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28 October 2019

Committee Secretary

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

Via email: [corporations.joint@aph.gov.au](mailto:corporations.joint@aph.gov.au)

Dear Committee Secretary,

EY welcomes the opportunity to provide a submission to the Parliamentary Joint Committee (PJC) on Corporations and Financial Services' inquiry into the regulation of auditing in Australia. We consider the inquiry to be an important element in ensuring that government, business and community expectations are being met.

We believe the stewardship of the financial reporting framework, as well as the associated role of directors, management, auditors and regulators, are central to maintaining the trust and confidence of investors in Australian capital markets which, in turn, have a key role in facilitating economic growth in Australia and our region.

This inquiry provides an opportunity to look at the continued improvement of the audit profession, including its ability to attract and retain skilled professionals, the role multidisciplinary firms play in delivering quality audits, the provision of non-audit services to audit clients, and the management of conflicts. We believe the inquiry would also be assisted by examining the responsibilities of all stakeholders in the financial reporting chain to ensure these roles are clear and well understood.

It is important that this conversation about the continued improvement of the audit profession is held in the context of Australia's historic corporate law reforms that have enhanced the independence and quality of financial reporting. This includes the introduction of personally signed audit reports, auditing standards having the force of law, and the Corporate Law Economic Reform Program (CLERP) 9 reforms in 2004 that saw the introduction of signed independence declarations by the audit partner and five-year mandatory audit partner rotation.

EY believes Australians' confidence in the quality of financial statement auditing is justified and EY is committed to the continual improvement of audit quality so this confidence can be maintained in the decades ahead.

The most important input to the continued improvement of audit quality is the ability to attract and retain skilled professionals who exercise judgement and apply scepticism in the application of auditing standards.

Sir Donald Brydon, who is leading an independent review into the quality and effectiveness of audit in the United Kingdom, recently highlighted an important factor for audit quality: the profession being attractive to the brightest and the best who can have confidence that a good piece of professional work will not be misdescribed in times of stress.

A multidisciplinary model has been an important feature of our firm since inception and is fundamental to accessing the necessary specialist skills to perform quality financial statement audits. Ready access to tax, valuation and other experts who understand the requirements of auditing, and are subject to audit independence requirements, is integral to the delivery of a quality audit.

Audit independence is critical to our audit practice and to maintaining the public-interest obligations of our firm and employees. We do not undertake non-audit services that would compromise our independence, and our firm's policies ensure we are meeting our professional and public-interest obligations.

The suggestion that the audit of financial statements is a "loss leader" for the sale of non-audit services is not correct. Our audit partners are incentivised and remunerated for delivering quality audits and not for selling non-audit services to audit clients.

Along with this inquiry, there are a range of international reviews considering the regulation of auditing. It is important that the legislative requirements flowing from these reviews are considered; however, we must ultimately determine a model that works to ensure financial reporting quality that is specific to the circumstances of the market in Australia. Importantly, this determination should consider Australia's global connectivity, as well as the potential to add additional costs to Australian businesses, without being confident of the benefit.

In closing, we remain committed to our role in the delivery of high-quality audits of financial statements and transparency in reporting. We strongly support change that will improve the performance and accountability of all parties, including EY, involved in the financial reporting chain.

We look forward to discussing our submission and recommendations so that trust and confidence in capital markets can continue to be enhanced for the benefit of all Australians.

Yours sincerely,

**Glenn Carmody**

Oceania Assurance Managing  
Partner

EY Australia

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EY Australia

# Regulation of Auditing inquiry

Parliamentary Joint Committee on  
Corporations and Financial Services

EY Submission

28 October 2019

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## Introduction

The quality of financial reports is critical to maintaining trust and confidence in capital markets.

Financial statement auditing, the subject of this inquiry, supports this confidence. A high-quality audit provides independent assurance that the financial report as a whole is free of material misstatement, and ensures material deficiencies are detected and addressed or communicated with users of the report.

As the Australian Securities and Investments Commission (ASIC) has outlined in its submission to this inquiry, while auditors have primary responsibility for audit quality, improving audit quality is a matter requiring collective action by various parties in the financial reporting chain.

An effective financial reporting chain sees directors, audit committees and management supporting quality audits through the production of quality financial reports.

EY is committed to supporting this collective action and continuing the important role of improving audit quality.

## About EY

EY is a global multidisciplinary professional services firm. In Australia, we employ nearly 6,000 people led by over 500 partners. Our purpose is to build a better working world for our people, our clients and our communities; and the insights and quality services we deliver help build trust and confidence in the capital markets.

We believe a better working world is one where economic growth is sustainable and inclusive. We work continuously to improve the quality of all our services by investing in our people and innovation. We are proud of our work with clients and engagement with stakeholders, and we use our knowledge, skills and experience to help fulfil our purpose and create positive change.

Our purpose unites us, and our values define who we are. They are the fundamental beliefs of our global organisation. They guide our actions and behaviours, influence the ways in which we work with each other, and steer the ways in which we serve our clients and engage with our communities.

