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

On-line submission:
https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/RegulationofAuditing/Submissions

Dear Parliamentary Joint Committee

Submission on Parliamentary Joint Committee (PJC) on Corporations and Financial Services Inquiry Regulation of auditing in Australia

CPA Australia represents the diverse interests of more than 164,000 members working in 150 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

CPA Australia welcomes the PJC inquiry which raises a number of important issues regarding the on-going relevance, reliability and value of external audit, which it is critical to address in order to provide public confidence in the outcomes of external audit and in turn capital markets.

We consider that the terms of reference for PJC inquiry fall under five main topics, whilst also inviting comment on "any related matter". Consequently, we have structured our response under the following five topics, and offer a range of recommendations for consideration by the PJC in its Inquiry:

1. Auditor Independence: Potential conflicts of interest from non-assurance services – *terms of reference 1 and 2*
2. Competition in the Audit and Consulting Market– *term of reference 3*
3. Audit Quality – *terms of reference 4 and 5*
4. Scope and Purpose of Audit – *terms of reference 6 and 7*
5. The Role and Effectiveness of Legislation and Regulators – *terms of reference 8 through 11*

We offer the following recommendations for consideration in relation to these five topics. In considering these recommendations, it is critical that the Australian context is carefully considered. That is, solutions and proposals identified in other jurisdictions may not be relevant for the Australian financial and economic environment, and the Australian audit market:

1. Auditor Independence: Potential conflicts of interest from non-assurance services (NAS)

   1.1 Greater transparency in financial reports of audit and NAS fees
   1.2 Consider whether additional requirements are needed to identify the type or volume of NAS that are considered threats to independence and which need to be mitigated
   1.3 Consider guidance on periodic audit tendering for listed entities
   1.4 Mandate electronic lodgement of financial reports and provide free access

2. Competition in the Audit and Consulting Market

   2.1 Consider available research on competition in the Australian audit market
   2.2 Monitor the recommendations and regulatory response to the UK inquiries and consultations on audit quality and the audit market

3. Audit Quality

   3.1 Enhance the role of Audit Committees
   3.2 Identify benchmarks for reliable measures of audit quality
   3.3 Consider the impact of existing initiatives in assessing the potential merits of new initiatives

4. Scope and Purpose of Audit

   4.1 Understand and clarify financial report users' needs and ensure that the audit scope better meets the expectations of users
   4.2 Consider the need for enhancement of the Operating and Financial Review (OFR)
   4.3 Monitor the recommendations and regulatory response to the UK Brydon review on the quality and effectiveness of audit

5. The Role and Effectiveness of Legislation and Regulators

   5.1 Require clearance by the Australian Auditing and Assurance Board (AUASB) of legislation or regulations for audits or assurance engagements
   5.2 Enhance ASIC Financial Report and Auditor Inspections funding and due process
   5.3 Conduct a root cause analysis of corporate failure and fraud as a basis for designing a regulatory response

CPA Australia's detailed perspective on the issues underlying these five topics and the matters which we recommend are provided in the attachment.

We have conducted outreach amongst our membership to gather their views and concerns on the topics covered by the terms of reference. In addition, we joined an Accounting Professional and Ethical Standards Board (APESB) Roundtable in Sydney and participated in discussions at ASIC Standing Committee, Australian Institute of Company Directors (AICD) Reporting Committee, Emerging Reporting and Auditing Issues Discussion Group, Large National Networks discussion group and with the AUASB. We have sought relevant research on the matters covered by the terms of reference.

If you require further information on the views expressed in this submission, please contact Dr Gary Pflugrath, Executive General Manager, Policy and Advocacy on +61 3 9606 9941 or at Gary.Pflugrath@cpaaustralia.com.au, or Claire Grayston, Policy Adviser – Audit and Assurance, on +61 3 9606 5183 or at claire.grayston@cpaaustralia.com.au.

Yours sincerely

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ATTACHMENT

1. Auditor Independence: Potential conflicts of interest from non-assurance services

Relevant terms of reference:

1. *the relationship between auditing and consulting services and potential conflicts of interests;*
2. *other potential conflicts of interests;*

Issues:

Sources of conflicts

Conflicts of interest, which pose a threat to an auditor's independence (either actual or perceived) and which may negatively impact audit quality, can arise from a range of circumstances including, provision of "non-assurance services" (NAS) – including consulting services – to audit clients; relationships between the auditor (including the firm, team and other relevant parties) and the client; long associations between the auditor and the client or related parties and over-reliance on the fees from a particular client.

