

CONSULTATION PAPER

CP 01/11
(June 2011)



Consultation Paper: Proposed Definition of *Public Interest Entity* for the Code

Prepared and issued by **Accounting Professional & Ethical Standards Board Limited**

Commenting on this Consultation Paper

Comments on this Consultation Paper should be forwarded so as to arrive by **28 July 2011**.

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A copy of all submissions will be placed on public record on the APESB website: www.apesb.org.au.

Obtaining a copy of this Consultation Paper

This Consultation Paper is available on the APESB website: www.apesb.org.au. Alternatively, any individual or organisation may obtain one printed copy of this Consultation Paper without charge until **28 July 2011** by contacting:

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Reasons for issuing Consultation Paper 01/11

Accounting Professional & Ethical Standards Board Limited (APESB) is reviewing the definition of "*Public Interest Entity*" in the revised APES 110 *Code of Ethics for Professional Accountants* (APES 110) in the Australian context. The definition of *Public Interest Entity* is central to the "stricter" independence requirements of section 290 of the revised Code.

Proposed operative date

It is intended that this definition of *Public Interest Entity* in the revised APES 110 will be operative from **1 January 2012**.

Request for comments

Comments are invited on this Consultation Paper: Proposed Definition for *Public Interest Entity* by **28 July 2011**. APESB would prefer that respondents express a clear opinion on the specific questions raised and that opinions are supplemented by detailed comments, whether supportive or critical, on any matter. APESB regards both critical and supportive comments as essential to a balanced view of the proposed Standard.

Background

At the November 2010 Board meeting, APESB approved a project to explore further the definition of *Public Interest Entity* in the revised APES 110 *Code of Ethics for Professional Accountants* (the Code) in the Australian context. The current definition of *Public Interest Entity* is the same as the IESBA's definition without any Australian modification or guidance.

At the time of issuing the revised APES 110 the Board considered the definition of *Public Interest Entity* taking into account existing and proposed definitions in several other jurisdictions.

The benefits of having an Australian definition is supported by:

- the professional bodies; and
- Australian Securities and Investments Commission (ASIC).

The professional bodies have asserted that the benefit of an Australian definition is in the public interest and that it would ensure that certain entities would always be treated as *Public Interest Entities* rather than risking non-consensus between firms. The Professional bodies have stated in their submission that they support a *Public Interest Entity* definition in the Australian context.

ASIC has recommended to the APESB that the *Public Interest Entity* be defined with reference to AASB's definition of *Publicly Accountable Entity*. In ASIC's view this represents better practice for Australian entities and their auditors to have consistency in approach in the sense that the entities which are held to the higher financial reporting requirements are the same entities that are held to the stricter auditor independence requirements.

The previous IESBA Code applied the more restrictive auditor independence provisions to Listed Entities. By defining "*Public Interest Entity*" in the manner noted above, IESBA clearly intended that the more restrictive independence requirements to apply to entities where an important public interest exists (i.e. not only Listed Entities). If the intention was to apply only to Listed Entities then limb (a) of the definition would have been sufficient and it would not be necessary to have limb (b) or to change the application from Listed Entities (in the previous IESBA Code) to *Public Interest Entities* in the new IESBA Code.

At the 2010 World Congress of Accountants the IESBA Chairman publicly stated that the definition of *Public Interest Entities* covers more than Listed Entities. As an example, he noted that the European Union (EU) definition captures banks and insurance companies in addition to listed companies.

The Consultation Paper addresses the following matters:

- (i) APESB's proposed definition of a "*Public Interest Entity*" for APES 110;
- (ii) APESB's preliminary views on entities that will generally be captured by the definition of a *Public Interest Entity*; and
- (iii) APESB's view that the definition of a *Public Interest Entity* in APES 110 is different to AASB's definition of a *Publicly Accountable Entity*.

(i) APESB's proposed definition of a "Public Interest Entity" for APES 110

APESB is proposing the following amendments to the definition of "Public Interest Entity" in the revised APES 110.

290.25 Public Interest Entity

- (a) *A Listed Entity; and*
- (b) *An entity (a) defined by regulation or legislation as a public interest entity or (b) for which the audit is required by regulation or legislation to be conducted in compliance with the same Independence requirements that apply to the audit of Listed Entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator.*

290.26 Firms and member bodies ~~shall be encouraged to~~ determine whether to treat additional entities, or certain categories of entities, as Public Interest Entities because they have a large number and wide range of stakeholders. Factors to be considered include:

- *The nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders. Examples may include financial institutions, such as banks and insurance companies, public issuers of debt and equity instruments and pension funds;*
- *Size; and*
- *Number of employees.*

Discussion

APESB proposes to amend paragraph 290.26 to strengthen the requirement and to include the reference to "public issuers of debt and equity instruments".

