009, the issue of 2,498,005 shares to Mr Humann and 1,427,432 shares to Professor Richmond both issues being at 1.4 cents per share, in payment of their Directors Fees to 30 June 2009. The shares were priced at the ASX volume weighted average price in the month leading up to 30 June 2009.
- On 29 January 2010, the issue of 1,327,586 shares to Mr Humann, 689,655 shares to Professor Richmond and 427,276 shares to Mr Slack, all the issues being at 2.9 cents per share, in payment of their Directors Fees to 31 December 2009. The shares were priced at the ASX volume weighted average price in the month leading up to 31 December 2009.

During the year to 30 June 2009 ordinary shares were issued to Professor Richmond and Mr Humann in satisfaction of Directors fees. These Director transactions were approved by shareholders in General Meeting on 18 October 2008. The transactions were as follows:

- On 7 July 2008, the issue of 1,091,700 shares to Professor Richmond and 1,786,440 shares to Mr Humann, both issues being at 1.911 cents per share, in payment of their Directors Fees to 30 June 2008. The shares were priced at the ASX volume weighted average price in the month leading up to 30 June 2008.
- On 7 January 2009, the issue of 1,718,213 shares to Professor Richmond and 3,006,873 shares to Mr Humann, both issues being at 1.164 cents per share, in payment of their Directors Fees to 31 December 2008. The shares were priced at the ASX volume weighted average price in the month leading up to 31 December 2008.

Advanced Braking Technology Components Top 20 Shareholders Source: 2010 Annual Report page 93:

	No. of Shares	%
1 Windpac Pty Ltd	105,799,750	11.89
2 530 Collins St Pty Ltd	33,649,127	3.78
3 MR Richard Andrew Palmer	24,334,036	2.73
4 Mrs Tracey-Ann Palmer	22,144,893	2.49
5 Mr Dale Albert Monson & Mrs Dagmar Erna Monson <Dale Monson S/F NO. 2 A/C>	21,865,697	2.46
6 Mr Richard Palmer & Mrs Tracey-Ann Palmer <PALMER FAMILY RETIRE A/C>	20,000,000	2.25
7 Knarf Investments Pty Ltd <Terrigal A/C>	15,145,980	1.70
8 Lost Ark Nominees Pty Ltd <Mya Super A/C>	15,112,500	1.70
9 Claymore Capital Pty Ltd	13,937,500	1.57
10 Mr Jim Sumpter & Mrs Dale Elizabeth Sumpter	13,864,169	1.56
11 Mr David Humann & Mrs Anne Humann <David & Anne Humann S/F A/C>	13,378,323	1.50
12 Galvale Pty Ltd	13,097,882	1.47
13 Mr Peter Rodney Bower	12,563,299	1.41
14 Mondale Investments Pty Ltd	12,273,927	1.38
15 Annapurna Pty Ltd	12,000,000	1.35
16 R E Jones Properties Pty Ltd <Greenhill Property A/C>	10,829,399	1.22
Spinite Pty Ltd	10,375,000	1.17
17 Kittredge Pty Ltd	10,329,399	1.16
18 Cautious Pty Ltd <The Reserve A/C>	10,011,667	1.13
19 Valette Pty Ltd <McCleland Family A/C>	9,650,000	1.08
20 Mr John Lindsay Cutbush & Mr Duncan Lindsay Cutbush <Cutbush Family S/F A/C>	8,309,882	0.93
	408,672,430	45.93

Directors of Advanced Engine Components
Mr. Graham Keys BEc (Monash) ACA FFin MAICD(Dip) (Non-executive Chairman)
Mr. Keys is a former corporate finance partner of Ernst & Young. He has experience as Executive Director, and subsequently Managing Director, of a publicly listed company, as non-executive Chairman of publicly listed companies and as the executive officer of two large private companies. He formed Norvest Corporate Pty Ltd, a specialist corporate advisory firm, in April 2000 and is the current Executive Chairman of that company. He was appointed a Non-executive Director of AEC on 9 May 2003 and Chairman on 19 October 2004. During the past three years, Mr. Keys has also served as a director of Brand New Vintage Ltd, Cape Range Wireless Ltd and Sterling Biofuels International Ltd.

Mr. Antony Middleton BE MBA FIE (Aust) FCILT (Managing Director)
Mr. Middleton holds a Bachelor of Engineering and Master of Business Administration from the University of Western Australia, and a Company Directors' Diploma from the University of New England. Mr. Middleton has held senior management positions with government agencies including Chairman and Chief Executive Officer of Transperth and also on various international engineering projects. He is past National Chairman and a Fellow of the Chartered Institute of Logistics and Transport in Australia, and a Fellow of the Institution of Engineers (Australia). Mr. Middleton is currently the President of Natural Gas Vehicles for Australia (NGVA) the body representing all sectors of the natural gas vehicle industry in Australia. Mr. Middleton was appointed a Director of AEC in March 1997 and Chairman in December 2002. He retired as Chairman and was appointed Managing Director in August 2003. During the past three years Mr. Middleton has not served as a director for any other Australian listed companies.