Current restrictions on potential conflicts

The Corporations Act has extensive provisions to address conflicts of interest for auditors arising from relationships and requires audit partner rotation for listed companies. The Code of Ethics for Professional Accountants (the Code) issued by the APESB, which complies with the international code issued by the International Ethical Standards Board for Accountants (IESBA), applies a threats and safeguards approach to independence, covering self-interest threat arising from financial interests, self-review threats from auditing the auditor's own work and familiarity threats from a close relationship with the client. The Code also contains prohibitions on the provision of certain NAS by auditors of public interest entities (PIEs) to their audit clients, and certain material NAS for all audits. The Code limits the receipt of audit fees from any one PIE and its related entities, to 15% of the firm's total audit fees over a two-year period. The Code also includes auditor rotation requirements.

Disclosure of audit and non-audit service fees

In considering whether the provision of NAS may create conflicts of interest, it is important to differentiate between:

- Audit-related services, which are either required to be provided by the auditor of the entity or are complementary to the audit and so do not create a conflict of interest.
- NAS conducted for audit clients, which may create a conflict of interest, and
- NAS conducted for non-audit clients, which would not prima facie create a conflict of interest.

The Australian Financial Reporting framework of the Australian Accounting Standards Board (AASB) requires an entity to "disclose fees to each auditor or reviewer, including any network firm, separately for: (a) the audit or review of the financial statements; and (b) all other services performed during the reporting period."[1] In comparison, the US Securities and Exchange Commission (SEC) requires companies to disclose fees paid to the principal auditor in four categories, "audit", "audit-related" (being fees "reasonably related to the performance of the audit or review of the registrant's financial statements"), "tax", and "all other" (including a narrative description of what those other fees are), for

[1] AASB 1054 *Australian Additional Disclosures*

the two most recent years. This disclosure required by the US SEC provides greater transparency, than the AASB discloses, about fees which may create a conflict of interest.

Solutions for regulation of NAS

Perceptions and expectations regarding which NAS are acceptable to be conducted in conjunction with the audit are changing, which creates a level of uncertainty amongst auditors. Our outreach indicates that greater clarity regarding acceptable and unacceptable NAS would provide auditors with certainty regarding the requirements and expectations.

The Auditors General (A-G) have tight restrictions on the provision of NAS to audit clients by those conducting outsourced audits on behalf of the A-G. Some A-Gs do not allow any NAS, whilst others have procedures in place to evaluate requests and may allow NAS in limited circumstances.

Certain Members of Parliament in the UK called for a "break-up" of the audit firms, which was somewhat moderated in the recommendation by the Competition and Markets Authority (CMA)[2] to give the regulator powers to design an 'operational split' between the audit practices and non-audit practices of the 'Big Four' firms. This proposal interprets perceived threats as arising from NAS provided to non-audit clients, in addition to NAS provided to audit clients. The UK's Department of Business, Energy and Industrial Strategy (BEIS) is consulting[3] on the CMA's recommendations. Arguably, such a split could have significant and unintended consequences, which could negatively impact audit quality, as it may limit access to expertise needed on the audit.

IESBA is currently working on projects on NAS to tighten up permissible services, and audit fees to better address fee dependency, with exposure drafts due for approval in December 2019.

Audit Rotation

Auditor rotation is required for listed entities, Australian Prudential Regulation Authority (APRA) regulated entities and other PIEs under the Code of Ethics, the Corporations Act and APRA Prudential Standards, with time "on" the audit ranging from 5 to 7 years and time "off" from 2 to 5 years depending on the type of entity and the auditor role. Mandatory audit firm rotation has been introduced in some countries, including under the EU Directive[4] which has a maximum 10-year mandatory firm rotation extending to a maximum of 20 years if a public tender is conducted, however it has been discontinued in other jurisdictions (e.g., in certain circumstances in South Korea, Singapore, and Brazil) or considered and rejected in others (e.g., USA). It is argued that while audit firm rotation may improve stakeholders' perception of independence, it may negatively impact audit quality during the initial phase when the auditor is gaining an understanding of the client. Academic research on the topic is mixed, but generally it shows that audit firm rotation may not be effective in enhancing perceptions of independence or audit quality.[5] [6] In fact, much of that research finds that longer tenure is associated with quality and the early years of tenure with relatively lower audit quality. In Australia, being a relatively small capital market with companies geographically widely spread, mandatory firm rotation could result in difficulties in some companies finding a suitable auditor with the

