

**AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY**

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**WAYNE BYRES**

Chairman

24 October 2019

Committee Secretariat  
Parliamentary Joint Committee on Corporations and Financial Services (the committee)

Dear [REDACTED]

**INQUIRY INTO REGULATION OF AUDITING IN AUSTRALIA**

Thank you for your 7 August 2019 invitation to make a submission on this inquiry.

The Australian Prudential Regulation Authority (APRA) welcomes the opportunity to engage with the committee on this matter. APRA's role is to protect the interests of bank depositors, insurance policyholders and superannuation fund members and promote financial system stability more generally. Independent, high quality audits play an important role within the regulatory framework we administer, helping to build public trust and confidence in the financial system.

APRA relies to a significant extent on the provision of data and related information from regulated financial institutions as a means to assess their financial soundness. This data is often derived from, or based on, audited financial information and the reliability of this information is critical to APRA being able to accurately assess the prudential health of regulated institutions.

APRA also engages with auditors under so-called tripartite arrangements that involve APRA, the regulated entity and its external auditor. Under these arrangements, APRA engages auditors to prepare assurance reports on specific topics.

APRA is aware of concerns that have been raised at both a domestic and international level around audit quality, and we have been involved in initiatives at both a Basel Committee on Banking Supervision (BCBS) and Financial Stability Board (FSB) level. Our own experiences with regard to issues arising from our tripartite arrangements with auditors echo some of these concerns. Overall, APRA notes that our experiences have been mixed on audit quality and we are considering refinements to our requirements in this area. As such, APRA welcomes initiatives to improve the quality of audits. The Attachment to this letter sets out APRA's views on selected matters in the Terms of Reference.

Please feel free to contact Rob Sharma on [REDACTED] should you wish to discuss this submission further.

Yours sincerely,

## ATTACHMENT A

### INQUIRY INTO THE REGULATION OF AUDITING IN AUSTRALIA RESPONSE TO MATTERS CONTAINED IN THE TERMS OF REFERENCE

Audits are an important warning mechanism for APRA. APRA requires regulated entities to appoint an external auditor, with specific roles and responsibilities as set out in APRA's prudential framework.<sup>1</sup>

APRA regularly liaises with the relevant professional bodies and standards setters<sup>2</sup> and has been involved in global initiatives on audit quality.

Under APRA's framework, auditors prepare annual prudential assurance reports as well as other reports of a non-recurring nature.

#### APRA Specific Reports provided by External Auditors

##### *Annual prudential assurance reports*

The annual prudential assurance reports require auditors to provide independent assurance on whether the regulated entity has:

- provided reliable data to APRA;
- satisfactory internal controls designed to ensure compliance with all applicable prudential requirements; and
- complied with all requirements under the relevant industry Act(s) and the *Financial Sector (Collection of Data) Act 2001 (FSCODA)*, including compliance with prudential standards and reporting standards during the financial year.

##### *Non-recurring reports*

APRA may require a regulated entity to engage an auditor to provide a report on a specific subject matter. The report prepared may be by the existing appointed auditor or another auditor. Subject matters covered can include any aspects of the regulated entity's operations, prudential reporting, risk management systems or financial position.

##### *Review and follow-up by APRA on Reports*

APRA supervisors review and follow-up findings from these reports as part of their ongoing supervisory process. Where significant prudential issues are identified, APRA supervisors will liaise with both the auditors and regulated entities to ensure that these issues are appropriately addressed.

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<sup>1</sup> The relevant prudential standards are *Prudential Standard APS 310 Audit and Related Matters*; *Prudential Standard GPS 310 Audit and Related Matters*; *Prudential Standard LPS 310 Audit and Related Matters*; *Prudential Standard HPS 310 Audit and Related Matters* and *Prudential Standard SPS 310 Audit and Related Matters*. Auditors may also be required to review the risk management framework in accordance with paragraphs 44 and 45 of *Prudential Standard CPS 220 Risk Management*. Auditors also need to provide assurance that ADIs satisfy the internal control requirements relating to Single Customer View Data and Financial Claims Scheme payment and reporting information in accordance with paragraphs 27 to 29 of *Prudential Standard APS 910 Financial Claims Scheme*.

