



ASIC
Australian Securities &
Investments Commission

PJC INQUIRY INTO THE REGULATION OF AUDITING

Submission by the Australian Securities and Investments Commission

Introduction

A. Why is audit important?

1. The quality of financial reports is key to confident and informed markets and investors, and the ability of Australian companies to attract capital. Financial reports should provide information that is useful and meaningful so investors and others can use that information to make decisions about the allocation of scarce resources.
2. Auditors have an important role in the effective operation of our capital markets. High-quality audits support the quality of financial reports and enable investors to rely on the auditor's independent assessment of those financial reports.
3. If a company fails but its financial report did not properly show its declining financial position and results, or going concern issues, it is reasonable for questions to be asked about the role played by the company directors and the auditor. Questions may also be asked if investment decisions are made using financial reports that do not reflect a company's true financial position and performance. As noted in a recent report by the UK Competition and Markets Authority (UK CMA), 'Audits cannot be expected to prevent company failure, nor are they likely to be the cause of failure; but they are a vital part of the warning system that should protect savers' interests.' In the United Kingdom, recent corporate collapses have brought this issue into the spotlight. It is timely to consider audit regulation in Australia, even in the absence of such high-profile failures.

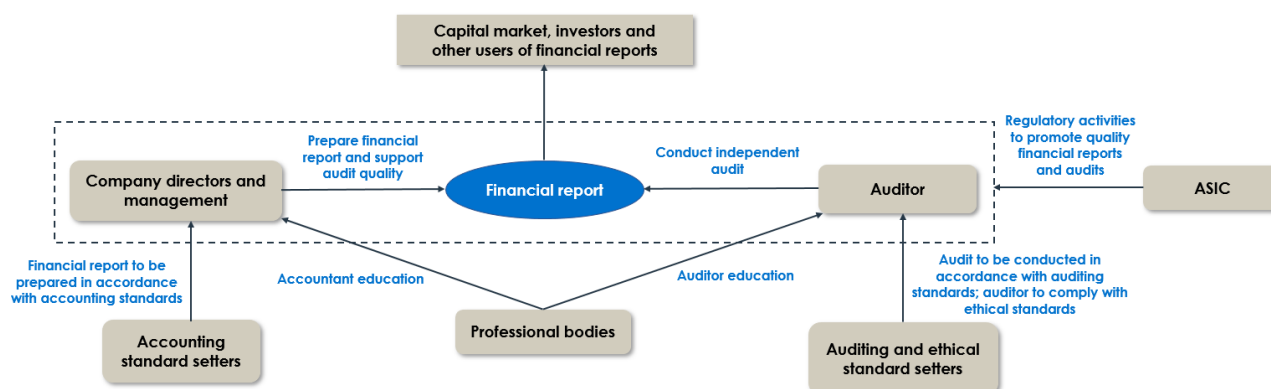
Note: See UK CMA, *Statutory audit services market study*, final summary report, 18 April 2019, p 2.

B. What is audit quality?

4. For regulatory purposes, audit quality refers to matters that contribute to the likelihood that the auditor will:
 - (a) achieve the fundamental objective of obtaining reasonable assurance that the financial report as a whole is free of material misstatement
 - (b) ensure material deficiencies detected are addressed or communicated through the audit report.
5. This includes appropriately challenging key accounting estimates and treatments that can materially affect the reported financial position and results.

C. Parties contributing to quality financial reporting

6. Directors are responsible for the financial report. This includes ensuring it provides useful and meaningful information for investors and other users of the report.
7. While auditors have the primary responsibility for audit quality, improving audit quality is a matter requiring collective actions by various parties in the financial reporting chain. Company directors, audit committees and management have key roles in supporting quality audits.
8. Figure 1 shows the key parties that contribute to quality financial reporting and audit. The roles of these parties are explained further in Sections D to F below, with a focus on how they should contribute to quality audits.

Figure 1: Key parties contributing to quality financial reporting

Note: This figure is explained in Sections D–F below (accessible version).

9. It is important to consider the roles and responsibilities of all parties that contribute to audit quality when considering the regulatory framework.