[2] CMA Statutory audit services market study
[3] BEIS Future of Audit inquiry
[4] Regulation (EU) No 537/2014 and Directive 2014/56/EU of the European Parliament and of the Council of the European Union.
[5] 'Mandatory audit firm rotation and audit quality' (2008) and "Does mandatory audit firm rotation enhance auditor independence? Evidence from Spain" (2009).
[6] European Parliament Study; EU Statutory Audit Reform Impact on costs, concentration and competition.

appropriate specialisations in required locations.

Transparency of information

Currently financial reports are lodged as pdfs to ASIC. Consequently, in order to analyse or compare those reports, the information needs to be extracted manually. This impacts the transparency of and ease with which information about auditors and audit fees can be obtained. Standard Business Reporting (SBR) in XBRL (eXtensible Business Reporting Language) or Inline eXtensible Business Reporting Language (iXBRL) format enables electronic submission of financial information, but has not been mandated in Australia and has not been taken up voluntarily by companies. In contrast, in 2018 the US SEC issued a Rule that requires registrants to use the iXBRL format in their submissions of operating company financial statement information and fund risk/return summary information.

Corporate data held in the ASIC registry can only be accessed for a fee. This inhibits the timely free-flow of information to promote transparency, and facilitate comparison and analysis of data between companies, across industries and markets. For example, access to audit and NAS fees information across private and public companies would help inform more relevant research and debate.

Recommendations:

1.1 Greater transparency in financial reports of audit and NAS fees

Require disclosure of fees to paid to the auditor in useful categories, such as those required in the US: Audit Fees, Audit Related Fees, Tax Fees, and All Other Fees, with a narrative description of other fees. To assist in fulfilling these requirements, issue guidance to clarify which fees fall within each category. This would enable better differentiation between NAS which need to be conducted by the auditor of the entity and NAS which could give rise to a conflict of interest and consequently a threat to independence that needs to be mitigated.

1.2 Consider whether additional requirements are needed to identify the type or volume of NAS that are considered threats to independence and which need to be mitigated

Consider the outcomes of the IESBA projects on NAS and fees, including exposure drafts when available, which are considering the nature and materiality of NAS, including tax services, which should not be provided to audit clients and the level of fees which are acceptable from one audit client. Consider how the capping of fees from NAS or prohibitions on certain NAS for audit clients proposed in these exposure drafts may impact requirements in Australia.

Any recommendations made by the UK BEIS need to be assessed in the context of the Australian audit market to determine if they would enhance audit quality. For example, we do not believe it is necessary to separate operations that provide audit services from those providing NAS services within the firms, which is under consideration in the UK's BEIS consultation on the CMA Statutory audit services market study, primarily as there may be unintended consequences, including reduced access to experts within the firm.

1.3 Consider guidance on periodic audit tendering for listed entities

As there is a lack of evidence to support the notion that audit firm rotation improves audit quality and given that auditor rotation is already in place, consideration might be given to adopting as best practice, audit tendering at reasonable intervals. This could be done through ASX listing rules or Corporate Governance Principles and Recommendations. For example, suggesting tenders every 10 years may be worth exploring to avoid very long tenures which create a lack of independence of appearance.

1.4 <u>Mandate electronic lodgement of financial reports and provide free access</u>

Mandating electronic lodgement of financial reports and other information with ASIC using XBRL or iXBRL format and removing ASIC registry fees for access to corporate information would enable greater transparency, comparability and facilitate analysis on a timelier basis, thereby reducing laborious and costly manual analysis. Better information availability would be beneficial in informing the PJC across all of the terms of reference of its Inquiry.

2. Competition in the Audit and Consulting Market

Relevant terms of reference:

3. the level and effectiveness of competition in audit and related consulting services;

<u>Issues:</u>

Level of competition

Recent research shows that the audit market in Australia[7] is more competitive overall than some other major jurisdictions, with less than 40% of the listed companies audited by the Big 4 in Australia, compared to over 84% in the UK and 70% in the US. However, the market is highly segmented with the Big 4 auditing 90% of the largest 200 companies by number and 98% of the largest 200 companies by capitalisation. The audit market is moderately concentrated for other large entities and not concentrated for the medium and small listed audits. Nevertheless, concentration is not necessarily a reflection of lack of competition but rather could be a reflection of audit firm's capacity to undertake certain audit engagements.