<sup>2</sup> Chartered Accountants ANZ and CPA Australia, as well as International standards setters (IAASB, IESBA) and Australian standards setters (AASB, AUASB, APESB).

## Potential conflicts of interests

A conflict of interest is defined as circumstances where an auditor is not capable of exercising objective and impartial judgement in relation to the conduct of the audit.

There have been concerns raised both domestically and globally about both auditing and consulting services being provided by the same firm, and that this creates a potential conflict of interest. APRA notes that the current regulatory architecture imposes several requirements to mitigate and manage the ethical threats faced by auditors. In addition, global auditing and ethical standards setters continue to strengthen the requirements relating to audit quality (with a focus on firm culture, professional scepticism and professional judgement) and auditor independence (including actual and perceived conflicts of interest).<sup>3</sup>

APRA's approach is consistent with international practice. Its prudential requirements are also substantially consistent with the *Corporations Act 2001* independence requirements. APRA also imposes its own requirements on auditors to manage conflicts of interests. Specifically, APRA requires an auditor to:

- satisfy the auditor independence requirements of Prudential Standard *CPS 510 Governance* (CPS 510); and
- meet the requirements of Prudential Standard *CPS 520 Fit and Proper* (CPS 520).<sup>4</sup>

As part of the process of ascertaining the independence of the auditor, an APRA-regulated institution must obtain a declaration from the auditor that the auditor is independent, both in appearance and in fact; and the auditor has no potential conflict of interest situation. In addition, the Board Audit Committee must review the engagement of the auditor at least annually, and make its own assessment of whether the auditor meets the:

- *APES 110 Code of Ethics for Professional Accountants* auditor independence requirements; and
- Additional independence requirements in an APRA prudential standard (CPS 510).

There are also requirements relating to rotation and removal of auditors.<sup>5</sup>

Under APRA's prudential requirements, an individual who plays a significant role in the audit of an APRA-regulated institution for five successive years, or for more than five years out of seven successive years, generally cannot continue to play a significant role in the audit until at least a further two years have passed. APRA may grant an exemption from this requirement if the individual provides specialist services that are otherwise not readily available, or there are no other registered company auditors available to provide satisfactory services for the APRA-regulated institution. APRA has granted a small number of such exemptions (e.g. when there is a transfer of superannuation business or an insurer's business is in run-off). Such exemptions are typically granted for short periods, where APRA is satisfied that doing so will not compromise sound prudential outcomes.

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<sup>3</sup> These global standards are then adopted by Australian auditing and ethical standards setters.

<sup>4</sup> *Prudential Standard SPS 510 Governance* and *Prudential Standard SPS 520 Fit and Proper* (SPS 520) contain similar requirements for the superannuation industry.

<sup>5</sup> Classified as holding a 'responsible person position'. Refer to the definition in CPS 520, paragraph 24. Also refer to SPS 520, paragraph 15.



AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

In practice, however, it can be difficult to establish at what point the conduct of both auditing and consulting services leads to a conflict of interest within the same firm.

APRA is aware that the European Union has considered mandatory firm rotation after a definite period (10 to 15 years), capped the provision of non-audit work, and prohibited some forms of non-audit work to strengthen auditor independence and reduce the potential for conflicts of interest. In the UK, the Financial Reporting Council is moving towards the introduction of a list of permitted services that auditors can provide, limiting these to those which are closely related to the audit and/or required by law and regulation. The viability of these approaches could be explored as part of this inquiry.

Auditors may be removed with powers provided under various industry Acts.<sup>6</sup> APRA considers these powers to be important prudential controls, given the reliance placed on auditors. These powers have been exercised in the past. For example, APRA disqualified a number of auditors under the *Superannuation Industry (Supervision) Act 1993* in the early 2000s.

### **The level and effectiveness of competition in audit and related consulting services**

Audit services for large diversified and complex institutions are typically provided by global multidisciplinary firms. These firms have a global network, significant resources and the expertise necessary to conduct large and complex assurance engagements. On audits of large and complex entities, it can take years for practitioners to build the knowledge base required to effectively understand the institution and conduct quality audits.