Mr. Kin Wa Pun (Albert) MSC BSocSc (Non-Executive Director)
Mr Pun has significant international investment experience. Mr Pun is the Managing Director and founder of Cherry Capital Management Limited ('Cherry'), a Hong Kong based financial advisory company, providing strategic and financial advice to its clients. He is currently appointed as the Chief Advisor of KGI Asia Limited, a Hong Kong based regional investment bank. Prior to joining Cherry, Mr Pun was the Chief Financial Officer and a member of the board of Directors of KG Investment Holdings Limited, a regional financial services group in Hong Kong. Both KGI Asia Limited and KG Investment Holdings Limited are part of the Koos Group which is one of the largest business groups in Taiwan. Mr Pun also previously worked at Morgan Stanley Asia Limited as Vice President. Mr Pun has a Master of Sciences and Bachelor of Social Sciences degree from the University of Hong Kong. Mr. Pun was appointed a Non-executive Director of AEC on 28 November 2006. During the past three years Mr. Pun has not served as a director for any other Australian listed companies.

Mr. Ming Fai (Arnold) Chan BSocSc (Non-Executive Director) (Resigned 24 September 2010)
Mr Chan has significant international investment experience. He is currently the Chief Executive Officer of Full Seas Technology Limited which is a technology provider for an

intelligent management system used in electric power network in some Chinese cities. Prior to that, he was the President of Dandelion Capital Group ('Dandelion'), a company focusing on special situation investment opportunities in China. Mr Chan has over twenty years experience in investment advisory and asset management. He established Dandelion, in 2006, and co-founded the KGI Group, a pan-Asian investment bank, in 1997. He has also worked with HSBC and Jardine Fleming, based in Hong Kong, with responsibilities throughout Asia. Mr Chan is an independent non-executive Director of China LotSynergy Holdings Limited a company listed on the Hong Kong stock exchange. Mr Chan has a Bachelor of Social Sciences degree from the University of Hong Kong with a major in Economics. Mr. Chan was appointed a Non-executive Director of AEC on 28 May 2009. During the past three years Mr. Chan has not served as a director for any other Australian listed companies.

Mr. Vivekananthan MV Nathan (Non-Executive Director) (Appointed 18 February 2010)
Mr Nathan is the Deputy Chairman of Deleum Berhad ('Deleum') a Malaysian based public listed company. Deleum was incorporated in November 2005 and is the holding company of Delcom Services Sdn Bhd (DSSB). DSSB has been supplying a diverse range of supporting specialised products and services to the oil and gas industry for over 25 years. Mr Nathan is a co-founder of DSSB. He joined ESSO Malaysia in 1962 in the Instrumentation and Electrical Engineering Services Department and undertook assignments at ESSO refineries in Malaysia and Thailand. He then worked for Mobil Refinery, Singapore and subsequently as Project Engineer with Avery Laurence (S) Pte Ltd on various projects in Brunei, Thailand and Indonesia and also attended training in Japan with Yokogawa Electric Works. He later joined Teledyne Inc. and was based in the USA for training in management before being posted as its Marketing Director of the Far East Operations. In 1982, together with his founding partners he spearheaded DSSB's venture into the oil and gas industry and was appointed as its Managing Director and later re-designated as President. He was appointed the Deputy Executive Chairman of Deleum in 2006 and re-designated to his current position in June 2010. Mr Nathan is a Council Member of the Malaysian Gas Association and sits on the boards of World Gas Conference (WGC) 2012, Malaysia Deepwater Production Contractors Sdn Bhd and Malaysia Deepwater Floating Terminal (Kikeh) Ltd.

Mr. Manharlal Bhaichand Gathani Jain (Non-Executive Director) (Appointed 18 February 2010)
Mr Gathani is a Director of PKF Tax Services Sdn Bhd in Malaysia and a Fellow of the Malaysian Institute of Taxation. He joined the Inland Revenue Board of Malaysia (IRB) soon after completing his Bachelor of Arts at the University of Malaya. His long service culminated in the Directorship of the East Malaysian IRB office of Sabah in 1975. He was awarded the 'Ahli Darjah Setia Kinabalu' (ADSK) title by the Yang Di Pertua Sabah in 1978. He has successfully integrated his long civil service career with a successful professional practice since his departure from the IRB. Mr Gathani's experience and interpretation of the tax laws have gained him wide recognition in the business community. He has acted as an advisor to a number of corporations for all kinds of strategic tax and business related matters. He has also served in the publication committee of the Malaysian Institute of Taxation.

Source 2010 Annual Report Advanced Engine Components p. 3-4.

In terms of Board Diversity, Advanced Engine Components on page 18 of its 2010 Annual Report states:

'The Board has not developed a specific diversity policy, however strictly adheres to its equal opportunity and antidiscrimination commitments in the Company's Code of Conduct. Given the present size of the Company and the historical hiring rate, the Board believes no greater diversity or other benefits could be gained by establishing a diversity policy. The Board will re-consider establishing a diversity policy as the Company's operations and employee numbers grow. If an existing position becomes available within the Company, diversity within the organisation will be considered when reviewing candidates for the position. AEC encourages women to apply for positions that become available, currently 20% of the AEC Group employees are female.'