Every day, each one of us makes choices and decisions that directly affect the way we experience each other, as well as the way our clients and wider communities experience us. Our values give us confidence that we are using the same principles to help us make these decisions throughout our global organisation.

We deliver services through our four service lines: Assurance, Advisory, Tax and Transaction Advisory Services. Through our deep sector knowledge, we fulfil our role in capital markets, help our clients to capitalise on new opportunities, and manage risk to deliver sustainable growth. EY has been a multidisciplinary firm since inception. Today, most of our revenue comes from audit, assurance services and tax advisory, which have been at the foundation of our business for over 100 years.

Financial statement auditing is delivered via our Assurance service line, comprising 141 assurance partners and 1,500 skilled professionals.

### Our values

Who we are:

- ▶ people who demonstrate integrity, respect and teaming
- ▶ people with energy, enthusiasm and the courage to lead
- ▶ people who build relationships based on doing the right thing.

At the heart of every quality EY audit are our partners and staff who assess risk, obtain audit evidence and form opinions as to whether a financial report is true and fair. In the 2019 financial year, our Assurance business hired an additional 205 full-time-equivalent staff to create greater capacity during peak periods. This is in addition to our annual intake of over 200 graduates in 2019.

EY recognises our public interest obligations. Our Global Code of Conduct<sup>1</sup> is a clear set of business conduct standards that build upon our values to provide the ethical and behavioural framework on which we base our decisions every day. The code is anchored in our values and beliefs. It underpins all that we do and is supported by the EY/Ethics Hotline for staff to raise any concerns about inconsistent actions or behaviours with an independent third party.

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<sup>1</sup> [EY Global Code of Conduct](#)

## EY's response to the PJC terms of reference

### Terms of reference 1: The relationship between auditing and consulting services, and potential conflicts of interests

The findings of academic research consistently conclude that multidisciplinary firms – drawing on deep methodology and frameworks for assurance, combined with specialist and subject matter expertise – are well positioned to meet the audit needs of a complex business.<sup>2</sup>

#### The role of multidisciplinary firms in delivering quality audits

The wide range of highly experienced subject matter specialists in a multidisciplinary firm are required to supplement the skill and expertise of our core audit teams to conduct high-quality audits, where expertise is necessary. The use of these specialists is supported by the stated views of ASIC and recognised as a key component to ensuring the delivery of high-quality audits.

ASIC's audit inspection findings consistently highlight auditing accounting estimates, such as fair-value determination and impairment assessments, as the areas requiring the greatest improvement in audit quality.

Specialist skills are required to effectively audit estimates such as intangible asset valuations, rehabilitation estimates, insurance liabilities, property valuations, plant and equipment valuations, business valuations, and other complex fair-value asset and liability estimates.

As audits and the business environment become increasingly complex, new areas of specialist skills will be required to execute effective high-quality audits. Expertise in artificial intelligence, cyber, analytics, robotics, blockchain and other emerging disciplines are increasingly required and there is a continuing trend for increased involvement of specialist resources. These new skills reside in and are being developed in our non-assurance service lines.

In the financial year ended 30 June 2019, 8.7 per cent of time spent on the Australian Securities Exchange (ASX) 300 audits conducted by EY Australia, was incurred by specialists from other service lines as their expertise was required in the execution of the audit. When specialists from the other service lines assist in audits, they become subject to the heightened independence rules applicable to audit team members.

The structure of EY, together with external regulation, EY policies and other factors combine to ensure the audit practice can operate independently to avoid threats to independence and to manage conflicts of interest.

In summary, the benefits of the multidisciplinary model include:

- ▶ using specialists across functions within the same firm ensures that they are all bound by the same standards of quality, independence and ethics, share common professional values, and are intertwined in a culture and brand built on a reputation for high-quality audits
- ▶ enabling investment in research and development in specialist areas, given economies of scale
- ▶ growth in other service lines strengthens the audit practice with additional highly skilled resources
- ▶ sharing the development of technology solutions, including analytics and robotics, across service lines enables solutions built on the same platforms to support each discipline, and reduces the cost within each service line

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<sup>2</sup> [What Is the Relationship between Audit Quality and Non-Audit Services?](#) An Overview of the Existing Literature, 2018, Jan Bouwens, Amsterdam Business School.

- ▶ increased financial stability as revenue is diversified across different sectors, service lines and through services that experience different demand cycles from clients
- ▶ a more sustainable operating model, as the firm is less vulnerable to economic shocks.

## Provision of non-audit services to audit clients is well-managed

In addition to undertaking the audit of a client's financial statements, EY Australia is often required to undertake specific non-financial statement audits or audit-related services as a result of legislation, or company-specific contractual or licence requirements.

EY Australia will also undertake other assurance services for audit clients, which can include (but are not limited to) an entity's licence requirements of ASIC or Australian Prudential Regulation Authority (outlined in APRA's submission to this inquiry), Independent Accountants' Reports (IARs) or sustainability reporting, which are services performed under relevant Australian standards.

The directors or audit committee may also elect to ask the auditor to provide additional non-audit-related (other) services to the company. The audit committee will determine when the auditor is best placed to provide additional services due to the nature of the issue and the knowledge of the auditor.

