

Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into the regulation of Auditing in Australia

ASIC response to written question on notice

Question No: 10
Topic: **PJC Inquiry into the regulation of Auditing in Australia**
Reference: Written

Question:

1) NAB and EY:

- a) The evidence given by NAB senior executives Chronican and Lennon at the House Economics Committee on Friday 15 November 2019 was to the effect that NAB's auditor, EY was engaged to undertake the CPS 220 review as EY posed a lower risk of being conflicted than the other three major firms, due to the higher likelihood of those other firms reviewing their own work. Putting aside the independence issues arising from the very close relationship between EY and the NAB, does the approach adopted give ASIC any cause for concern regarding any actual or perceived conflict of interest?
- b) Was ASIC aware of the very close working relationship between NAB and EY as demonstrated when EY was performing the CPS 220 risk management framework review and preparing the statutory report, required by APRA?
 - i) If so, how and when did ASIC become aware?
- c) Does the close working relationship demonstrated by the NAB and EY give ASIC cause for concern regarding an actual or perceived lack of independence?
- d) Does ASIC consider EY meets the auditor requirements of independence as prescribed in section 324CD (1) of the CA and paragraph 100.12 of the APES 110 Code of Ethics for Professional Accountants.
 - i) If so, on what basis?
- e) In light of its close relationship with the NAB, has ASIC considered whether EY has the required level of independence (either actual or perceived) to continue in the role of NAB's auditor?
- f) What if anything has ASIC done to investigate this matter?
- g) Did the NAB report there was a problem with the self-managed superannuation products the NAB was selling in the market?
 - i) If so when?
- h) Did EY consider whether this was a reportable breach? If so, did EY report this breach to ASIC as required by s311 (as NAB's auditor) and/or s990K of the CA (as NAB's Australian Financial Services Licensee auditor)?
- i) If not, why? If so, when? What action is ASIC taking or proposing to take regarding this matter?

2) Blacklisted audit partners by investors

- a) Is ASIC aware of a blacklist of audit partners? If so, what has ASIC done in response?

3) Around company failure

- a) When a company fails and its financial report doesn't show this declining financial position, or going concern issues... would you say it is reasonable to ask questions around the role of the auditor? To what extent can we hold an auditor responsible?

4) Around independent expert self-selection

- a) Does ASIC allow the financial institution to select ANY one of the 4 Firms as the IE to provide assurance over the implementation of the remediation program
- b) I'm interested in understanding whether ASIC has been prepared to accommodate the financial institutions influencing the key steps in the enforceable undertaking process, including the:
- (i) selection of the IE to be appointed,
 - (ii) determination of the scope of the IE's work,
 - (iii) interpretation of the engagement terms,
 - (iv) settling of the findings and recommendations in the report beyond the correction of factual information (including the inclusion and exclusion of information); and
 - (v) media release announcing the outcome.

5) Around reporting dates:

- a) Is there any chance an entity could flood the audit team with information close to the reporting due date in the hope that scrutiny will not be effectively applied?
- b) Have you ever seen this occur?
- c) Is there pressure for auditors to sign off on the date in time for financial report printing? – how often do we see the publishing of financial reports delayed?
- d) What is the process to reduce problems imbedded close to the end date for printing of annual reports?

6) Relationship between ASIC and CA ANZ

- a) CA ANZ and ASIC don't appear to have consistent messaging and views on the state of audit quality in Australia.
- b) ASIC has repeatedly questioned the quality of corporate audits by the big four and flagged concern about "deep-rooted problems in the audit market".
- c) In contrast, CA ANZ pronounced at the start of the year (in an AFR opinion piece from February) that audit was in "a golden age" and has pushed to vastly expand the type of work auditors carry out into areas such as environmental, social and governance assurance. (i) Does ASIC have any ideas as to why your views appear to conflict?
- b) In an AFR article published in October, CA ANZ claimed that the body hadn't conducted any reviews of the quality control systems of the big four (their members) in the past 5 years as they claimed to have an '*understanding with ASIC that it would not do audit inspections of large firms alongside the regulators own review program*' (i) Does such an understanding exist?
- (ii) Do you think it would be wise for CA ANZ to inspect the audit files of its biggest members to promote quality audits?