Note 29. Related Party Disclosure Advanced Engine Components (ASX Code ACE)
Transactions and balances with Key Management Personnel
Directors
Mr Keys
Mr Keys is a Director and the major Shareholder of Norvest Corporate Pty Ltd, which provides various corporate, capital raising, accounting, management and company secretarial services to the Company at normal commercial rates. During the year Norvest Corporate Pty Ltd supplied these services to the Company to the value of $297,812 (2009: $286,088). As at 30 June 2010, the Company owed Norvest Corporate Pty Ltd $342,409 (2009: $234,733), this amount is reflected in payables and is non interest bearing. During the year, Norvest Corporate Pty Ltd made various unsecured loans to the Company with a maximum outstanding at any point in time of $46,361 (2009: $300,000). At 30 June 2010 the amount outstanding was $Nil (2009: $46,361). Interest of 15% pa was payable on the daily outstanding balance. In April 2009, Norvest Corporate Pty Ltd facilitated refinancing of the CIM SSF $750,000 loan through a syndicate of investors. Mr Keys, through his private company Seibu Pty Ltd ATF G L Keys FT, provided $315,000 of the funding. Pursuant to the terms of the refinancing, and shareholder approval granted on 3 July 2009, Seibu Pty Ltd is entitled to receive interest of 15% pa, calculated on the outstanding daily loan balance, and has been granted 4,117,000 options. The options are exercisable on or before 30 November 2011 at various exercise prices calculated on the volume weighted average share price in the month preceding the date of issue. $47,250 (2009: $7,897) interest was paid during the year ended 30 June 2010 and $315,000 (2009: $315,000) was still outstanding as at 30 June 2010. During the year Norvest Corporate Pty Ltd facilitated $400,000 of the rights issues monies be placed on deposit at call with an associated company. The monies on deposit earned 9% pa interest. At 30 June 2010 the balance owing to AEC, inclusive of accrued interest, was $318,621. Subsequent to year end AEC has redrawn the deposit in full to meet ongoing cash flow requirements.

Mr Middleton
Mr Middleton, through his private company Jildane Pty Ltd ATF Middleton Super Fund, provided $30,000 of the syndicate funding to refinance the CIM SSF $750,000 loan. Pursuant to the terms of the refinancing, and shareholder approval granted on 3 July 2009, Jildane Pty Ltd is entitled to receive interest of 15% pa, calculated on the outstanding daily loan balance, and has been granted 368,000 options. The options are exercisable on or before 30 November 2011 at various exercise prices calculated on the volume weighted average share price in the month preceding the date of issue. $4,500 (2009: $1,122) interest was paid during the year ended 30 June 2010 and $30,000 (2009: $30,000) was still outstanding as at 30 June 2010.

Mr Pun
Mr Pun is a Director of AEC's major shareholder 698 Capital International Ltd and its related entity, 698 Capital Asia Pacific Limited ('698 Capital'). In August 2008, 698 Capital agreed to provide AEC with a $2 million sales financing facility. Interest is charged at the National Australia Bank Indicator rate at the time of execution of the agreement together with a $17,500 facility fee. As AEC shareholders agreed to the issue of 5 million options, exercisable at 20 cents on or before 31 December 2010, the interest rate was reduced by 0.75%. 698 Capital subsequently agreed to increase the sales financing facility to $3 million in 2009. 698 Capital received a $16,750 facility fee and 6 million options, as approved by shareholders on 25 November 2009, for increasing and extending the facility. The options are exercisable on or before 30 November 2011 at various exercise prices calculated on the volume weighted average share price in each of the six months preceding the date of issue. In February 2010, 698 Capital's $750,000 short term loan and $3,000,000 sales financing facility, together with all outstanding interest, were consolidated as one loan repayable at call (note 20(vi)). During the 2010 financial year, the $3,000,000 due to 698 Capital under the convertible note that expired on 31 December 2009 (note 20(vii)) was restructured as a non current loan and extended to 31 December 2011 (note 22). The accrued interest on the convertible note was offset against 698 Capital's equity subscription under the rights issue. The Company issued 3,000,000 options to 698 Capital, as approved by shareholders, for extending the loan and in lieu of a 1% increase in the base interest rate on the loan. The options are exercisable on or before 30 November 2011 at an exercise price of 5.5 cents per share. 698 Capital provided $375,000 of the syndicate funding to refinance the CIM SSF $750,000 loan. Pursuant to the terms of the refinancing, and shareholder approval granted on 3 July 2009, 698 Capital is entitled to receive interest of 15% pa, calculated on the outstanding daily loan balance, and has been granted 4,875,000 options. The options are exercisable on or before 30 November 2011 at various exercise prices calculated on the volume weighted average share price in the month preceding the date of issue. Total interest of $56,250 (2009: $14,024) was paid during the year ended 30 June 2010.

Other balances with related parties
The Company has certain loans with 698 Capital Asia Pacific Ltd ('698'), a company of which Mr A Pun is a Director, which are disclosed above and included in notes 20 and 22. 698 has resolved to provide financial support, in circumstances that will enable the Company to be able to meet its debts as and when they fall due, at least until one year

from signature of the Directors Declaration. This support is subject to 698 Capital International Limited remaining the majority shareholder of the company.