In addition to the other Australian legislation that addresses auditor independence, Australian Accounting Standard AASB 1054 requires financial statement disclosure of total audit fees and total fees for non-audit services. It also requires disclosure of the nature of non-audit services. These disclosures, specific to Australia, are additional to those of international jurisdictions and provide extra information to the capital markets to support confidence in auditor independence.

A lack of guidance as to how to categorise non-audit services has led to inconsistencies in how companies disclose these fees in annual financial statements. EY Australia believes that consistency of disclosures in this area would aid transparency and provide clarity to the debate around the appropriate nature and value of non-audit services.

EY Australia believes this disclosure should be made according to the following common framework with four categories of fees disclosed.

Category	Types of services delivered	ASX 300 auditor revenue (source ASIC)	EY's ASX 300 audit client fee revenue (source EY)
Statutory audit fees	Fees paid relating to the statutory financial statement audit and half-year review of any entity within the group, local and international.	70%	72%
Audit-related services	Other audits or reporting that auditors are either required to undertake or are best placed to undertake under legislation, regulation or contract. These services are typically provided by the same audit partner and staff, and include regulatory audits, compliance plan audits, grant audits, covenant reporting to banks and associated entity audits.		
Other assurance services	This would include services conducted in accordance with the assurance framework contained in Australian Auditing Standards (such as IARs, sustainability reporting and agreed-upon procedures reports), as well as other areas of assurance.	12%	14%
Non-audit-related (other) services	Tax compliance services, consulting and other services permitted under the Corporations Act, APES 110, and Australian Auditing Standards.	18%	14%



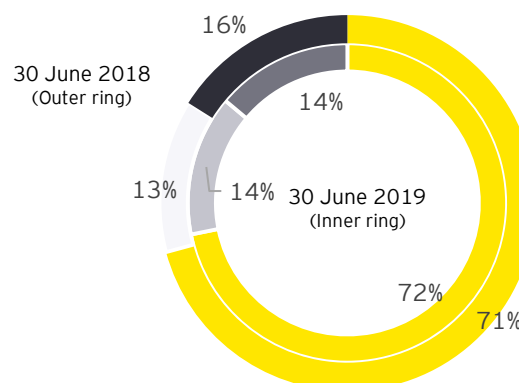
Non-audit services of any type are provided by EY Australia only when permitted by the APES 110 Code of Ethics for Professional Accountants independence standards, EY Australia policy and individual company-specific board or audit committee policies, the latter of which are often more restrictive than the APES 110 independence standards.

Regardless of the type of work performed, in all instances EY Australia policy requires the audit partner to approve the provision of all non-audit services before any such engagement is accepted to ensure non-permitted services cannot be inadvertently provided to an audit client.

EY will not undertake non-audit services for a client where there is an independence risk associated with self-reviewing our work or taking on management responsibilities at the audit client.

Analysis of EY Australia's ASX 300 audit clients demonstrates that non-audit services, other than audit-related or other assurance services, comprised 14 per cent of EY Australia's revenue for this audit client group in the 2019 financial year.

EY ASX300 fee revenue



- Audit fee
- Audit related and other assurance services
- Non audit related or other services

We operate our business with the expectation that our audit engagements be profitable, hold partners accountable for this, and do not price our audit engagements with the expectation or consideration of non-audit-related services we may be asked to provide. The suggestion that the audit of financial statements is a "loss leader" for the sale of non-audit services is not correct.

## Recommendation 1:

**Reform accounting standards to require consistent financial report disclosure of the components of non-audit services and their dollar value according to a common framework.**

## Management of non-audit-related (other) services

We consider the independence framework that governs the provision of non-audit services is poorly understood outside of directors, management and auditors. EY supports the development of a list of prohibited non-audit services to provide increased assurance that these potential conflicts of interest are being appropriately managed.

EY believes this list of prohibited non-audit services in the Australian Auditing Standards would formalise the existing Corporations Act requirements and the APES 110 framework to inspire greater public confidence in the management of non-audit services provided to audit clients by auditors. The US adopts a similar approach, as does the European Union, including the UK.

The Corporations Act requirement for an auditor's independence declaration could then be expanded to require the auditor to specifically confirm that no prohibited non-audit services have been provided.

## Recommendation 2:

**Codify a list of prohibited non-audit services and require the auditor to provide an annual declaration of compliance with this list.**

### Terms of reference 2: Other potential conflicts of interests

The nature of the multidisciplinary firm means that EY Australia provides services to both audit clients and non-audit clients.

When the interests of an audit client and non-audit client are in conflict, EY Australia will follow the prescriptive guidance of the Corporations Act and, specifically, APES 110 to ensure that no conflict of interest is created through this situation.

Non-audit clients deliver around two-thirds of EY Australia's revenue, with audit clients representing the remainder. This remaining one third includes both audit fees and fees for non-audit services to audit clients.

When providing services to non-audit clients, EY takes conflicts of interest seriously and has a comprehensive approach to managing conflicts of interest, where we avoid any activity that could possibly threaten our objectivity or integrity.