Answer:

1) NAB and EY

- a) The response by officers of National Australia Bank Limited (NAB) at House Economics Committee on Friday 15 November 2019 appears to refer to potential conflicts that could affect a firm's objectivity **in providing a CPS 220 review** for a bank rather potential conflicts that could affect the objectivity of a firm in conducting the audit of the financial report of a bank. As discussed at PJC hearings, there are different independence considerations that apply in relation to appointing a consultant to do CPS 220 work compared to being a company auditor. It is a matter for the Australian Prudential Regulation Authority (APRA) as to the degree of independence and objectivity that they require of the provider of a CPS 220 review.

ASIC's regulatory remit covers the audit of the financial report of a bank under Chapter 2M of the *Corporations Act 2001*. ASIC would be concerned if the auditor of the financial report did not meet the independence requirements of the *Corporations Act 2001* (the Act) or provisions of the profession's Code of Ethics due to a conflict of interest arising from the provision of a CPS 220 review.

At present, under current laws, it is not clear that any actual or perceived conflict of interest from the provision of a CPS 220 review by an audit firm significantly affects the objectivity of the auditor in auditing the financial report of a bank such as to breach auditor independence obligations.

- b) ASIC is aware that there is a long standing relationships between Ernst & Young Australia (EY) and NAB given that EY has been the auditor of NAB since 2004. The information we have on the details of that relationship and how it operates in practice, comes from information in the public domain.

The extent of non-audit services provided by EY as a whole is reflected in the disclosures in NAB's annual reports on fees paid to EY for non-audit services.

The Act contains provisions for the rotation of lead and review audit partners of listed companies, such as NAB. These provisions require partners to be involved in the audit for no more than 5 years, with a two year cooling off period. The period of involvement can be extended to 6 or 7 years in certain circumstances,

- c) No. At present, we are not aware of any information to suggest that EY's relationship with NAB differs significantly from the relationship between a bank auditor and bank. There is no

evidence to give ASIC cause for concern regarding an actual or perceived lack of independence in the context of the audit of the financial report under current laws.

- d) Section 324CD of the Act defines conflict of interest for the purposes of applying the general provisions of the Act requiring the auditor of a financial report to be independent. Section 324CD(1) says:

- “(1) For the purposes of sections 324CA, 324CB and 324CC, a conflict of interest situation exists in relation to an audited body at a particular time if, because of circumstances that exist at that time:
- (a) the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body; or
 - (b) a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body.

Paragraph 100.2 of APES 110 *Code of Ethics for Professional Accountants* says:

“100.2 This Code contains three parts. Part A establishes the fundamental principles of professional ethics for Members and provides a conceptual framework that Members shall apply to:

- (a) Identify threats to compliance with the fundamental principles;
- (b) Evaluate the significance of the threats identified; and
- (c) Apply safeguards, when necessary, to eliminate the threats or reduce them to an Acceptable Level. Safeguards are necessary when the Member determines that the threats are not at a level at which a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the Member at that time, that compliance with the fundamental principles is not compromised.

A Member shall use professional judgement in applying this conceptual framework.”

Paragraph 100.5 says:

“100.5 A Member shall comply with the following fundamental principles:

...

- (b) Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional or business judgements. ...”

We are not aware of any information to suggest there was a conflict of interest situation affecting the audit of the financial report of NAB or that the auditor’s independence and objectivity was compromised for the audit of the financial report under current laws.

- e) We are not aware of any other information to suggest that EY’s relationship with NAB differs significantly from the relationship between a bank auditor and bank. We currently have no basis to conclude that EY is in a conflict of interest situation that has an actual or perceived effect on the conduct of the audit of the bank’s financial report that would bring into question the continuation of the role of EY as NAB’s auditor under current laws.

ASIC considers possible auditor independence issues when reviewing audit files as a part of our audit firm inspections.