(ii) APESB's preliminary views on entities that will generally be captured by the definition of a Public Interest Entity

A listed entity in Australia is defined in the *Corporations Act 2001*. The *Corporations Act 2001* defines a listed entity as:

- Listed companies, listed bodies or listed registered scheme (s.9 *Corporations Act 2001*)

Accordingly these entities will be captured by limb (a) of the definition.

In the Australian context, the following entities are likely to have a public interest element or share the need for similar auditor independence requirements as a listed entity:

- Disclosing entities (as defined in section 111AC of the *Corporations Act 2001*);
- Co-operatives that issue debentures to the public;

- Authorized Deposit-taking Institutions (that are subject to APS 510 issued by APRA);
- General Insurance Companies (that are subject to GPS 510 issued by APRA);
- Life Insurance Companies (that are subject to LPS 510 issued by APRA); and
- Australian Government and State, Territory and Local Governments which have tier 1 reporting requirements as defined by AASB 1053.

Disclosing entities

Disclosing entities are defined in section 111AC of the *Corporations Act 2001* in the following manner:

- 1) *If any securities of a body (except interests in a managed investment scheme) are Enhanced Disclosure Securities, the body is a Disclosing Entity for the purposes of this Act.*
- 2) *If any interests in a managed investment scheme are Enhanced Disclosure Securities, the undertaking to which the interests relate is a Disclosing Entity for the purposes of this act.*

Enhanced Disclosure securities are defined in Section 111 AD of the *Corporations Act 2001*.

Co-operatives

Co-operatives which issue debentures to the public will have a *Public Interest* element and thus are likely to be classified as a Public Interest Entity. These entities are also captured in the AASB's definition of Publicly Accountable Entities.

Authorised Deposit-taking Institutions, General Insurance and Life Insurance that are subject to APRA Prudential standards

Australian Prudential Regulatory Authority (APRA) has issued prudential standards that cover Authorised Deposit-taking Institutions (ADIs), Life Insurance, General Insurance, and Superannuation. The prudential standards for Life Insurance, General Insurance and ADIs require the entities captured by these standards to follow similar audit rotation obligations as those of Listed Entities in the *Corporations Act 2001*. Furthermore, these prudential standards require compliance with independence requirements of APES 110.

- ADIs – **Prudential Standard APS 510 Governance** covers Independence tests set out in APES 110 (Para 60) and Auditor rotation (Para 77).
- General Insurance – **Prudential Standards GPS 510 Governance** covers Independence tests set out in APES 110 (Paragraph 62) and Auditor rotation (Paragraph 77); and
- Life Insurance – **Prudential Standards LPS 510 Governance** covers auditor Independence tests set out in APES 110 (Paragraph 58) and Auditor rotation (Paragraph 75);

As ADIs, General Insurance and Life Insurance companies which are subject to the above mentioned prudential standards have similar auditor rotation requirements as per the *Corporations Act 2001* and need to comply with Independence tests set out in APES 110, it could be argued that they satisfy limb (b) of paragraph 290.25 (b).

Public Sector Entities

Australian Government and State, Territory and Local Governments that have tier 1 financial reporting requirements are likely to be considered Public Interest Entities. In classifying these public sector entities to have tier 1 reporting requirements the Australian Accounting Standards Board (AASB) took in to consideration specified criteria cited below in paragraph BC63 of AASB 1053 as a whole, including these entities coercive power to tax, rate or levy. The criteria specified in BC 63 of AASB 1053 are:

- (a) *the entity's coercive power to obtain public funds: the Board noted this notion of coercive power is a narrow criterion and on its own would be helpful only in a limited number of cases for jurisdictions in identifying entities falling under each Tier;*
- (b) *level of public funds used by the entity: entities in the public sector vary in the degree to which they are publicly funded, the discretion over the distribution or expenditure of public funds, and the nature of that spending (for example, operational compared with income redistribution);*
- (c) *risk profile: generally, risk in the public sector is a reference to uncertainty in achieving an organisation's objectives and more comprehensive disclosures may be warranted where an entity is seen as having a high risk profile;*
- (d) *level of complexity: the level of complexity of public sector entities varies with the nature, diversity and range of their activities, which may also point to the existence of a wide range of stakeholders; and*
- (e) *financial profile: the financial profile of a public sector entity may point to its economic significance and ability in providing services, which would in turn have an impact on the level of public interest.*

Accordingly all the entities noted above, ranging from Disclosing entities to public sector entities, are likely to satisfy paragraph 290.25 (b) of the definition.