Audits of the largest APRA-regulated entities are concentrated in a few firms. APRA notes that based on total assets, 90 per cent of the top 20 regulated entities are audited by the Big 4 accounting firms. This level of dominance by the Big 4 has been raised as a concern by various stakeholders and is an understandable concern. There is, however, a need to balance this concern against the level of expertise and resources that are required to conduct the audits of large, diversified and complex entities. High quality audits of large and complex institutions require well-resourced, multi-disciplinary teams with specific expertise in some highly specialised areas (e.g. actuarial and valuation).

It would be questionable whether a smaller firm would have the resources and capacity to individually undertake an audit of this magnitude. The U.K. [Future of Audit Inquiry \(April 2019\)](#) has recommended joint audits of larger listed companies by a large audit firm and a small audit firm. The viability of the U.K. approach could be explored as part of this inquiry.

### **Audit quality**

This is an area that is receiving significant focus around the globe. Internationally, there have been ongoing initiatives to improve audit quality by auditing standards setters and regulators. APRA is engaged in global initiatives on audit quality through the BCBS and the FSB. For the past three years, APRA has been involved in meetings organised by the FSB with the International Forum of Independent Audit Regulators (IFIAR) and the Global Public Policy Committee on audit quality (GPPC). IFIAR has been conducting annual reviews on audit quality. From our perspective, we are of the view that audit quality is being taken seriously by IFIAR and the GPPC, who have acknowledged that more work needs to be done. APRA monitors international efforts relating to independence and audit quality, and will continue to contribute to these efforts through its international liaison activities.

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<sup>6</sup> Refer to section 17 of the *Banking Act 1959*; section 44 of the *Insurance Act 1973*; sections 85 and 230B(2)(g) of the *Life Insurance Act 1995*; and section 131AA of the *Superannuation Industry (Supervision) Act 1993*.

AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

Domestically, we have, from time to time, identified some deficiencies from our supervisory activities. APRA has observed instances where auditors have not detected data quality and compliance issues within regulated entities. Typically, APRA supervisors directly engage with auditors and regulated entities when material audit quality issues relating to prudential matters and APRA reporting arise.

In APRA's experience, the overall quality of work conducted by auditors on tripartite and non-recurring engagements has been mixed. We have noted that the benefits achieved from auditors are broadly commensurate with the level of effort expended by the auditor to plan, perform and report on the work in line with the engagement terms as well as APRA maintaining an ongoing dialogue as the work is being undertaken. This closer engagement has helped significantly in improving the quality of the audits conducted. A recent example of a successful special purpose audit engagement was the APRA Authorised Deposit-taking Institution (ADI) Targeted Review for 2016/17 *Accuracy of data used in home loan underwriting*. Some of the resultant audit reports that were tendered as evidence are available on the Royal Commission website.

Improving audit quality remains a work in progress. The work done by the Australian Securities and Investments Commission (ASIC) as part of its surveillance program, and the additional focus from the Financial Reporting Council (FRC) are welcome initiatives. APRA also liaises with ASIC and the FRC on audit quality matters relating to its regulated entities.

APRA expects auditors to conduct high quality engagements on prudential compliance and accuracy of regulatory reporting for APRA and its regulated entities. APRA is considering refinements (clarification and strengthening) to its audit related requirements in CPS 510, CPS 520 and CPS 220 to take account of recent experience and international developments.

### **Valuations of intangible assets**

APRA's prudential framework for ADIs and insurers generally requires goodwill and other intangible assets (including capitalised expenses) to be deducted (excluded) for capital purposes. Hence, issues associated with the valuation (including impairment testing) of goodwill and intangibles do not generally have any prudential impact on APRA regulated entities.

### **The role and effectiveness of audit in detecting and reporting fraud and misconduct**

Following the Royal Commission, APRA is strengthening its focus on misconduct risk within the prudential framework.<sup>7</sup> Consideration is also being given to what is expected of auditors in the reporting of material misconduct to APRA.

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<sup>7</sup> Misconduct risk – means the risk associated with action or inaction by a person covered by an entity's remuneration policy that falls short of expected standards, including legal, professional, internal conduct and ethical standards; See draft Prudential Standard CPS 511 *Remuneration* (open for consultation) at link [here](#).