ASIC has also commenced a review of how conflicts of interest are handled at the largest six audit firms. We will review firm policy, processes and procedures, interview firm leadership and review other relevant records and evidence. This work will continue throughout 2020.

- f) Please refer to the response to question 1(e) above. ASIC has made no specific inquiries of NAB or EY in relation to EY’s independence as NAB’s auditor.

As part of ASIC's investigation of NAB charging fees without providing services over the period from 2013 to 2018, ASIC obtained a draft CPS 220 report and other notes from EY.

As noted in response to question 1e), ASIC has commenced a review of conflicts of interest at the largest six audit firms.

- g) After making all relevant inquiries within ASIC and searching our records, from 1 July 2016 to 11 December 2019, we can find no record that NAB reported to ASIC specifically regarding a problem with the self-managed superannuation products that NAB was providing in the market.

However, six reports were lodged with ASIC by NAB over this period regarding breaches related to SMSF clients. These reports concerned advice provided to SMSF clients, non-compliance with education requirements by an adviser and incorrect interest accrued on deposit accounts offered to SMSFs. These reports were lodged on 8 September 2017, 21 March 2018, 14 June 2018, 29 August 2018, 2 October 2018 and 12 December 2018.

- h) From our records of s311 and s990K notifications from EY over the period from 1 July 2016 to 11 December 2019, we found one notification reported to us on 16 November 2018 under s990K in connection with a breach related to the self-managed superannuation products. The auditor reported an earlier notification dated 29 August 2018 from NAB concerning a system error which accrued a lower rate of interest on the deposit accounts of SMSFs since 2014.
- i) As a system fix was implemented in April 2018 to address the matter referred to in h), ASIC did not take further action.

2) **Blacklisted audit partners by investors**

- a) ASIC is not aware of a black list of audit partners. As discussed in the response to an earlier question on notice, an article by Mr Edmund Tadros and Ms Vesna Poljak in the Australian Financial Review on 24 January 2019 and titled *Auditors 'compromised' by providing consulting work: ASIC* says:

“Fund managers watch the audit relationship closely.

Alarm bells go off at Ophir if the audit firm changes outside of a five-year term. It's not too dissimilar to when a CFO unexpectedly resigns,” said Andrew Mitchell, a senior portfolio manager.

It is also important to follow who the audit partner is. We have a list of audit partners who have been involved with questionable audits. We just won't go near a company that is using one of these audit partners”

We contacted Mr Andrew Mitchell of Ophir Asset Management to get an understanding of how Ophir identifies “questionable audits” and the source of the information they use for this purpose. There are third parties in the market (e.g. some proxy advisors) that provide reports on a subscription basis containing third party analysis of individual company performance and reporting. We understand that Ophir uses one of these services and that is what the article was referring to.

We encourage those who have identified concerns with the quality of audits conducted by individual auditors or audit firms and authorised audit companies to report those concerns to ASIC.

3) **Around company failure**

- a) In paragraph 8 of ASIC Report 461 *Audit inspection program report for 2014-15* (released in December 2015) we said:

“If a company fails and the financial report did not properly show the declining financial position and results or going concern issues of the company, it is reasonable

that questions would be raised about the role of the company directors and the auditor. Questions may also be raised if investment decisions are made on financial reports that do not otherwise reflect a company's true financial position and performance. If the auditor did not obtain reasonable assurance that the financial report was free of material misstatement, apply sufficient scepticism to accounting estimates and treatments, or address any deficiencies detected, investors and other users of financial reports would be concerned."

While company failures are not always accompanied by failures in financial reporting or audit, we continue to hold the view outlined above. We may take undertake surveillance of auditors where we have concerns that investors and markets were not properly informed through financial reports or where we have other reasons for possible concerns with the audit. If we find that the audit was deficient, we may refer the lead audit partner to the Companies Auditors Disciplinary Board seeking suspension or deregistration of the auditor

Other actions may include action under the new fault-based criminal offence for a registered company auditor who fails to conduct audits in accordance with legally enforceable auditing standards (s307A of the *Corporations Act 2001*) incurs a maximum penalty of \$50,400 or two years' imprisonment, or both. The strict liability offence incurs a maximum penalty of \$10,500.