The primary responsibility for managing conflicts of interest with non-audit clients sits with our engagement partners. They use the requirements of APES 110, alongside our policies and procedures, to identify and manage transactional, relational, advocacy and personal conflicts of interest, as well as conflicts arising from clients who are in competition with one another.

Each of our service lines has extensive quality-control procedures that must be followed before an engagement can be executed or completed and reports issued. All service lines have quality review programs in place where engagements of all partners can be selected for independent quality review and assessed for compliance with our policies and procedures.

EY recognises our clients' needs are increasingly complex, and they operate in increasingly interconnected markets. This dynamic and interconnected world also means that entering into client relationships requires our engagement partners to have a view beyond technical compliance with regulations, policies and procedures when assessing conflicts of interest.

We have introduced a requirement to take a step back after going through the "technical" questions on engagement acceptance and then ask – even if we can take on the engagement—should we?

To foster these considerations and formalise this judgement, EY introduced language to the process which we apply for acceptance of all clients and engagements. This covers:

- ▶ whether the engagement meets our public interest obligations and upholds EY's integrity
- ▶ whether the engagement meets EY's values and Global Code of Conduct
- ▶ how EY's engagement may be seen over the passage of time.

The quality of the work we deliver builds confidence in our services and, in turn, is a key factor in why we continue to be asked to perform work for our clients. These policies, procedures, independent reviews and commitment to asking, "Should we?" ensure that client work is not compromised in the interest of generating further revenue.

## Terms of reference 3: The level and effectiveness of competition in audit and related consulting services

The market for the provision of audit services is highly competitive, as demonstrated in the Auditing and Assurance Standards Board (AUASB) Research Report 3.<sup>3</sup>

Directors and audit committee members often observe audits executed by multiple firms and utilise their experience to assess relative quality and performance, ensuring they have a strong understanding of the available services. EY's experience is that directors and audit committees are well-informed, educated and have the appropriate skills and resources to perform their role.

The tendering processes adopted by most audit committees is appropriate to their needs, and many adopt a blind tender process whereby a bidder provides its tender without the price until after a decision has been made as to the preferred bidder. This blind tender process helps create a more competitive market as the auditor's approach to technology, the relevant industry expertise, financial acumen and the capacity of the firm to access global networks (where needed) are evaluated before a price is agreed.

Competition for consulting services in Australia is hotly contested, with a range of local and global firms vying for work.

## Terms of reference 4: Audit quality, including valuations of intangible assets

Independent audit of financial statements is critical to maintaining trust and confidence in our capital markets. EY is committed to delivering high-quality audits, and this is reflected in the investments that we make in people and technology, our partner performance measures and engagement with regulators. We acknowledge that we need to improve audit quality.

Central to a high-quality audit are experienced individuals who have a deep understanding of the business they are auditing, assess risk, apply professional scepticism through a challenging mindset, maintain their independence, hold themselves to the highest levels of integrity, and apply appropriate judgements in concluding a financial report is true and fair.

Audit quality is also a focus for regulatory bodies, who measure and support improvements in audit quality through audit inspection findings.

We note the comments by the International Forum of Independent Audit Regulators, of which ASIC is a member, that "inspection findings, while important, should not be the sole measure of progress in audit quality; audit deficiencies identified and reported over the course of an inspection are neither 'balanced score cards' nor overall rating tools."<sup>4</sup>

We support, and have actively participated in, ASIC's ongoing work to identify and report upon a broader range of audit quality indicators following a recommendation from the PJC in February 2019. The reporting of a range of audit quality indicators, of which inspection results is one component, provides a more balanced analysis that will give stakeholders greater clarity and, we believe, support the ongoing confidence in financial markets.

EY acknowledged that audit quality needed to improve some years ago, and we have invested US\$450 million in audit quality initiatives across the globe over the past 10 years. While there has been significant investment to date, we must, and will, continue to invest in audit quality initiatives to drive improvements in response to changing business environments.

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<sup>3</sup> [Audit Market Structure and Competition in Australia: 2012-2018](#), 2019, Professor Elizabeth Carson, UNSW Sydney.

<sup>4</sup> [Survey of Inspection Findings: 2018](#), 2019, International Forum of Independent Audit Regulators.

In February 2019, we established the Audit Quality Governance Committee (AQGC) in EY Australia to oversee matters relating to audit quality and support the initiatives under the EY global Sustainable Audit Quality (SAQ) program.

The AQGC assesses the results of the external and internal audit quality reviews, as well as the application of the audit quality component of an individual partner's performance ratings, and receives regular updates on the SAQ program and audit transformation activities. EY's SAQ program includes the following initiatives:

- ▶ setting the right tone from the top
- ▶ driving accountability for audit-quality outcomes
- ▶ strengthening our people capabilities
- ▶ providing simplification
- ▶ adding quality support to our audit practice
- ▶ enhancing technology tools.