D. The role of auditors

10. The role of the auditor is to conduct an audit and provide independent assurance on the financial report. The independence and objectivity of the auditor, and confidence in the quality of the audit, are key to investor and market confidence in financial reports. Auditors are primarily responsible for audit quality.
11. Good auditors are professional, ethical, act with integrity and are mindful of the potential harm to investors and other users of financial reports from inaccurate financial reporting. Auditors must obtain reasonable assurance that financial reports are free of material misstatement, apply sufficient scepticism to accounting estimates and treatments, and address any deficiencies detected, so that investors and other users of financial reports can have confidence in the quality of the information they contain: see [Information Sheet 222](#) *Improving and maintaining audit quality* (INFO 222).
12. Auditors should deliver professional, high-quality audits through:
 - (a) strong audit firm cultures and leadership focused on quality audits
 - (b) recognition at all levels in those firms of the need to improve audit quality
 - (c) ensuring that partners have an appropriate risk appetite and focus on potential harm to investors from deficient audit work
 - (d) applying professional scepticism to audit evidence, and accounting policies and estimates, and providing genuine support for auditors who challenge audited entities
 - (e) appropriate experience and expertise of audit partners and staff for increasingly complex audits
 - (f) identifying and addressing audit risks and issues on a timely basis
 - (g) effective supervision and review during the audit and in post-completion reviews
 - (h) effective root cause analysis on identified audit deficiencies
 - (i) accountability of audit partners and others within the firms for inadequate audit work
 - (j) sufficient partner involvement in audits.
13. While the focus of this submission is on the audit of financial reports under the *Corporations Act 2001* (the Act), importantly the Act often also requires auditors to report on aspects of non-financial risks. For example, auditors of some Australian financial services (AFS) licensees are required to report on the internal controls of the licence holder. The mismanagement of non-financial risks has been highlighted in recent inquiries and reviews such as the Financial Services Royal Commission and the APRA Prudential Inquiry into the Commonwealth Bank.

E. The role of directors and management

14. Directors are responsible for the financial report. Directors should ensure that financial reports provide timely, useful and meaningful information for investors and other users of the report. Company directors, audit committees and management also have key roles in supporting quality audits.
15. Audit quality supports financial reporting quality, which in turn enhances market confidence in a company's reported financial position and results. It is therefore in the interests of directors and audit committees to support the audit process. The Australian Securities and Investments Commission (ASIC) has published or contributed to several documents which set out the roles of key stakeholders in contributing to financial reporting and audit quality.

Note: See [Information Sheet 183](#) *Directors and financial reporting* (INFO 183), [Information Sheet 196](#) *Audit quality: The role of directors and audit committees* (INFO 196), [Information Sheet 223](#) *Audit quality—The role of others* (INFO 223), International Organization of Securities Commissions (IOSCO), *Report on good practices for audit committees in supporting audit quality* (January 2019).

16. Among other matters, directors and audit committees should consider:
 - (a) non-executive directors recommending audit firm appointments and setting audit fees
 - (b) assessing the commitment of the auditors to audit quality
 - (c) reviewing the resources devoted to the audit, including the amount of partner time
 - (d) reviewing the need for the auditor to use experts and the reliance on other auditors
 - (e) accountability of the engagement audit partner, the review partner, specialists and audit team members for audit quality
 - (f) facilitating the audit process, including support by the audited entity's management for the audit process
 - (g) two-way communication with the auditor on concerns and risk areas
 - (h) assessing the level of professional scepticism exhibited by the auditor in challenging estimates and accounting policy choices
 - (i) ensuring independence of the auditor
 - (j) asking for the results of any review of the audit engagement files by ASIC
 - (k) reviewing audit firm responses to findings from ASIC audit inspections.
17. Further, directors and audit committees should ensure the company's internal governance and risk frameworks are robust and support the preparation of financial statements 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:
 - (a) ensure appropriate processes and records to support the information in their financial report
 - (b) apply appropriate experience and expertise to produce quality financial information and financial reports, and appropriate analysis and documentation on a timely basis for audit.
18. Directors and management should not unduly influence auditors. Auditors are required to report attempts by any party at the audited entity to influence their opinion or approach. However, there was only one possible breach reported by an auditor in this area in the two years to 30 June 2019 and we will conduct further work to consider whether the level of breach reporting reflects actual practice. We note there is currently no specific offence for those who seek to coerce or inappropriately influence an auditor and we will also consider whether this appears to be a problem in practice.

F. The role of ASIC

19. ASIC has many important roles. These include:

- (a) maintaining, facilitating and improving the performance of the financial system and the entities within that system
- (b) promoting the confident and informed participation of investors and consumers in the financial system.

20. ASIC is the conduct regulator responsible for registering company auditors, assessing their compliance with the financial reporting and audit requirements of the Act, and for taking administrative or enforcement action where the circumstances warrant. We take these actions to promote quality financial reporting and audit.

Note: ASIC's ability to impose conditions on the registration of company auditors is more limited than for other groups such as self-managed superannuation fund (SMSF) auditors or AFS licensees.