We are actively reviewing current financial reporting and audit matters, where we have concerns, to determine matters for which court action is appropriate as a public deterrent.

4) Around independent expert self-selection

- a) As a matter of practice, ASIC has not allowed an audit firm that audits the financial report of a financial institution to undertake any assurance work over the implementation of ASIC related remediation plans or the review of compliance with undertakings under ASIC Court enforceable undertakings (CEUs).

The role of an independent expert is not limited to the largest four accounting firms for these purposes. The primary consideration when determining the appropriateness of an independent expert is their qualifications, experience and competence to perform the task.

Where an accounting firm is used, we may require that a lawyer be part of the independent expert team. This will ensure, for example, that assessments of an entity's policies, procedures and consumer files have the benefit of legal experience and understanding.

- b) The financial institution would bear the cost of any assurance work and engage an audit firm or other independent expert in most cases. In these cases, ASIC's current practice is:
- i) A condition of any CEU would be that an assurance provider or independent expert only be appointed if ASIC approved the appointment;
 - ii) ASIC would not accept a CEU unless the terms of the CEU require that the scope of the independent expert's work is agreed by ASIC;
 - iii) ASIC will review the engagement letter between the financial institution and the independent expert to ensure that the scope and terms are clear and appropriate;
 - iv) Findings would normally be settled between the independent expert and the financial institution, although ASIC would consider the impact of any deficiencies and any further actions; and
 - v) A condition of any CEU would be that the independent expert's report is provided to ASIC. We may publish that report. For example, in a matter involving responsible lending and BMW Finance, ASIC an interim compliance report, a final compliance report and Ernst & Young's remediation report on ASIC's public CEU register.

In some cases, ASIC procures and contracts directly with the independent expert. For example, the CEUs with the banks on foreign exchange contracts. The banks meet the cost of

the independent expert but the terms of reference are set by ASIC and the independent experts are directly accountable to ASIC.

5) Around reporting dates

- a) It could occur that an entity delivers a high volume of information required for an audit to the audit team close to the financial reporting deadline for a wide range of reasons. It would be speculation at best to try and attribute any intention to the company in the absence of probative evidence.
- b) We do not have information on the number of cases where adverse findings from our review of audit files in our audit inspections or surveillance are caused by deadline pressures, or the identities of the companies concerned.

However, we expect audit firms to conduct root cause analysis on the causes of our adverse inspection findings and their own internal quality reviews of audits. They should then identify actions to address these root causes. Our discussions with the firms on the thematic root causes of audit deficiencies indicate that deadline pressures are a contributing factor to a number of audit deficiencies. The largest six firms domestically and internationally have recognised the importance of effective project management of audits to address these pressures.

Auditors are also required to notify ASIC of suspected contraventions of the *Corporations Act 2001* (the Act). As shown in Appendix D to our submission to the Committee's Inquiry on the Regulation of Auditing in Australia, many such notifications concern failures by companies to meet deadlines for the lodgement of financial reports with ASIC. The auditors may or may not outline the causes of such failures, and the causes may vary. Our systems do not separately capture information on the causes of failure to lodge financial reports by the reporting deadline.

- c) There may be pressure for auditors to provide their audit or review reports in time for reporting deadlines to be met. For example, ASX listed entities that do not meet their reporting deadlines will be suspended from trading. At 30 June 2019, there were 2,269 Australian formed entities listed on ASX and 43 entities were suspended from trading for failing to meet report deadlines in the 12 months from 1 July 2018 and 30 June 2019.
- d) Ways to address deadline pressures close to reporting dates include:
 - (i) Companies should have appropriate resources and capabilities to deliver financial information for audit on a timely basis. ASIC has published or contributed to several documents which set out the roles of key stakeholders in contributing to timely and high quality financial reporting and audit quality:
 - ASIC Information Sheet 183 *Directors and financial reporting*;
 - ASIC Information Sheet 196 *Audit quality: The role of directors and audit committees*;
 - ASIC Information Sheet 223 *Audit quality—The role of others* (INFO 223); and
 - The International Organization of Securities Commissions (IOSCO) also issued *Report on good practices for audit committees in supporting audit quality* (January 2019).
 - (ii) In particular, directors and audit committees should ensure the company's internal governance and risk frameworks are robust and support the preparation of financial statements that are free of material misstatements. Management should produce information on a timely basis that is supported by appropriate analysis and documentation for audit. Company management should:
 - Ensure appropriate processes and records to support the information in the financial report; and

- Apply appropriate experience and expertise to produce quality financial information and financial reports, and appropriate analysis and documentation on a timely basis for audit.