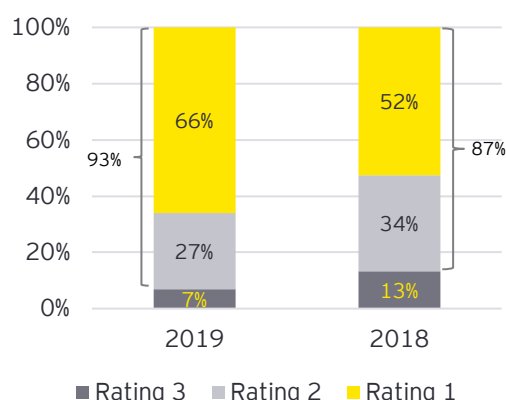
EY partners are subject to an intensive internal Audit Quality Review (AQR) process, which involves their audit files being subject to a globally consistent comprehensive review by a partner independent of their home office. Every audit partners' work is reviewed at least once every three years, the frequency of which is increased should quality concerns be apparent.

#### Case study: Valuing intangible assets

An example of the effectiveness of our SAQ program is the ongoing improvements to how we audit the valuation of intangible assets. After root-cause analysis on audit engagements, where ASIC or audit quality reviews had raised concerns, we developed changes in our approach relating to involvement of valuation specialists, provided additional guidance on audit procedures and required audit evidence, developed tools to assist in ensuring consistency in the manner and detail in which our judgements are documented, and provided significant additional training to all our assurance and subject matter experts.

This work has resulted in a 60 per cent reduction in the level of findings relating to audit procedures on impairment of intangible assets from 2016 to 2018.

EY's AQR Results



We evaluate the results of our AQR review on a three-point scale: 1 = no or minor findings; 2 = findings that were more than minor but less than material; 3 = material findings.

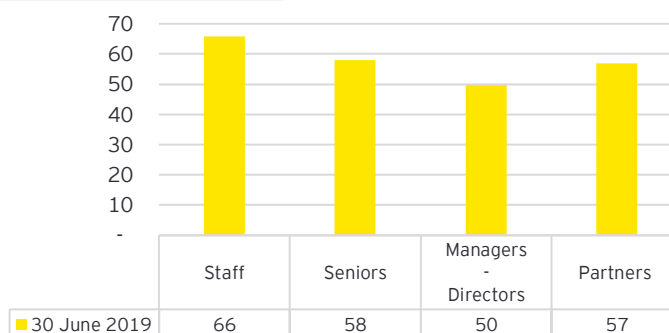
In 2019, EY Australia's AQR program resulted in the inspection of 44 audit engagements, and 93 per cent of the engagements inspected were rated as having no material findings. For 2018, 38 engagements were reviewed in AQR, of which 87 per cent were rated as having no material findings or deficiencies.

The results of internal and external reviews are an important aspect of partner remuneration, with poor audit-quality results incurring financial penalties.

EY's audit partners are subject to a performance rating cap, should their audit quality results be unsatisfactory, regardless of their performance in other areas.

Training of all staff is an important contributor to upholding quality in the performance of audits. In the 2019 financial year, EY invested an average of 59 training hours in our Australian Assurance service-line staff.

2019: Average learning hours



## Terms of reference 5: Matters arising from Australian and international reviews of auditing

As several matters being considered by this inquiry are also being considered in other jurisdictions, Australia should closely monitor the impact of regulatory changes being considered overseas after they are implemented to ensure these changes have the desired impact and the benefits outweigh the costs. We must be wary of unintended consequences and unwarranted cost.

Financial reporting frameworks are the key focus of several significant international reviews underway to assess the role of statutory audits in the context of broader corporate reporting requirements. For example, the UK Brydon Review<sup>5</sup> will examine the existing purpose, scope and quality of statutory audit in the UK, in order to determine:

- ▶ the needs and expectations of users of financial and non-financial corporate reporting
- ▶ how far the audit process and product may need to improve and evolve to meet the needs of users and to serve the wider public interest
- ▶ what specific changes to the statutory audit model and wider regulatory framework for audit may be needed to deliver this, including any changes to company law
- ▶ whether other forms of business assurance should be developed or enhanced to enable shareholders and other stakeholders to better assess the future financial prospects and sustainability of companies.

Other recent studies and inquiries in the UK have led to some relevant findings for this Australian inquiry. The most recent study into non-audit services by the Competition and Markets Authority in the UK “found limited evidence of conflicts between audit and non-audit work at the client level, primarily because of the restrictions in place on cross-selling.” Prior to this, the Sharman Panel of Inquiry in 2012 introduced a range of reforms, including longer term viability reporting and an auditor statement on this.

In the Netherlands, the Inquiry into the Future of the Auditing Sector has released its interim recommendations for comment.<sup>6</sup> These interim recommendations are wide ranging and include the following:

- ▶ To reduce the gap between users’ wishes and what an audit entails, the topics of continuity and fraud must have a larger and more prominent position in audits
- ▶ The primary responsibility for internal control and the accuracy of the annual financial statements lies with the company itself. To reflect this, the board should issue an in-control statement (following the American model), to be audited by the auditor.