Advanced Engine Components Top 20 Shareholders Source: 2010 Annual Report page 78:

		No. of Shares	%
1	698 Capital International Ltd	84,423,731	41.45
2	Mr Vivekananthan M V Nathan	30,590,910	15.02
3	HSBC Custody Nominees (Australia) Limited	14,416,682	7.08
4	Seibu Pty Ltd GL Keys Super Fund Account	4,933,334	2.42
5	DBS Vickers Securities (Singapore) Pte Ltd	3,801,336	1.87
6	Citicorp Nominees Pty Limited	2,666,666	1.31
7	Mr Mark John Conway	2,629,203	(a) 1.29
8	Jildane Pty Ltd <Middleton Super Fund A/C>	2,091,336	1.03
9	Jildane Pty Ltd <Middleton Super Fund A/C>	2,047,853	1.01
10	Mr. Paul Massarotto	1,893,185	0.93
11	Mr Paul Robert Baster <Baster Family A/C>	1,700,000	0.83
12	Jingie Investments Pty Ltd	1,600,000	0.79
13	H L Fry Holdings Pty Ltd <Super Fund No 2 Account>	1,200,000	0.59
14	Rodney Ralph Gregory and Philip Geoffrey Gregory	1,017,000	0.5
15	Mr Boyd Stewart Milligan	948,418	0.47
16	Mr Paul Robert Baster <Baster Family Account>	900,000	0.44
17	Jildane Pty Ltd	874,075	0.43
18	Mr Robert Bruce Thompson & Mrs Lorraine Florence Thompson <RB & LF Thompson S/P/F A/C>	830,000	0.41
19	Mr Allan Graham Jenzen & Mrs Elizabeth Jenzen <A&E Jenzen P/L No.2 S/F A/C>	750,000	0.37
20	Aileendonan Investments Pty Ltd	700,000	0.34

2b. What is the proportion of each board that is independent?
Despite having four out of five directors as non-executive, Advanced Engine Components has only two out of five independent directors. That is, there is not a majority of independent directors on its board. The following extract from page 19 of the 2010 Advanced Engine Components provides the rationale for this assessment.

'The Board considers Mr Keys and Mr Gathani to be independent based on the criteria for independence included in the Company's *Policy on Assessing the Independence of Directors* and the ASX Principles & Recommendations. When applying the Company's

Policy on Assessing the Independence of Directors and the ASX Principles & Recommendations Mr Pun is not considered an independent Director due to his direct association with the major shareholder of the Company and Mr. Nathan is not considered an independent Director due to his significant shareholding. As only two of the five Directors are independent, there is not a majority of independent Directors on the Board. The Board believes that given the size and scale of the Company, it is not practical to have a majority of independent Directors. The Board will continue to reassess its composition on a regular basis to ensure it has the necessary skill set and decision making capabilities to best serve all shareholders.'

For Advanced Braking Technology, three of five directors are independent and hence a majority of the board is independent (refer page 11 of the 2010 Annual Report).

'The Board comprises three non-executive independent Directors. Details of the Directors are set out in the Directors' Report.'

'Independence of Directors
The Board has reviewed the position and associations of all non-executive Directors in office at the date of this report and considers that all the Directors are independent. In considering whether a Director is independent, the Board has regard to the independence criteria in ASX Best Practice Recommendations Principle 2 and other facts, information and circumstances that the Board considers relevant. The Board assesses the independence of new Directors upon appointment and reviews their independence, and the independence of the other Directors, as appropriate. The Board considers that all Directors meet the criteria in ASX Principle 2. They have no material business or contractual relationship with the Company, other than as Directors and Shareholders, and no conflicts of interest which could interfere with the exercise of independent judgement. Accordingly, they are considered to be independent.'

2c. Why does director independence matter to shareholders?

Independence matters to shareholders because board members have significant responsibilities in advising, challenging, and compensating management. If a board member is not independent from management, they may be unable to complete their responsibilities in a manner that is consistent with the best interests of the shareholders. Public disclosure of audit and other fees paid to the audit firm is important in helping shareholders assess auditor independence. With these disclosures, shareholders can better understand the relative size of the audit engagement to the other engagements by the same firm and they can be assured that non-audit fees do not dwarf audit fees to such a great extent that the auditor is no longer independent economically or in mental attitude.

2d. What characteristics are the companies seeking when considering individuals to serve on their boards?

Advanced Braking Technology states the following on page 11 of its 2010 Annual Report:

'The Board seeks to establish a Board that consists of Directors with an appropriate range of experience, skill, knowledge and vision to enable it to operate the Company's business with excellence. To maintain this, the Company's policy is that non-executive directors should serve at least 3 years. At the completion of the first 3 years, the position of the Director is reviewed to ascertain if circumstances warrant a further term.'

Advanced Engine Components does not make a similar statement.

2e. How are board members compensated? Could the nature of the compensation potentially affect the directors' independence? Explain.

The issue of director compensation and independence is important because directors are the last line of management oversight and protection against management override. If the amount of share ownership were to become very high in relationship to the directors' net worth, then there might be a question as to whether director's would make accounting decisions based on the effect it might have on share prices.

In the case of Ford, approximately $40,000 of stock would not be significant enough to any of the independent directors that it would affect accounting decisions. Further, the value of the company's shares is more important over the longer run and would help the directors focus on building long-term value for the company. That objective should align them with the shareholders best interest.