- 21. We assess compliance with the financial reporting and audit requirements primarily through our targeted audit firm inspections and financial reporting surveillance program, both of which are conducted on an ongoing basis throughout each year: see Figure 2. Our current audit inspection program includes a focus on audit firm culture, talent, governance, conflicts of interest and accountability.
- 22. Audit firm inspections include reviewing key areas in about 60 files each year relating to audits of financial reports of listed entities and other public interest entities and reviewing action plans of the largest six audit firms to improve audit quality.
- 23. Our financial reporting surveillance includes proactive reviews of about 300 financial reports of listed entities and other public interest entities each year.
- 24. We report our findings from these surveillance programs and set out areas where we consider directors and auditors should focus to improve financial reporting and audit quality.
- 25. The role of governance as well as the responsibility of directors, audit committees and management for audit quality is an area that ASIC's Corporate Governance Task Force will consider as they conduct an analysis of selected findings from our financial reporting surveillances and audit file reviews. They will consider the effectiveness of the audit firm's root cause analysis and the firm's actions to address the findings. They will also consider the role of the audit committee, and whether there were governance failings within the audited entity and/or audit firm.
- 26. We publish guidance for directors, management and auditors on their roles in improving financial reporting and audit quality and on how ASIC is applying the legislative provisions. We also suggest improvements to accounting, auditing and ethical standards where our practical experience indicates that would be desirable.
- 27. We have responsibility for granting appropriate relief (e.g. waivers) from financial reporting and audit provisions of the Act, registering auditors and consenting to the resignation of registered company auditors as auditors of individual public companies.
- 28. Where we find breaches of the law, we consider whether to take enforcement action. In the case of auditors, this includes whether to refer conduct to the Companies Auditors Disciplinary Board (CADB). We also consider whether litigation is appropriate to achieve a broader public deterrent.
- 29. Figure 2 illustrates the key relationships and responsibilities in the financial reporting chain and ASIC's regulatory activities in more detail.

DIRECTORS AND MANAGEMENT

Primary responsibility for quality of financial report

ASIC enforcement
New Office of Enforcement

Management
Prepare financial statements on a timely basis supported by good financial records and analysis

Board of Directors/Audit Committee

- Oversee management
- Appoint auditor, set fees
- Sign financial report

ASIC guidance/education on quality audits

- Media releases, reports, information sheets, speeches, podcasts, etc

ASIC financial reporting surveillance

- 300 public interest entities per annum

ASIC guidance/education on quality financial reporting

- Media releases, reports, information sheets, speeches, podcasts, etc

ASIC review of non-audit fees for ASX 300

- Write to some audit committees

Capital Market
(Investors & potential investors); Other users

AUDITORS
Provide confidence about information in financial report

ASIC registers company auditors
ASIC consent to resignation of company auditors

ASIC enforcement

- Referrals to CADB
- New Office of Enforcement

Auditors
Determine audit approach and perform audit procedures based upon:

- Professional judgement
- Professional scepticism

Issue audit report

CADB

- Conduct auditor disciplinary hearings from ASIC's or APRA's referrals
- Matters can be appealed at AAT or Courts

Treasury (legislation)
Standard setters (IASB/AASB, IAASB/AUASB, IESBA/APESB)
FRC (oversees AUASB and AASB)
Professional bodies (CA ANZ, CPAA, IPA)

Set standards and requirements regarding:

- Audit requirements
- Auditing, accounting standards
- Auditor independence requirements

ASIC provides comments on legislation and standards

Global leadership of largest six firm networks

- Develop audit methodologies and guidance
- Conduct quality reviews
- Global culture

ASIC works with foreign securities and audit regulators

- Influencing global audit firm networks
- Suggesting improvements to the accounting, auditing and ethical standards

ASIC audit firm inspection program

Firms that audit public interest entities:

- Audit file reviews (60 per annum)
- Public report with Big 4 individual firm findings

Largest six firms:

- Review action plans to improve audit quality
- Review of conflict of interest, culture, talent, governance and accountability focused on audit quality

Publish Audit Quality Measures with next inspection report

Key:

AASB – Australian Accounting Standards Board. Government agency
AAT – Administrative Appeals Tribunal
AUASB – Auditing and Assurance Standards Board. Government agency
APESB – Accounting Professional & Ethical Standards Board. Funded by CA ANZ, CPAA and IPA, who make appointments to the Board
CA ANZ – Chartered Accountants Australia & New Zealand. Professional accounting body

Financial reporting and audit quality in Australia

G. Financial reporting quality in Australia

30. The independent audit contributes to the quality of financial reports. Our proactive risk-based surveillance of the financial reports of public interest entities continues to lead to material changes to net assets and profits in about 4–5% of the financial reports reviewed, which is comparable to other major jurisdictions. These changes relate to matters not properly identified or addressed in the company's financial reporting process or the independent audit.