As noted in ASIC's submission to PJC (see paragraphs 40-42), in the US there are rules that company management sign off on internal controls regarding financial reporting and for auditors to report on the accuracy of the company management assertion that internal accounting controls in place are operational and effective. These requirements affect Australian companies that have securities listed on a US market or are subsidiaries of US listed entities. However, these requirements are not part of the Australian regulatory framework.

- (iii) Audit firms should ensure that there is effective project management of audits by auditors. This includes leadership ensuring the proper resourcing of individual audits, monitoring by audit leadership of the achievement of milestones for the completion of key elements of audits, acting when milestones are not met, and agreeing the timing of delivery of items for audit with company management. ASIC reviewed project management processes at the six largest firms in 2017.
- (iv) Audit firms should review whether they are effectively staffed for peak audit periods and address any issues through recruitment, staff retention, secondments from affiliate audit firms internationally or domestically, contracting experienced auditors for peak periods, and appropriate use of offshore service centres.
- (v) Companies may use provisions in the Act that allow them to change their financial years away from the peak reporting season of 30 June. However, we understand that many companies prefer to report at 30 June so as to, for example, report at the same time as competitors in markets.
- (vi) If an auditor is given insufficient time to conduct an effective audit before the reporting deadline, the auditor should not render their audit report until an effective audit has been completed even if the reporting deadline will be missed.
- (vii) In some circumstances, the auditor may need to issue a modified audit report due to a limitation on scope if the audit, or report that the company has failed to keep proper books and records to allow financial reports to be prepared. The auditor may also be required to report a suspected contravention of the Act to ASIC.
- (viii) Deliberate attempts to place pressure on the audit team that involve withholding information and explanations may be a breach of the requirement of the Act that company officers provide the information and explanations that the auditor reasonably requires.

6) Relationship between ASIC and CA ANZ

a) to c)

We are not aware of any statements or views of CA ANZ that contradict ASIC's reports of its findings from our reviews of audits of financial reports in our audit inspections, or our view that audit firms need to take further action to improve audit quality and the consistency of audit execution. CA ANZ posted responses that were supportive of the key messages in ASIC's last two audit inspection reports REP 648 *Audit inspection report for 2018-19* and REP 607 *Audit inspection program report 2017-18*.

In the article in the Australian Financial Review from 12 February 2019 *This is the golden age of audit: Chartered Accountants ANZ* (AFR article), CA ANZ refers to the demand for auditors to provide audit and assurance services in new areas in the future that are beyond the current legislative requirements to audit financial reports.

We have not disagreed with the comments attributed to CA ANZ in the AFR article. Whether any such audit or assurance services should be mandatory sometime in the future is a policy matter for Government. In the meantime, the voluntary use of such services is a matter for companies, investors and markets, and auditors.

d)(i) CA ANZ does not review audits performed by the Australian firms of Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers (the Big 4 firms).

There was no agreement with ASIC that CA ANZ would not undertake proactive reviews of audits conducted by the Big 4 firms. That decision was made by CA ANZ.

Of course, ASIC was aware of the decision by CA ANZ, which they made having regard to possible duplication with ASIC's audit inspections. Instead, CA ANZ's resources are focussed on the review of audit and non-audit services provided by other firms.

For completeness, we note that ASIC does provide details of audits being reviewed at a firm to CA ANZ if we have received consent from the firm to disclose that information.

d)(ii) It is a matter for CA ANZ as to whether it inspects the audit files of the largest audit firms.