Advanced Engine Components Source: 2010 Annual Report page 13 discloses:

Remuneration of Directors

	Short Term Salary & Fees $	Post Employment Superannuation $	Long Term Long Service Leave Provision $	Share-based Payment Options $	Total $	% of Value of Remuneration that Consists of Options
Mr G Keys	25,000				25,000	
Mr A Middleton	65,869	102,557	3,714		172,140	
Mr A Pun	-	-	-	-	-	
Mr A Chan	15,000				15,000	
Mr V Nathan	-	-	-	-	-	
Mr M Gathani	-	-	-	-	-	

Advanced Engine Components Source: 2010 Annual Report page 5 discloses:

'DIRECTORS' INTERESTS
As at the date of this report, the interests of the Directors in the shares and options of Advanced Engine Components
Limited were:

Director	Number of Ordinary Shares	Number of Options over Ordinary Shares
Mr. G Keys (ii)	4,933,334	4,392,000
Mr. A Middleton (ii)	5,013,264	768,000
Mr. A Pun (i)(ii)	333,334	18,875,000
Mr V Nathan	30,590,910	-
Mr M Gathani	-	-

Advanced Braking Technology Source: 2010 Annual Report page 23 discloses:

	Salary & Fees	Post Employment Super	Equity Share Options	Equity Ordinary Shares	Total
D.Humann	-	-	-	70,000	70,000
M.Richmond	-	-	-	40,000	40,000
D.Slack	-	-	-	32,291	32,291
K.Johnsen	275,229	24,771	40,500	-	340,500

That is, non-executive directors are paid only in ordinary shares and the executive director is paid salary and options in an attempt to align interests.

Advanced Braking Technology Source: 2010 Annual Report page 23 discloses:
Directors' interests
The relevant interest of each Director in the share capital of the Company, as notified by the Directors to the Australian Stock Exchange in accordance with s205G(1) of the *Corporations Act 2001*, at the date of this report is as follows:

Director	Ordinary shares
D Humann	13,378,323
M Richmond	8,117,211
D Slack	113,832,883
K Johnsen	1,559,818

The relevant interest of each Director in share options of the as notified by the Directors to the Australian Stock Exchange in accordance with S205G(1) of the *Corporations Act 2001*, at the date of this report is as follows:

Director	Unlisted options
D Humann	nil
M Richmond	nil
D Slack	20,000,000
K Johnsen	7,500,000

Note 19, page 64, discloses that Contributed Equity consists of 769,454,464 shares, so D. Slack with the largest holding has 15% of issued shares.

Advanced Braking Technology Source 2010 Annual Report, pages 25-26 discloses that:
'Remuneration Policy
The remuneration policy of the Company is to pay non executive Directors and specified executives at market rates which are sourced from average wage and salary publications. In addition Directors and employees are issued share options to encourage loyalty and provide an incentive through the sharing of wealth created through equity growth which is linked to Company performance. The Remuneration Committee members believe the remuneration policy to be appropriate and effective and tailored to increase congruence between shareholders and Directors and executives.

The board seeks to set aggregate remuneration at a level that provides the Company with the ability to attract and retain directors of the highest calibre, whilst incurring a cost that is acceptable to shareholders.

The amount of aggregate remuneration sought to be approved by shareholders and the fee structure is reviewed against fees paid to non-executive directors of comparable companies. The Company's constitution and the ASX listing rules specify that the non-executive directors' fee pool shall be determined from time to time by a general meeting. The latest determination was at the 2005 annual general meeting (AGM) held on 1 November 2005 when shareholders approved an aggregate fee pool of $300,000 per year.

The board will not seek any increase for the non-executive directors' pool at the 2010 AGM.

Structure
The remuneration of non-executive directors consists of directors' fees. Non-executive directors do not receive retirement benefits, nor do they participate in any incentive programs. Each non-executive director received a base fee of $40,000 for being a director of the Group. An additional fee of $30,000 is paid to the Chairman.'

3a. Describe each company's audit committee and its duties.

Advanced Braking Technology Source 2010 Annual Report page 13:
'AUDIT COMMITTEE
The Board has delegated the Audit review responsibilities to a sub-committee of the Board, consisting of two non executive Directors, Professor Malcolm Richmond (Chairperson) and Mr David Slack. Meetings are held throughout the year between the Audit Committee, the Company's CFO and the auditors to discuss the Company's ongoing activities and to discuss any proposed changes prior to their implementation and to seek advice in relation thereto. The Board has no formal procedures for the selection, appointment or rotation of its external auditor but reviews this matter on an ongoing basis and implements changes as required.'

Advanced Engine Components Source 2010 Annual Report page 20:

'Audit Committee
To assist in the execution of its responsibilities, the Board has established an Audit Committee. The primary role of the Audit Committee is to monitor and review, on behalf of the Board, the effectiveness of the control environment of the Group in the areas of operational and balance sheet risk, legal/regulatory compliance and financial reporting. The overriding objective of the Committee is to provide an independent and objective review of financial and other information prepared by management, in particular that to be provided to members and/or filed with regulators. The Committee meets and receives regular reports from its external auditors concerning matters that arise in connection with their audit. The Committee is also responsible for review of performance of the external auditors.