The Canadian regulator, Canadian Public Accountability Board (CPAB), is examining several critical audit-quality matters concerning the future of audit, the profession and regulatory oversight.<sup>7</sup> These matters include the following:

- ▶ conducting a thematic review of the issue of fraud and the work performed by auditors in this regard, including how auditors are complying with current standards, and what might need to change to address users’ expectations that auditors will detect fraudulent financial reporting
- ▶ assessing ongoing concern, including the expectations of stakeholders and practical improvements that could be made in this area
- ▶ auditing crypto-assets.

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<sup>5</sup> [Independent review into the quality and effectiveness of audit review: terms of reference](#), 2019, Sir Donald Brydon, Department for Business, Energy & Industrial Strategy.

<sup>6</sup> [Provisional findings of the Committee on the Future of the Auditing Sector; 2019](#); Prof. A.T. Ottow, Prof. E. Dijkgraaf, Mr M.E. de Vries RA.

<sup>7</sup> [CPAB Audit Quality Insights Report: 2019 - Fall Inspections Results](#), 2019.

Many of these international reviews have included comparisons or recommendations introduced as part of the US Sarbanes-Oxley (SOX) regime, introduced in 2002, which requires management to provide an attestation as to their internal controls based on testing they have performed. Other jurisdictions, including Japan, have introduced similar regimes. In some cases, the auditor is required to provide a separate opinion in relation to the internal control attestation.

## Terms of reference 6: Changes in the role of audit and the scope of audit products

We have observed that there is often a disconnect between the regulatory requirements of an audit and financial reporting, and the general understanding in society. Considerations of the role of financial statement auditing should be made in the context of the broader financial reporting framework in which audit operates and this disconnect of understanding.

### The role of financial reporting

Areas of debate and discussion in Australia and globally around financial reporting frameworks have included responsibility for fraud and misconduct, appropriate cyber risk-management frameworks, climate and environment risk-related change reporting, and economic viability reporting.

EY supports a broad review of the financial reporting framework in Australia by the Financial Reporting Council (FRC) to identify whether additional areas of reporting should be required.

It is critical that Australia maintains its consistency with current and emerging global frameworks for financial reporting to ensure that our country continues to be a destination for foreign capital and an attractive place to invest.

Any reform should be mindful of potential unintended consequences, such as the burden on smaller businesses, and the applicability to entities where there is a public interest, while ensuring the right balance of the cost and the benefit of any changes.

### Recommendation 3:

**The FRC should conduct a broad-ranging review of whether the current financial reporting framework should evolve to meet changing expectations.**

### The role of financial statement auditing

The auditor's role in preventing and detecting fraud, along with assessing economic viability, are areas where there is the greatest disconnect between the frameworks for financial reporting and financial statement audit, and expectations of the audit.

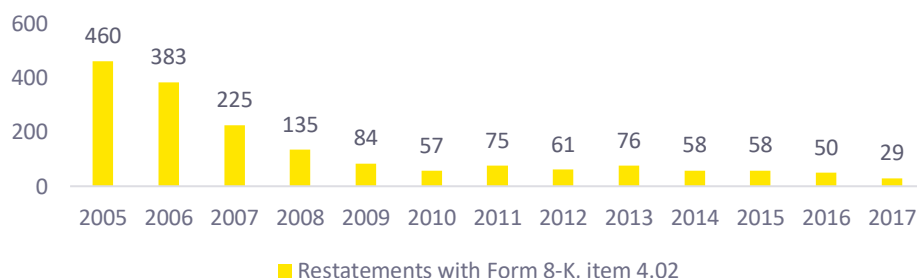
The primary responsibility for the prevention and detection of fraud and non-compliance with laws and regulations rests with those charged with governance and the management of an entity. Australian Auditing Standards require auditors to provide reasonable assurance that the financial statements of the companies they audit are free from material misstatements, whether those are caused by fraud or error. Reasonable assurance is not a guarantee.

The primary responsibility for the economic viability of a business also rests with management and the directors. This is part of their role in the broader financial reporting ecosystem, which also sees them responsible for governance over appropriate internal controls and culture.

Following the review of the broader financial reporting framework, consultation should be undertaken to assess whether reform is required as to the scope of audit and/or audit reporting requirements, taking ongoing international developments into consideration, such as the UK's requirement for longer term viability reporting.

It is also worthwhile considering evidence from the US, which indicates that the level of financial statement restatements has reduced since the introduction of SOX in 2002, as demonstrated below.

Restatements from Accelerated filers  
Source: Audit Analytics (2017 Financial Restatements)



As auditing techniques evolve in response to changes in business, it is important that auditing standards are also responsive to changes in the business environment. We encourage the AuASB development of guidance and local standards that support the delivery of higher-quality audits, particularly in areas relating to the use of digital and data-analytic audit tools.

Any reform should not add expensive burdens on Australian business without an appropriate level of improvement in trust and confidence in capital markets.

