

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

**ASA SUBMISSION TO THE PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND
FINANCIAL SERVICES INQUIRY ON REGULATION OF AUDITING IN AUSTRALIA**

Dear Sir or Madam

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. ASA is an independent not-for-profit organisation funded by and operating in the interests of its members, primarily individual and retail investors and self-managed superannuation fund (SMSF) trustees. ASA also represents those investors and shareholders who are not members, but follow ASA through various means, as our relevance extends to the broader investor community.

In response to the Inquiry into the regulation of auditing in Australia, ASA would like to make the following points:

Role of audit and auditors

- ASA sees external auditors and the audit of financial accounts as part of a chain of assurance which supports the quality and maintenance of investor confidence in the information presented in financial reports. The agents or actors in this chain of assurance include directors (full board), audit committee, executives, internal auditors, external auditors, regulators and shareholders, all fulfilling expectations of their role. The degree of assurance and confidence relies on the independence of the agents, and management and minimisation of conflicts of interest as well as perception of conflicts of interest
- It is the responsibility of the Board of Directors of a listed Company to appoint an auditor to assess their financial statements and form an audit opinion about whether a company's financial reports comply with the relevant legislative requirements. The appointment is subject to shareholder approval. There are clear rules within several key pieces of legislation that define how this should work. **ASA is supportive of a tender process in the appointment of the external auditor, as an indicator of a comprehensive approach which actively entertains the decision to change audit firm rather than a measure to contain the audit costs.**
- In forming the above audit opinion, the external auditor tests the financial reporting framework and internal controls of the company. The external auditor may also be instructed under the audit engagement letter to undertake additional procedures of an audit nature in the interests of governing and managing risk by external assurance, but not strictly necessary for the audit opinion to be formed. ASA considers the directors' effective management of the engagement of the external auditor and insistence on independence is critical to confidence in the quality of financial information and that the share market is as fair a playing field as it can be.
- ASA believes that there should be clear disclosure within annual reports around the appointment and engagement of the external auditor. At a bare minimum, **the date of the audit firm appointment, current audit partner's commencement and most recent tender date should be**

clearly stated in the annual report. Additionally, listing which board members were involved in the appointing of an auditor, description of the tendering process, declaration of any conflicts of interest or potential for compromise of independence and a description of the scope of audit should be considered. ASA believes that declaring the Board of Directors and other executives and management personnel in the company who may have any material bearing upon the appointment of an auditor will provide shareholders with maximum transparency, and as a result confidence in the process. ASA believes that defining the terms of reference in relation to the appointment of an auditor will help shareholders and external stakeholders more effectively analyse potential conflicts of interest that could arise with the external auditor appointment.

- ASA believes that audit firms have a responsibility to provide assurance over the accounts that the wider investment community (including retail shareholders) can rely on to make investment decisions, and therefore maintain investor confidence in the market. Audit reports should clearly demonstrate concrete examples of the auditor's professional scepticism and provide a reasonable definition of how the auditor may have dealt with fraud and misconduct risk specifically relating to the company's financial movements.
- The addition of Key Audit Matters has enhanced the transparency of audit practice, and opened up additional areas to questioning by shareholders at the Annual General Meeting, which is another stepping stone in maintaining and building investor confidence.

Audit industry structure & market competition

- ASA found that research has indicated that audit quality drops when regulatory policy invites significant audit tendering or rotation of audit directorsⁱ. Research indicates that longer periods of having a single auditor or lead audit partner facilitates development of expertise and expertise is one of the key factors that enable specialisation and better quality of audit reporting. ASA sees this need for expertise must be balanced by the need for actual and perceived independence and has determined that the 10-year mark is where directors need to question whether it is time to change auditors. We note with interest the inclusion of the requirement to put the external auditor appointment to tender at 10 years tenure in the UK Corporate Governance Code since 2012 (and the requirement to report on an if not why note basis), and the EU requirement for firms to change audit firms at 10 years, or at 20 years if there has been a tender at 10 years.
- Research has indicated that in Australia, the largest and most complex clients featuring in the 200 largest companies by market capitalisation are audited each year by the Big Four firms (90% of total). Just over 60 to 70% of the next 300 largest clients are audited by the Big Four firms and only about 35% of medium-sized clients are audited by the Big 4. Small clients that are audited by Big 4 have fallen from 18.8% to 9.9% between 2012 and 2018ⁱⁱ. ASA believes that oversight of the nature of tenders (effectively limiting the number of loss leading tenders and discounts auditing firms offer) is likely to underpin audit quality and ensure the likelihood of fewer corners being cut.
- ASA finds that expertise is a key factor in ensuring audit quality is high. Ensuring that disclosures relating to a Company's choice of auditor can provide adequate information relating to the skills and abilities of the auditors and auditing team involved in the assessment of the Company's financial performance and other information will provide shareholders and stakeholders a clearer picture of how and why the auditor has supported the Company's assertions in relation to performance. Having a public tender process in the appointing of an auditor will also ensure that stakeholders can capably vote to approve the changing of an auditor at the appropriate time, providing them with the ability to voice their concerns in appropriate forums including annual general meetings.