Solutions to insufficient competition

There are a number of measures which could potentially increase competition in the audit market, such as regulator appointment of auditors or greater disclosure and transparency of the auditor appointment process. However, measures to increase competition have the potential to have a detrimental impact on audit quality. It is important that a clear need for greater competition in the Australian audit market be firmly established, along with recognition of the potential conflicts with and detrimental impacts on audit quality, before searching for solutions to perceived competition concerns.

The BEIS have been consulting on the CMA's proposal to mandate 'Joint Audits' of FTSE 350 companies, 97% of which are currently audited by the Big 4 firms. They suggested this in order to address concerns regarding a lack of choice and competition and to provide greater opportunity for challenger firms to participate in the audit market. Joint audits are an extreme measure to create a significant change in a short timeframe which will almost certainly result in an increase in audit fees without evidence that this measure would enhance audit quality. We suggest that the imperative for building capacity in mid-tier firms in conducting large audits, and the impact on audit quality of joint audits, must be clearly and firmly established to justify consideration of such solutions, especially given the cost implications of such arrangements.

Some of our members indicate that mid-tier audit firms do not necessarily have the industry specialisations, scale, geographic spread or resources to tender for or undertake audits of the ASX 200, so may not choose to take on such clients.

[7] See AUASB Research Report *Audit Market Structure and Competition in Australia 2012-2018* (Oct 2019)

We do not comment on competition for related consulting services as that is a matter for the procurement processes of the relevant Government Department or company to assess based on the service providers available whilst applying appropriate due process.

Recommendations:

2.1 Evaluate adequacy of competition in the Australian audit market based on evidence

Draw on research on the audit market in Australia to understand the current level of market concentration and competition, in order to determine whether action is needed on competition and what the appropriate response should be. We suggest that radical reform in this regard is not justified in Australia, based on current research.

2.2 Explore solutions only for clearly established shortcomings in competition and consider potential consequences

Only if clearly identified problems can be established should solutions be considered. The potential unintended consequences of any solutions need to be carefully considered, particularly any negative impact on audit quality.

2.3 Monitor the recommendations and regulatory response to the UK inquiries and consultations on audit quality and the audit market

Consider the outcomes of the BIES consultation in the light of the evidence regarding the level of competition in Australia and consider whether proposed reforms are suitable in this market.

3. Audit Quality

Relevant terms of reference:

4. audit quality, including valuations of intangible assets;

5. matters arising from Australian and international reviews of auditing;

Issues:

Role of others in audit quality

Audits do not operate in isolation, but in the context of the broader financial reporting supply chain. Consequently, audit quality is impacted by a range of factors, including the quality of financial report preparation, the effectiveness of corporate governance and adequacy of internal controls. Boards and audit committees' roles are critical in ensuring robust controls, accurate reporting and good governance, as well as choosing auditors based on quality and industry specialisation rather than price. See:

- IAASB Framework for Audit Quality
- ASIC INFO 183 Directors and financial reporting
- ASIC INFO 196 Audit quality: The role of directors and audit committees
- ASIC INFO 223 Audit quality - The role of others

The UK's CMA audit market study likewise noted the important role that audit committees play in appointing, supporting and challenging auditors and proposed enhanced regulatory oversight of audit committees to ensure that they select auditors based on quality of audit rather than any other criteria. Consequently, the CMA recommended regulatory oversight of audit committees.

Causal factors for corporate failure of fraud, need to be analysed as discussed in section 4 below, If contributing factors are found to include poor Board decisions or inadequate audit committee recommendations, there may be a need to consider more robust minimum education standards, financial literacy requirements and greater diversity, which increases diverse perspectives and counters cultural constraints such as “groupthink”.