The Committee is comprised of Mr Graham Keys (Chairman) and Mr Albert Pun both of whom are non-executive Directors. Mr Graham Keys is considered independent. Details of the Directors' attendance at the Audit Committee meetings are set out in the Directors' Report.

The Audit Committee provides recommendations to the Board in relation to the initial appointment of the external auditor and the appointment of a new external auditor should a vacancy arise. Any appointment of a new external auditor made by the Board must be ratified by shareholders at the next annual general meeting.

Proposed external auditors must be able to demonstrate complete independence from the Group and an ability to maintain independence through the engagement period. In addition, the successful candidate for external auditor must have arrangements in place for the rotation of the audit engagement partner on a regular basis. Other than these mandatory criteria, the Board may select an external auditor based on other criteria relevant to the Company such as references, cost and any other matters deemed relevant by the Board.

A formal Audit Committee Charter has been adopted, a copy of which is available on the Company's website. The Company Secretary provides secretarial services for the audit committee, whilst the Managing Director and Finance Manager are invited to audit committee meetings in attendance only.'

3b. Who could be designated as financial expert(s) on the audit committee?
For Advanced Engine Components Mr Keys, disclosed in the description of directors as a former corporate finance partner of Ernst & Young, could be considered as a financial expert.

For Advanced Braking Technology Mr Humann could be considered as a financial expert. He is described on page 19 of the 2010 Annual Report as 'a Fellow of the Institute of Chartered Accountant, A Fellow of the Institute of Certified Practicing Accountants and Fellow of the Australian Institute of Company Directors. He was Chairman and Senior Partner of Price Waterhouse (Hong Kong and China firm) from 1986 until 1994. Mr Humann was also the Managing Partner of Price Waterhouse, Asia Pacific Region, and a member of the World Board of Price Waterhouse and of the global firm's World Executive Committee based in London and New York.' In addition, Professor Malcolm Richard may be a financial expert because he is described as a visiting Professor of Business at the University of Western Australia, however, his qualifications are not disclosed.

3c. What was the attendance record of directors and audit committee members at meetings?

Advanced Engine Components Source 2010 Annual Report page 9:
'MEETINGS OF AUDIT COMMITTEE
'The Company's Audit Committee comprised of two non-executive Directors, Mr. G Keys and Mr. A Pun. During the financial year, two Audit Committee meetings were held, which were attended by BDO Audit (WA) Pty Ltd, the Company's auditors.

	Audit Committee	
Members	**Held**	**Attended**
Mr. G Keys (Chairman)	2	2
Mr. A Pun	2	1

3d. What were the audit fees for each company for 2010 and 2009? Did either company purchase non-audit services (NAS) from the auditor. If so, what categories of NAS were purchased? Why are other fees paid to the audit firm important? Why is it important that these fees be disclosed?

Advanced Braking Technology Source 2010 Annual Report page 23:
'Audit Committee meetings
During the financial year there were 2 meetings of the Audit Committee. The attendances of the Audit Committee During the year Professor Richmond retired from the Audit committee and the vacancy was filled by Mr Slack. Members at these meetings were:

	Meetings	
	Attended	**Possible Attended**
D Humann	2	2
D Slack	1	1
M Richmond	1	1'

3e. What are the audit fees as a percentage of (a) total revenue and (b) total assets?

Advanced Braking Technology Source 2010 Annual Report page 54:

	Economic Entity		Parent Entity	
	2010	**2009**	**2010**	**2009**
	$'000	**$'000**	**$'000**	**$'000**
6. AUDITORS' REMUNERATION				
Remuneration of the auditor of the economic entity for:				
Auditing the financial statements	32	30	27	25
Other services - - - -				
	32	30	27	25
Remuneration of auditor Safe Effect (Thailand) Pty Ltd	5	5	-	-

Advanced Braking Technology audit fees as a percentage of:
a. Total Revenue=32,000/227,000=14.10%
b. Total Asset =32,000/5,319,000=0.60%

Advanced Engine Components Source 2010 Annual Report page 49:
12. Remuneration of Auditors

	2010	**2009**
	$	$
Auditors of the Group - BDO Audit (WA) Pty Ltd: audit and review of the financial report		
- Current year	36,447	51,966
Auditors of subsidiary – BDO China		
- Current year	6,860	15,984
	43,307	67,950

Advanced Braking Technology audit fees as a percentage of:
a. Total Revenue=43,307/1,647,506=2.63%
b. Total Asset =43,307/9,362,022=0.46%

Neither company purchases non audit services from its auditor.

3f. With which of the ASX Corporate Governance Recommendations does each company not comply? What are the disadvantages to shareholders of such non-compliance? What, if any, are the differences in corporate governance mechanisms adopted by each company?

Advanced Engine Components Non-Compliance Source: Extract from Annual Report pages 23-25:
'2.1 A majority of the Board should be independent Directors.

Currently, the Company has two independent Directors and three Directors that are not considered to be independent.
The Board considers that its structure has been, and continues to be, appropriate in the context of the Company's recent history and the scope and scale of the Company's operations. Persons have been selected as Directors to bring specific skills and industry experience relevant to the Company. The Board will continue to reassess its composition on a regular basis to ensure it has the necessary skill set and decision making capabilities to best serve all shareholders.