- The audit market dominance of the Big Four firms among ASX-listed companies concerns ASA. The lack of choice is not helped by the movement of audit staff between companies, audit firms and regulators. ASA would prefer specificity in terms of waiting periods that need to be adhered to when auditors at the partner level are moving from one firm and the restrictions that may be placed on companies appointing familiar auditors at a different firm as a result of such movement. The appointment of former audit partners as a director of a former client firm is another area of potential conflict or capture that needs to have greater clarity of waiting period or in some cases direct exclusion. Given the benefit of the skills and experience of a former audit partner to non-aligned companies, the wording of any restrictions needs to be carefully articulated.
- As audit firms, especially the Big 4, increasingly pursue expansion, the services they offer are diversified. ASA would like a clear definition of acceptable audit and audit related services and non-audit services that a firm may provide to a Company. Research literature reviews have indicated that there are associated risks with non-audit services being provided by audit firms to clients with some finding that there is a link to low financial reporting quality and some finding that there is a higher risk of being sanctioned for fraudⁱⁱⁱ. Cited studies indicate that there are other significant negative associations related to a Company's availing of non-audit services and non-audit tax services that need to be addressed. ASA typically checks company's accounts to see that the expenses for non-audit services are less than those for audit services.
- While ASA understands that some of these non-audit services have been addressed in the Ramsay report relating to auditor independence^{iv} and a more comprehensive definition would be part of the International Ethics Standards Board for Accountants' standards^v, ASA believes that clearly defining specific standards of what services can and cannot be provided by audit providers who are engaged with a Company will reduce potential conflicts of interest.

Audit quality

- With regard to its audit inspection program for 2015–16, ASIC stated, *"In our view, in 25% of the total 390 key audit areas that we reviewed across 93 audit files at firms of different sizes, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 19% of 463 key audit areas in the previous 18-month period ended 30 June 2015"*.
- ASA believes that declining audit quality is a material concern for retail shareholders, particularly at the levels indicated by ASIC. Unfortunately, audit weaknesses can take a long time to detect and may only become obvious after a catalyst which reveals a company's losses. Such events reduce market confidence in general, and especially retail shareholders trust in the level playing field.
- We encourage AISC to delineate clearer benchmarks for factors contributing to a perceived decline in audit quality. Such classification of the criticality of various measures could include whether there is a likelihood there is material misstatement, whether the number of audits labelled as poor should call into question any audits carried out by that auditor. Such information will be of key importance in understanding how audit quality can be improved. Providing detailed reports from regulators as well as the appointment of a committee to assess audit quality perceptions may provide a clear path towards addressing issues that would help restore investor trust and regulate oversight in the industry.

Independence and conflicts of interest

- The Enron/Arthur Anderson story highlighted the dangers of ‘moral seduction’ and ‘capture’ of audit firms by poor corporate culture. The ensuing collapse of Arthur Anderson and Big Four divestment of consulting practices underlined the market’s need to trust audit firms’ output. That the Big Four have subsequently developed new consulting practices and added more service lines such as legal and media advisory on top leaves ongoing doubt as to independence (note previous discussion on audit and non-audit services). The proliferation of other services means audit can be used as a loss leader to build relationships with companies in order to sell higher margin advisory services concurrently or subsequently.
- ASA also has concerns regarding conflict of interest with the outsourcing of internal audit functions by companies, particularly in relation to the Big Four audit firms.
- Clear identification of the tenure that an audit firm has been with a Company would provide stakeholders with a view on how to classify an auditors’ independence from the board. As previously indicated, research suggests a tenure of 8 to 10 years can produce audit reports of better quality, a longer engagement may be in the interest of stakeholders but only as long as there is clarity in terms of appointment and terms of reference being disclosed to relevant stakeholders and regulators.

Audit rotation and lead partner rotation

- ASA believes that good corporate governance mandates that audit firms should be reviewed periodically and there should be a competitive tender for the external audit every 10 years (or sooner where audited accounts have been shown to be deficient, inaccurate and in breach of the accounting standards). As mentioned above, the date of the most recent tender should be disclosed in the annual report. Beyond 10 years with the one auditor, the audit committee should disclose in the Annual Report the rationale and intentions for maintaining independence of the external auditor.
- ASA questions the auditors’ ability to rotate partners or lead auditors on a regular basis when specialist services are being offered. While ASA supports the practice of changing lead auditors on an account every five years, it is also clear that there needs to be a balance of training and skills. Disclosing relevant details about the audit team’s specific skills and abilities may help ensure more consistency in this area.
- ASA believes that the upcoming results of the Brydon Review taking place in the UK might provide more evidence-based assessment of how audit might be regulated in an economic and regulatory environment that operates similarly to the Australian model. ASA would urge the Committee to maintain an interest in the proceedings and carefully review relevant information that could help further identify areas worthy of investigation.

In summary, ASA welcomes greater scrutiny of the key role audit firms play in corporate governance and market transparency.

If you have any questions about this submission, please do not hesitate to contact Fiona Balzer, Policy & Advocacy Manager on (02) 9252 4244.

Yours sincerely



Annalisa Haskell
Chief Executive Officer
Australian Shareholders' Association

ⁱ Johnson, V., Khurana, I., and Reynolds, J., 2002, 'Audit-firm tenure and the quality of financial reports', *Contemporary Accounting Research*, Vol. 19, Iss. 4, pp. 637-660.

ⁱⁱ Carson, E, 2019, AUASB Research Report 3 - Audit Market Structure and Competition in Australia 2012-2018, 8 October 2019, Auditing and Assurance Standards Board, Australian Government.

ⁱⁱⁱ Tepalagul, N and Lin, L, 2015, 'Auditor Independence and Audit Quality: A Literature Review', *Journal of Accounting, Auditing and Finance*, Vol 30 (1), 101-21

^{iv} 2002, CLERP Paper no. 9: Proposals for Reform – Corporate Disclosure, Part 4 – Auditor Independence.

^v International Ethics Standards Board for Accountants, 2018, 'Non-assurance services – Exploring Issues to Determine a Way Forward', May 2018.