(iii) APESB's view that the definition of a Public Interest Entity is different to AASB's definition of a Publicly Accountable Entity

APESB considered whether the *Publicly Accountable Entity* definition used in the Australian Accounting Standards means the same as a *Public Interest Entity* for the purpose of APES 110.

Currently in Australia ASIC has not specified in regulation which entities have a public interest element. However, the Australian Accounting Standards Board (AASB) has defined *Publicly Accountable Entity* in AASB 1053 *Application of Tiers of Australian Accounting Standards* (AASB 1053) issued in June 2010. The AASB makes standards under Section 334 of the *Corporations Act* and in effect the standards issued by the AASB are legislative instruments. Accordingly legislation in Australia already specifies which entities have *public accountability*.

The AASB's definition of *Publicly Accountable Entity* is based on the International Accounting Standards Board's (IASB) definition. The IASB define "*public accountability*" to identify entities that are required to prepare financial statements based on full IFRS accounting standards. This definition with additional Australian guidance has been adopted by the AASB in Australia.

Extract from Appendix A of AASB 1053 *Application of Tiers of Australian Accounting Standards*:

Public accountability means accountability to those existing and potential resource providers and others external to the entity who make economic decisions but are not in a position to demand reports tailored to meet their particular information needs.

A for-profit private sector entity has public accountability if:

- (a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
- (b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

In AASB 1053 the AASB has deemed that in the for profit sector the following entities have "Public Accountability".

B2 The following for-profit entities are deemed to have public accountability:

- (a) disclosing entities, even if their debt or equity instruments are not traded in a public market or are not in the process of being issued for trading in a public market;
- (b) co-operatives that issue debentures;
- (c) registered managed investment schemes;
- (d) superannuation plans regulated by the Australian Prudential Regulation Authority (APRA) other than Small APRA Funds as defined by APRA Superannuation Circular No. III.E.1 Regulation of Small APRA Funds, December 2000; and
- (e) authorised deposit-taking institutions.

The tier 1 reporting requirements in AASB 1053 applies to the *Publicly Accountable Entities* in the 'for profit' sector as noted above and Australian Government, State, Territory and Local Government entities.

APESB is aware that AASB went through an extensive due process as part of the differential reporting project to identify which entities in Australia have public accountability.

The Australian regulator, ASIC, believes that the Australian definition for *Public Interest Entities* should be consistent with the definition of *Publicly Accountable Entity* adopted by the Australian Accounting Standard AASB 1053. As noted by ASIC this would increase simplicity and reduce any possible confusion amongst auditors and audit clients of which entities should be treated as having public accountability.

The current proposal in New Zealand is to adopt a *Public Interest Entity* definition which is linked to Issuers and entities subject to tier 1 reporting requirements which is similar to ASIC's preferred option.

In October 2009 the Australian Auditing and Assurance Standards Board (AUASB) issued Auditing Standard ASA 102 *Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements* (ASA 102). ASA 102 is a legislative instrument made under the *Corporations Act 2001* and specifies that in Australia the relevant ethical requirements are specified in APES 110. Accordingly ASA 102 provides APES 110 with a certain level of legal status in respect of *Corporations Act* audits.

If viewed in a "principles" based manner, it can be argued that in substance the *Public Interest Entity* and *Publicly Accountable Entity* are addressing similar concepts and thus legislation already exist in Australia on what is a "*Public Interest Entity*". Both definitions arguably have equal legal weight given its association with legislative instruments - AASB 1053 and ASA 102. However, *Publicly Accountable Entity* covers a much wider range of entities and is based on entities which require financial reports to be prepared whereas the current definition of *Public Interest Entity* focuses on entities that need to comply with Auditor Independence requirements.

From a legal perspective, the two definitions are different on the basis of their ordinary meaning and there are fundamental differences in the nature of the two definitions. *Publicly Accountable Entity* is an entity that trades their securities on a public market (or is in the process of doing so) or holds assets in a fiduciary capacity as their primary business.

The definition of *Public Interest Entity* relates to auditor independence requirements. Legal advice obtained by APESB indicates that whilst AASB 1053 is a legislative instrument, it is not legislation which requires an audit to be conducted in compliance with the same independence requirements that apply to the audit of Listed Entities.

In conclusion, the Board did not consider it appropriate to link the two definitions. Further, the AASB's definition of a *Publicly Accountable Entity* captures a broader category of entities of which some may not necessarily require the same level of independence requirements as a Listed Entity.

Specific matters for comment

Stakeholders are invited to comment on the following matters:

- i. APESB's proposed definition of "*Public Interest Entity*" for APES 110;
- ii. APESB's preliminary views on entities that will generally be captured by the definition of a *Public Interest Entity*; and
- iii. APESB's view that the definition of a *Public Interest Entity* in APES 110 is different to AASB's definition of a *Publicly Accountable Entity*.