2.4 The Board should establish a nomination committee.
The Board has not established a separate nomination committee, however, the responsibilities of a nomination committee are carried out by the full Board.
Given the present size of the Company, the whole Board acts as a nomination committee, if required. The Board believes no efficiencies or other benefits could be gained by establishing a separate Nomination Committee. However, it is noted the Board has adopted a Nomination Committee Charter. The Board will re-consider establishing a separate Nomination Committee as the Company's operations grow.

2.5 Companies should disclose the process for evaluating the performance of the Board, its committees and individual Directors.
The Company has in place informal procedures for evaluating the performance of the Board, its committees and individual Directors.
At this stage of the development of the Company, only informal procedures are in place for performance evaluation of the Board, its committees and individual Directors against qualitative indicators. During the financial year 2010 the Company undertook steps to roll out an employee survey as part of a 12 month action plan. The survey will evaluate the performance of senior executives and the Board. The completion of the employee survey is expected to be in the months following the end of financial year.

3.2 Companies should establish a policy concerning diversity including measurable objectives for achieving gender diversity.
The Board has not developed a specific diversity policy, however strictly adheres to its equal opportunity and anti-discrimination commitments in the Company's Code of Conduct.
Given the present size of the Company and the historical hiring rate, the Board believes no greater diversity or other benefits could be gained by establishing a diversity policy. The Board will re-consider establishing a diversity policy as the Company's operations and employee numbers grow. If an existing position becomes available within the Company, diversity within the organisation will be considered when reviewing candidates for the position.

4.2 The Audit Committee should consist of a majority of independent Directors, be chaired by an independent Director who is not Chair of the Board and have at least 3 members.

Currently, the Audit Committee has one independent Director and one Director who is not considered to be independent. There are only two members of the Audit Committee and the Committee is chaired by the Chairman of the Board.
The Board considers that the structure of the Audit Committee has been, and continues to be, appropriate in the context of the Company's recent history and the scope and scale of the Company's operations and given the size of the Board. The members of the Committee have specific skills and experience relevant to the efficient operation of the Committee. The Board will continue to reassess its composition of the Audit Committee on a regular basis to ensure it has the necessary skill set and experience to best serve the Board and all shareholders. It is noted the Chairman of the Committee, whilst Chair of the Board, is an independent Director that possesses skills and experience suitable for leading the Audit Committee.

8.1 The Board should establish a remuneration committee.
The Board has not established a separate remuneration committee however, the responsibilities of a remuneration committee are carried out by the full Board.
Given the present size of the Company, the whole Board acts as a remuneration committee, if required. The Board believes no efficiencies or other benefits could be gained by establishing a separate remuneration committee. All matters of remuneration are determined by the Board in accordance with Corporations Act requirements, particularly in respect of related party transactions. No director participates in any discussion or decision regarding his own remuneration or related issues. The Board has adopted a Remuneration Committee Charter and Remuneration Policy.'

Advanced Braking Technology Non-Compliance Source: Extract from Annual Report pages 15-18:
'ASX BEST PRACTICE RECOMMENDATIONS
Recommendation 3.3: Provide the information indicated in 'Guide to Reporting on Principle 3'.
The Company has made available a summary of its Code of Conduct and securities trading policy in this statement, but has not otherwise made this information publicly available.

Recommendation 4.3: Structure of the Audit Committee so that it consists of:
- only Non-Executive Directors;
- a majority of Independent Directors;
- an independent Chairperson, who is not chairperson of the Board;
- at least three members.
The Audit committee consists of two non Executive Directors with an independent Chairperson who is not the Chairperson of the Board.

Recommendation 7.3: Provide the information indicated in 'Guide to Reporting on Principle 7'.
The Company has provided relevant information in this Statement upon recognising and managing risk, but has not otherwise made a description of its risk management policy and internal compliance and control system publicly available.

Pursuant to the ASX Listing Rules, the Company advises that it does not comply with the following Best Practice Recommendations, issued by the ASX Corporate Governance Council. Reasons for the Company's non-compliance are detailed below.

Recommendation 2.4: The Board should establish a Nomination Committee.
The functions to be performed by a nomination committee under the ASX Best Practice Recommendations are currently performed by the full Board and this is reflected in the written policy setting out the responsibilities of the Board. Having regard to the number of members currently comprising the Company's Board, the Board does not consider it appropriate to delegate these responsibilities to a sub-committee. These arrangements will be reviewed periodically by the Board to ensure that they continue to be appropriate to the Company's circumstances.

Recommendation 2.5: Provide the information indicated in 'Guide to reporting on Principle 2'.
One of the matters to be included in the corporate governance section of the Annual Report pursuant to the *Guide to reporting on Principle 2* is *'the names of members of the nomination committee and their attendance at meetings of the committee'*. As stated in the previous paragraph, the Board does not consider it appropriate for the Company to establish a nomination committee and therefore this information has not been included in the annual report or otherwise made publicly available. In all other respects, the Company has complied with the disclosure requirements contained in the *Guide to reporting on Principle 2* by the inclusion of information in this Statement, but has not otherwise made the information publicly available.