Measures of audit quality

In its report on Oversight of ASIC, the Takeovers Panel and the Corporations Legislation No.1 of the 46th Parliament the PJC recommended that ASIC “devise and conduct a study which will generate results which are comparable over time to reflect changes in audit quality”, which ASIC plan to publish in December 2019. The measures identified in that report will be important as a starting point for establishing benchmarks for adequate audit quality. Improvements to audit quality come at a cost, so potential benefits need to be identified in terms of the level of quality sought. Some jurisdictions have identified Audit Quality Indicators (AQIs) including the Accounting and Corporate Regulatory Authority (ACRA) in Singapore[8] and Public Company Accounting Oversight Board (PCAOB) in the US[9] which can be used by audit committees, audit firms or stakeholders to assess quality. We understand that ASIC has been considering these indicators, amongst others, to arrive at the measures to be published.

We recognise that ASIC audit inspection findings, which focus on audits of PIEs, have been disappointing and, despite efforts by the audit firms to respond to those findings and lift audit quality, overall reported findings have shown only modest improvement over time. CPA Australia supports ASIC’s work on audit quality by sharing and explaining those findings to our members and encouraging them to address the themes arising from the reported findings in their audit practices, even where they were not inspected.

However, we caution against using the ASIC inspection findings as a measure of audit quality without consideration of the fact that ASIC uses a risk-based sample and therefore the rates of findings cannot be extrapolated to all audits of PIEs. The alternative measures being developed by ASIC may be able to provide a broader insight into the state of audit quality in Australia. ASIC’s review of financial reports of public interest entities (reporting periods: 30 June 2010 to 30 June 2018) has led to material changes to 4% of the financial reports reviewed. This is a measure of financial report quality, and although it does not represent a statistical sample, it may be indicative of audit quality. The Financial Reporting Council (FRC) and AUASB have conducted surveys[10] of audit committees and investors which paint a much more positive picture of the perceptions of audit quality in Australia.

In addition, the ATO conducts compliance reviews of self-managed superannuation fund (SMSF) auditors, but results are not publicly reported, and CPA Australia conducts quality reviews of all its public practitioners, as do the other professional accounting bodies, reporting on compliance with professional, ethical, auditing and assurance standards.

Initiatives to enhance audit quality

Significant recent projects by the International Auditing and Assurance Standards Board (IAASB) were aimed at improving audit quality by focussing on audit areas which regulator inspections identified as falling short of quality expectations. New standards have been adopted and proposed

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[8] ACRA-CPA Australia Joint Publication on Audit Quality Indicators and Guidance to Audit Firms on ACRA’s AQIs

[9] Audit Quality Indicators – Public Accounting Oversight Board

[10] Audit Quality in Australia: The Perspective of Audit Committee Chairs, and Audit Quality in Australia: The Perspectives of Professional Investors,

standards exposed by the AUASB (which uses international standards), including:

- Key Audit Matters introduced into listed company auditor's reports in 2016 to improve the information value of those reports, in revised standard ASA 701.
- Auditing standard ASA 540 *Auditing accounting estimates* revised to better address how to audit complex accounting estimates, including those required by accounting standard AASB 138 *Intangible assets* relevant to valuation of intangibles.
- Exposure draft ASA 315 *Identifying and Assessing the Risks of Material Misstatement* to improve consistency and effectiveness of the risk assessment process and embed professional scepticism.
- Exposure draft standards on quality management: ISQM 1, ISQM 2 and ISA 220 adopting a risk-based approach to quality management for audit firms and audit engagements.

The professional accounting bodies and the firms support projects aimed at improving audit quality. For example, new guides developed by CPA Australia and CA ANZ:

- Improving audit quality using an individual recognition and accountability framework
- Improving audit quality using root cause analysis

CPA Australia has recently developed on-line tools for risk management and quality control to assist public practitioners in meeting their obligations under the ethics standards, which we expect will improve their firm's audit practice management.

Emerging technologies such as robotic process automation (RPA), Blockchain Technology (BT) and Artificial Intelligence (AI) and Data Analytics (DA) for auditing purposes provide opportunities to improve audit outcomes by providing a more robust audit process, and some argue, a higher level of assurance. For instance, these technologies are said to effectively enhance audit quality by allowing for full population testing, providing an immutable audit trail and enabling continuous auditing through the instantaneous confirmation of transactions. The current consistency and availability of technologies are not such that use of any particular tools can be mandated.

Recommendations:

3.1 Enhance the role of Audit Committees

Consider means of strengthening the audit committee's governance and oversight of the external auditor's selection and work, as well as internal audit and financial reporting, which will strengthen the overall financial reporting supply chain. Consider the need for enhanced requirements for minimum educational standards, financial literacy and diversity for Boards and audit committees.