#### Recommendation 4:

**Further consultation on whether changes to the scope of audit and audit reporting framework requirements are needed to meet current and emerging expectations of the role of audit.**

#### Recommendation 5:

**AuASB review of auditing standards to ensure they acknowledge and support digital and data analytic-based audit tools and techniques being used, which replace traditional audit techniques for which these standards were originally written.**

### Terms of reference 7: The role and effectiveness of audit in detecting and reporting fraud and misconduct

As noted above, it is a common misunderstanding that it is the responsibility of auditors to detect all fraud. Australian Auditing Standards require auditors to provide reasonable assurance as to whether the financial statements of the companies they audit are free from material misstatements, whether those are caused by fraud or error. Reasonable assurance is not a guarantee that fraud does not exist beyond that parameter.

The primary responsibility for the prevention and detection of fraud and noncompliance with laws and regulations rests with those charged with governance and management of an entity.



The financial statement auditor does not play a role in providing any assurance on conduct or misconduct within an organisation, however, under recent reform to the Corporations Act, an increased range of individuals can make a protected disclosure of misconduct to any member of the audit team.

The range of individuals who can be a potential whistleblower and make a “qualifying protected disclosure” is broad and extends beyond current employees. The list of eligible whistleblowers in respect of a company includes (among others):

- ▶ officers of the company (current and former)
- ▶ employees of the company (current and former)
- ▶ persons who supply services or goods to the company
- ▶ persons who are associates of the company
- ▶ relatives or dependants of any of the above.

Recent updates to the whistleblowing provisions in the Corporations Act increased the range of instances that may give rise to a disclosure and can include (but are not limited to):

- ▶ allegations of fraud, corruption or unethical behaviour or misconduct
- ▶ noncompliance observed regarding company policy or the law
- ▶ concerns regarding questionable business practices or plans.

The new legislation imposes several obligations on EY, including:

- ▶ having a process in place to receive both internal and external whistleblowing disclosures, including anonymous disclosures
- ▶ having a process in place to investigate whistleblowing disclosures
- ▶ ensuring the whistleblower’s identity is kept anonymous and confidentiality is maintained
- ▶ ensuring that there are measures in place to protect whistleblowers from detrimental conduct or victimisation
- ▶ having a whistleblowing policy in place (by 1 January 2020).

The EY/Ethics Hotline is available to all EY partners and staff; it operates independently and effectively. As a result of the above Corporations Act reform, we are updating our whistleblowing policies and introducing new training and procedures.

## **Terms of reference 8: The effectiveness and appropriateness of legislation, regulation and licensing**

It is essential to have fair and balanced legislation governing financial reporting and the role of audit.

### **Australia’s effective independence legislation**

Auditors need to act, and be seen to act, with integrity, objectivity and professional scepticism, ensuring they are independent of mind and of appearance. EY believes the maintenance of independence and objectivity in relation to our audit clients is paramount to maintaining trust and confidence in audit.

Independence requirements are of such importance to an audit that they are contained in the Corporations Act 2001, Australian Auditing Standards<sup>8</sup> and the APES 110 Code of Ethics for Professional Accountants (including Independence Standards), all of which have the force of law in Australia.

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<sup>8</sup> Auditing Standard ASQC 1 [Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements](#); Auditing Standard ASA 220 [Quality Control for an Audit of a Financial Report and Other Historical Financial Information](#).



These cover a range of threats to independence that must be either managed or eliminated, any of which could result in a conflict of interest:

- ▶ personal investments and other financial arrangements of partners, staff, spouse and dependents
- ▶ employment relationships with audit clients
- ▶ non-audit services not permitted to be provided to audit clients
- ▶ business relationships with audit clients
- ▶ mandatory partner rotation and long association of senior staff with the audit client.

If a threat to independence exists, APES 110 requires firms to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards and, as needed, to withdraw from the engagement. Partners and staff undertake annual training on independence, and partners are held financially accountable for compliance.

The last significant reform to auditor independence was contained in CLERP 9, which required auditors to provide a personally signed annual independence declaration to the board of each audit client, and introduced five-year mandatory audit partner and quality-review partner rotation.

Together, these partner-rotation regimes ensure that auditors do not become overly familiar with the organisation they are auditing, which furthered Australia's reputation for having leading standards, dating back to the decades-earlier requirement for audit partners to personally sign off on company audit reports in their own name.

## Australia's unique criminal liability legislation

Auditors use their professional skill and scepticism to apply appropriate judgements in accordance with auditing standards, when concluding whether a financial report is true and fair.

The auditing standards are however often not expressed in a prescriptive way, but rather in a narrative format, by reference to principles and in varying degrees of generality. Therefore consideration of the application of auditing standards and assessment of audit wrongdoing, including in civil proceedings against audit firms, typically involves competing expert evidence as to the proper meaning, effect and interpretation of the standards.

Despite this inherent uncertainty, section 307A of the Corporations Act makes it a strict liability criminal offence to fail to comply with the auditing standards, which leads to liability regardless of fault. Strict liability means the defendant would be held liable even though they were not at fault, that is, the defendant's actions were not intentional, reckless or negligent.

In other words, an auditor may be prosecuted for failing to comply with the auditing standards even though those standards are open to interpretation and irrespective of any intention to commit wrongdoing.