Recommendation 9.2: The Board should establish a Remuneration Committee.
The functions to be performed by a remuneration committee under the ASX Best Practice Recommendations are currently performed by the full Board and this is reflected in the written policy setting out the responsibilities of the Board. Having regard to the number of members currently comprising the Company's Board, the Board does not consider it appropriate to delegate these responsibilities to a sub-committee. These arrangements will be reviewed periodically by the Board to ensure that they continue to be appropriate to the Company's circumstances.

Recommendation 9.5: Provide the information indicated in 'Guide to reporting on Principle 9'.
One of the matters to be included in the corporate governance section of the Annual Report pursuant to the *Guide to reporting on Principle 9* is "*the names of members of the remuneration committee and their attendance at meetings of the committee*". As stated in the previous paragraph, the Board does not consider it appropriate for the Company to establish a remuneration committee and therefore this information has not been included in the annual report. However as the Board fulfils the role of the remuneration committee, details of the Company's Directors and their attendance at Board meetings are set out in the Company's Annual Report. In all other respects, the Company has complied with the disclosure requirements contained in the *Guide to reporting on Principle 9*.

4a. Review the code of ethics for senior management and the board of directors. What are the main components of these codes? Provide a critique of the components and overall message contained in the codes.

Advanced Engine Components Source 2010 Annual Report pages 22-23:
'Code of Conduct
The Company has adopted a Code of Conduct that outlines how the Company expects its Directors and employees to behave and conduct business in the workplace on a range of issues. The Company is committed to the highest level of integrity and ethical standards in all business practices. The objective of the Code is to:

- provide a benchmark for professional behaviour;
- support the Company's business reputation and corporate image; and
- make Directors and employees aware of the consequences if they breach the code.

The Code records the Company's commitment and responsibilities with respect to various stakeholders, in particular, employees, clients, shareholders, governments and surrounding communities. It sets out the Company's expectations of its Directors and employees with respect to a range of issues including compliance with the law, fair dealing, discrimination, financial inducements, occupational health and safety, confidentiality of information, conflicts of interest, use of Company assets and outside employment. A breach of the code is subject to disciplinary action which may include termination of employment. A summary of the Code of Conduct is available on the Company's website.

Ethical Standards
The Board considers that the success of the Company will be enhanced by a strong ethical culture within the Group. Accordingly, the Board is committed to the highest level of integrity and ethical standards in all business practices. Employees must conduct themselves in a manner consistent with current community and corporate standards and in compliance with all legislation.

Guidelines for Dealing in Securities
The Guidelines for Dealing in Securities Policy adopted by the Board prohibits trading in shares by a Director, officer or employee during certain blackout periods (in particular, prior to release of interim or annual results) except in exceptional circumstances and subject to procedures set out in the Guidelines. Outside of these blackout periods, a Director, officer or employee must first obtain clearance in accordance with the Guidelines before trading in shares. For example:

- a Director must receive clearance from the Chairman before he may buy or sell shares;
- if the Chairman wishes to buy or sell shares he must first obtain clearance from the Managing Director; and
- other officers and employees must receive clearance from the Managing Director before they may buy or sell shares.

Directors must advise the Company Secretary of any transactions conducted by them in securities of the Company as soon as reasonably possible after the date of the change and in any event no later than three business days after the date of the change.
Directors, officers and employees must observe their obligations under the Corporations Act not to buy or sell shares if in possession of price sensitive non-public information and that they do not communicate price sensitive non-public information to any person who is likely to buy or sell shares or communicate such information to another party. A summary of the Guidelines for Dealing in Securities Policy is available on the Company's website.'

Advanced Braking Technology Source 2010 Annual Report pages 13-14:
'ETHICAL STANDARDS
In pursuit of the highest ethical standards, the Company has adopted a Code of Conduct which establishes the standards of behaviour required of Directors and employees in the conduct of the Company's affairs. This Code is provided to all Directors and employees. The Board monitors implementation of this Code. Unethical behaviour is to be reported to the Company's Managing Director (or in his place the Chairperson) as soon as practicable. The Code of Conduct is based on respect for the law, and acting accordingly, dealing with conflicts of interest appropriately, using the consolidated entity's assets responsibly and in the best interests of the Company, acting with integrity, being fair and honest in dealings, treating other people with dignity and being responsible for actions and accountable for the consequences.

TRADING IN THE COMPANY'S SECURITIES BY DIRECTORS AND EMPLOYEES
The Board has adopted a policy in relation to dealings in the securities of the Company which applies to all Directors and employees. Under the policy, Directors are prohibited from short term or 'active' trading in the Company's securities and Directors and employees are prohibited from dealing in the Company's securities whilst in possession of price sensitive information. The Company's Managing Director (or in his place the Chairperson) must also be notified of any proposed transaction. This policy is provided to all Directors and employees. Compliance with it is reviewed on an ongoing basis in accordance with the Company's risk management systems.'

4b. What, if any, guidelines does management provide as to how deviations from each company's code of ethics will be handled?

Advanced Engine Components Source: 2010 Annual Report page 22 and website (http://www.advancedengine.com/InvestorRelations) accessed 21 November 2011 states: 'A breach of the code is subject to disciplinary action which may include termination of employment.'
Advanced Braking Technology appears not to have either in its 2010 Annual Report or on its website any guidelines in relation to breaches of the company's code of ethics.