3.2 Identify benchmarks for reliable measures of audit quality

Use ASIC's audit quality measures, once published, as a basis for assessing suitable benchmarks which represent "what good looks like" so that attainable and acceptable levels of quality can be targeted for auditors.

3.3 Consider the impact of existing initiatives in assessing the potential merits of new initiatives

The implementation of new auditing standards, new guides and tools and other audit quality initiatives takes time to impact audit quality. Continually introducing more initiatives makes it difficult to determine which initiatives are successful in enhancing audit quality. Existing initiatives need to be assessed before additional reforms are overlaid to determine if they have been effective.

4. Scope and Purpose of Audit

Relevant terms of reference:

6. changes in the role of audit and the scope of audit products;

7. the role and effectiveness of audit in detecting and reporting fraud and misconduct;

<u>Issues:</u>

Audit expectation gap

The scope and purpose of audit is often misunderstood and can fall short of users' expectations. In order to determine how and to what extent this expectation gap can be addressed it has been broken down into the following categories:

- "delivery" or "performance gap" – any shortfall in audit quality against the AUASB standards and other requirements;
- "relevance gap" – the extent to which audited information fails to address the needs of stakeholders as the annual audit is restricted to identifying material misstatements in the financial report; and
- "service limitations gap" – primarily a result of inherent limitations in the conduct of an audit which is based on materiality and so does not check every balance or transaction.

How the gap can be addressed

The delivery gap is addressed in the audit quality section above.

The service limitations gap may be narrowed as technological solutions become more widely used, which can increase the extent and scope of testing and the reliability of underlying systems and data. It may also be addressed by strengthening the role of others in the financial reporting supply chain, including internal audit, audit committees and boards. This is also addressed in the audit quality section above.

The relevance gap provides the greatest opportunity for change to meet user needs. The subject matter of the audit could better match users' needs and expectations. In order to address those expectations, it is necessary to:

- Identify key users of corporate reporting, which should include investors (current and future) and other stakeholders who rely on financial reporting, directly or indirectly, such as creditors, employees, lenders and regulators.
- Determine users' needs and identify which are reasonable to meet, based on a cost/benefit analysis.
- Identify services which could address those needs.

Meeting user needs

Whilst we recommend an analysis of users and their needs, users' primary needs are likely to include:

- minimisation of unexpected corporate collapse; and
- prevention or early detection of fraud.

Subject to a cost/benefit and needs analyses, ways in which those needs could be met include:

- Prevent or early warning of corporate collapse
  - Assurance over the underlying data, assumptions and methodology used in preparing the OFR for listed entities, which underpin the statements in the OFR regarding the entity's business strategies, future prospects and material business risks, with appropriate caveats regarding uncertainty in the future outcomes.
  - Enhancing requirements for the OFR to address risks inherent in the business strategies to ensure transparent communication of those risks to stakeholders, the factors that may impact future performance and the company's risk appetite.
- Prevent and detect fraud
  - Introduction of a "SOX" or "SOX-light" internal control regime for listed or public interest entities modelled on US requirements in Sarbanes-Oxley Act of 2002 (SOX) section 404. SOX requires management evaluation of the effectiveness of internal controls over financial reporting (s.404(a)) and an independent assurance report by the auditor over that evaluation (s.404(b)). This also provides a more robust basis for accurate and reliable financial reporting.
  - Include controls for identifying and addressing fraud risk in the internal controls' report recommended above.

Research findings[11] on the impact of the SOX internal controls reporting regime in the US indicate significant costs but identifiable benefits of improved financial reporting. In addition, internal controls are significantly more effective and more timely than external audit in preventing and detecting fraud.

CPA Australia provided a submission[12] on the UK Brydon Review on the quality and effectiveness of audit, which is directly relevant to these terms of reference.

Identifying audited information

Companies' annual reports comprise sections which are audited alongside others which are not audited or assured. Whilst this is stated in the auditor's report, it may not be sufficiently clear with respect to the relative levels of reliance which the user can place on each section. The nuances of the work done by the auditor on "other information", which is not audited, are potentially unclear. It would reduce misunderstandings if the audited information was presented completely separately from unaudited information, which would necessitate either increasing the scope of the audit to encompass the entire annual report, or other corporate reports; or excluding information which is not audited from that report.