The imposition of strict criminal liability under section 307A is unique to Australia. By contrast, the regulatory regimes in place in the UK, US, Hong Kong and Singapore, treat auditor misconduct as a regulatory matter save in respect of knowing or reckless conduct (in other words, conduct which is tantamount to fraud).<sup>9</sup>

EY acknowledges that there will be some circumstances where it is appropriate to penalise an Auditor for their conduct and that the imposition of criminal liability is one way of emphasising the requirement to take appropriate professional care and deterring auditors from breaching their obligations. We also strongly support a rigorous regulatory response to audit problems, including appropriate regulatory sanctions. However, to impose strict criminal liability for conduct which may amount to no more than professional misjudgement is to venture beyond what is necessary to

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<sup>9</sup> See, for example, section 507 of the Companies Act 2006 (UK)

achieve the intended deterrent effect and instead presents a serious threat to the ability of the audit profession to attract and retain appropriately skilled individuals, and we believe this application of strict criminal liability should be independently reviewed.

## **Recommendation 6:**

**An independent review of the appropriateness of strict liability combined with criminal consequences as a penalty for auditors in the Corporations Act.**

## **The corporate governance of audit relationships**

Directors and audit committees play an important and legislated role in the financial reporting chain through establishing processes and policies relating to:

- ▶ oversight of management and the system of internal controls
- ▶ assessments of culture and the impact of culture on internal controls
- ▶ oversight of key accounting judgements and estimates
- ▶ assessment of auditor independence (including consideration and approval of non-audit services).

The application of governance by audit committees results in competitive audit tenders on a regular basis, such that the average tenure of EY's ASX-listed audit clients is 14 years, and the average tenure since the last tender is 10 years. This is comparable to the 10-year mandatory tender and 20-year mandatory rotation regimes adopted in Europe.

In the context of enhancing the confidence of capital markets, audit committees could have a role in updating and informing shareholders of matters relating to the financial statement reporting and the audit, particularly regarding areas of community concern such as audit tenure.

As discussed earlier in this submission, EY Australia believes legislation in this area is adequate, and this is supported by the body of academic research into audit-firm tenure and quality, which predominantly finds that longer audit firm tenure is associated with higher-quality audits.<sup>10</sup> It should not be assumed that reductions in audit tenure will increase audit quality.

Legislation and regulatory guidance should be developed to require a report to shareholders, as part of an annual report, by directors or the audit committee addressing auditor appointment and tenure. This could also take into account matters such as key financial reporting matters considered by them, non-audit services, and consideration of levels of assurance sought on areas outside the financial statements such as internal audit, cyber risk and sustainability assurance. The ASX Corporate Governance Council might consider providing guidance on this in the absence of legislation.

## **Recommendation 7:**

**Legislation should require directors and audit committees to provide enhanced reporting to shareholders relating to the key audit and financial reporting matters they have considered.**

<sup>10</sup> [Mandatory Audit Firm Rotation and Audit Quality](#); 2008; Andrew B Jackson, Michael Moldrich, Peter Roebuck; UNSW.

## Strengthening Australia's transparency reporting requirements

In 2013, Australia implemented a requirement for public transparency reporting on the internal governance and practices of audit firms, following the European Union in 2008 and Japan in 2009. Canada requires a limited set of disclosures publicly and a more fulsome private disclosure to the regulator, while the US has no requirement despite urging by the Public Company Accounting Oversight Board. EY Australia first published a transparency report in 2012.

In the intervening years since the introduction of transparency reporting in Australia, expectations of users of these reports has changed.

### **Recommendation 8:**

**Enhance current transparency reporting requirements to increase their effectiveness.**

## Terms of reference 9: The adequacy and performance of regulatory, standards, disciplinary and other bodies

### Australia's audit-inspection regime

ASIC currently inspects a small risk-based sample of listed company audits every year and, within these engagements, inspects audit procedures and conclusions in a select number of audit areas. ASIC selects engagements and the focus areas based on risk, and specifically cautions against generalising results across the entire market. Under the current regulatory regime, we believe the market has responded well to ASIC's regulatory involvement by undertaking root-cause assessments and making substantial changes to audit processes because of the regulator's actions.

ASIC audit inspection outcomes in Australia are not classified based on severity, which differs from several international jurisdictions, including Canada and the UK. While each of these territories use different metrics to determine severity, EY Australia believes the analysis of findings achieved through a severity assessment provides better transparency and understanding of the nature of inspection findings, which facilitates greater confidence in the quality of audit.

EY Australia also believes the addition of a random component to ASIC's risk-based inspection regime would enhance comparability of inspection outcomes over time and, ultimately, provide a better benchmark for the assessment of changes in audit quality.

Additionally, we believe ASIC could broaden its approach to assess in more detail the types of firm-wide cultural and governance drivers of audit quality, as well as systems of quality control contained in these reports. We believe these firm-wide drivers of audit quality have a significant impact on improving audit quality. We note that the above requirements would place pressure on ASIC's resourcing.

### **Recommendation 9:**

**Include severity assessments in ASIC's audit quality measures and expand ASIC's inspection program to include a random sample and a more detailed assessment of firms' systems of quality control.**