Influence of financial reporting

The complexity and level of estimation uncertainly of the financial reporting framework, which does not typically reflect the underlying value of the entity, and the range of voluntary corporate reporting, mean that the value of audit is entwined with the value of corporate reporting. Consequently, reforms in audit will be dependent on reforms to financial reporting or governance. Therefore, any reforms will need to be pursued in tandem.

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[11] SOX After 10 Years: A Multi-Disciplinary Review and The benefits and costs of exemptions to Section 404(b)

[12] Brydon Review: Submission on quality and effectiveness of audit

Recommendations:

4.1 Understand and clarify financial report users' needs and ensure that the audit scope better meets the expectations of users

To address users' needs explore the costs and benefits of introducing:

- an internal controls reporting regime modelled on US "SOX", with less prescriptive requirements to minimise regulatory impact ("SOX-light"), including controls to address assessed fraud risks.
- assurance on the OFR to the extent forward-projecting information can be assured.
- restricting information presented in annual reports to information which is audited or assured, so that the level of reliance which can be placed on that information is clear.

4.2 Consider the need for enhancement of the OFR

Benchmark other frameworks, such as the UK's Strategic report.

4.3 Monitor the recommendations and regulatory response to the UK Brydon review on the quality and effectiveness of audit.

Consider the suitability of any recommendations in the context of the Australian regulatory landscape.

5. The Role and Effectiveness of Legislation and Regulators

Relevant terms of reference:

8. *the effectiveness and appropriateness of legislation, regulation and licensing;*
9. *the extent of regulatory relief provided by the Australian Securities and Investments Commission through instruments and waivers;*
10. *the adequacy and performance of regulatory, standards, disciplinary and other bodies;*
11. *the effectiveness of enforcement by regulators;*

Issues:

Inconsistent requirements

There is a high volume of legislation and regulation at the Commonwealth and State level requiring audit and assurance engagements that are inconsistent with the AUASB standards, which professional accountants in Australia are required to follow. These requirements create compliance issues, and in some cases, independence conflicts for auditors; outcomes often fail to meet the expectations of the users of the auditor's report, such as state-based real estate trust account audits.

ASIC resources and oversight

Some people argue that ASIC does not have the resources to engage inspectors of an equivalent level of experience as auditors under review, or importantly to follow through all audit shortcomings to identify whether material misstatements have resulted. ASIC's resources, reported in their response to this inquiry, for audit oversight seem to be more limited in comparison to other jurisdictions. In addition, the avenues for firms to seek review of audit inspection findings or to escalate differences of view from inspectors can be problematic and would benefit from greater transparency.

Regulatory responses

In the light of research on the impact of increasing regulation[13], proposals for new requirements need to be underpinned by a thorough analysis of root cause so that the proposed solution directly addresses the problem and does not simply impose additional regulatory burden or result in unintended consequences.

Recommendations:

5.1 Require clearance by the AUASB of legislation or regulations for audits or assurance engagements

Consider a directive at Commonwealth and State levels to require government departments and agencies to obtain clearance by the AUASB for any requirements for audits, reviews, accountant's reports, declarations or examinations to ensure consistency with AUASB standards, with the aim of alleviating the myriad of untenable and inconsistent requirements.

5.2 Enhance ASIC Financial Report and Auditor Inspections funding and due process

Consider the adequacy of ASIC funding to ensure that ASIC has the number of staff, with level of experience and expertise needed, to conduct audit inspections and financial report surveillance of complex entities. Also, consider expanding the scope of ASIC's work to assess the incidence of material misstatement arising from poor audit files.

Clarify the due process for ASIC inspection findings to enable escalation by firms to a review panel or other mechanism.

5.3 Conduct a root cause analysis of corporate failure and fraud as a basis for designing a regulatory response

To enhance the regulation of auditing, root cause analysis needs to be conducted of underlying causes of corporate failures and incidence of significant fraud. These may be failings in internal controls, governance or financial reporting, inadequate audit, poor understanding of business risk, failure to mitigate business risks or other causes. Remedial measures, whether legislative, regulatory or voluntary, need to address the underlying causes identified.

6. Any related matters

Relevant terms of reference:

12. any related matter.

No further matters identified.

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[13] Research: Public Oversight of Audit Firms: The Slippery Slope of Enforcing Regulation and The effect of inspections, rotations and client preferences on staffing decisions