H. ASIC's inspection findings

31. We regularly publish findings of our audit firm inspection program—the last report was [Report 607](#) *Audit inspection program report for 2017–18* (REP 607) which was released in January 2019. It is important to note that the sample size for this program is necessarily small, and we target files that exhibit certain risk characteristics. Accordingly, these results may not be indicative of the entire audited population of 2,300 listed and about 30,000 unlisted entities. We also publish the methodology used for our audit inspection program.
32. For REP 607, we conducted proactive risk-based reviews of 347 key areas in 98 audit files in the 18 months to 30 June 2018. In our view, in 24% of the key audit areas we reviewed, auditors did not obtain reasonable assurance that the financial report as a whole was free from material misstatement. The figure was 20% for the largest six audit firms based on reviews of 281 key audit areas in 78 audit files.
33. Even where we believe audit quality is not at the required standard on a matter, our findings do not necessarily mean that the financial reports audited were materially misstated. Rather, in our view, the auditor did not have a sufficient basis to support their opinion on the financial report. In these cases, there is a risk that the financial report was materially misstated, and that investors or other users were not properly informed when making decisions based on that report.
34. In nine of the 98 audit files that we reviewed, we identified and raised financial reporting concerns that led to material changes to the net assets and profits reported by the companies concerned. The fact that this is higher than the 4–5% figure mentioned in paragraph 30 suggests that our risk targeting of audits is identifying higher risk matters.
35. The findings from our audit and financial report reviews mainly relate to asset values and revenue recognition. The nature of our findings are consistent with those of international regulators with responsibility for audit oversight: see International Forum of Independent Audit Regulators (IFIAR), *Survey of inspection findings 2018* (released May 2019).
36. While the largest firms continue to work to improve audit quality, the findings from our audit file reviews show that further efforts are required.
37. Our audit inspection approach is described in Appendix A. [REP 607](#) and [Information Sheet 224](#) *ASIC audit inspections* (INFO 224) provide further public information on ASIC's inspection findings and inspection approach.

I. Global influences on Australian audit quality

38. Audit quality is a global issue. The Big 4 audit firms that audit 95% of Australian listed companies by market capitalisation operate in global networks, and use global audit methodologies, tools, training and systems. Many audited entities operate in global markets and across borders. These entities use the same or similar accounting standards that can require complex judgements on accounting treatments and estimates. Auditors are required to comply with auditing and ethical standards that are developed internationally.
39. The Enron and WorldCom collapses in 2001 led to wide-reaching changes in the United States introduced by the US *Sarbanes-Oxley Act of 2002* (SOX). Due to the global nature of markets these provisions have the potential to directly impact entities in Australia that operate in the United States. Several SOX provisions have also been adopted in some form or another in various jurisdictions.

40. In particular, under a rule by the US Securities and Exchange Commission required by SOX, management of issuers of securities must sign off on internal controls. Under SOX (s302) company management must certify that they:
- (a) are responsible for establishing and maintaining internal controls
 - (b) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared
 - (c) have evaluated the effectiveness of the issuer's internal controls within 90 days prior to the report, and
 - (d) have presented in the report their conclusions about the effectiveness of their internal controls.
41. In addition, the auditor is required 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.
42. Reviews of the regulation of audit have been completed or are underway in the United Kingdom following recent high-profile collapses of entities and questions about audit work. Some pros and cons of reforms suggested in the United Kingdom and elsewhere are outlined in Appendix C.
43. If individual policy reforms suggested in the United Kingdom or elsewhere are considered in Australia we suggest they be carefully reviewed as to whether they promote audit quality in Australia.

J. Enhancements to the ASIC audit inspection program in 2019

44. ASIC's enhanced approach to supervision, led by both our Close and Continuous Monitoring team and the Corporate Governance Taskforce, is being adopted throughout the organisation. This has led to an evolution in the scope and approach to our 2019–20 audit inspections, which is reflected in the 'Root causes of financial reporting and audit findings' item in Table 1 below.
45. Table 1 shows new ASIC initiatives to promote improvements in audit quality and the measurement of audit quality. The proposed timing for these new initiatives is also set out.

Table 1: New ASIC initiatives

Audit firm governance review	A review that will look at governance, culture, talent, conflicts of interest and accountability for audit quality 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 has commenced and will be completed in the current financial year. We intend to publish our findings from this work.
Root causes of financial reporting and audit findings	<p>We will review the effectiveness of the root cause analysis conducted by firms on selected adverse findings from our financial reporting surveillances and inspections of audit files in areas such as valuation of intangibles. We will also review the identification and effectiveness of actions by firms to address these root causes. Our work will also extend to how audit committees fulfilled their role in ensuring the quality of the financial reporting and supporting the audit in relation to the matter that was the subject of the adverse findings. We will consider whether the results of this review indicate a need to improve governance at the company and/or audit firm, and whether existing legal provisions are acting as a deterrent to any poor conduct.</p> <p>Work will commence in the second quarter 2019–20 and we anticipate completing this work in the current financial year.</p>
Transparency	<p>We will report individual percentage findings from audit file reviews at each of the Big 4 audit firms in our next public audit inspection program report, which will be released no later than December 2019.</p> <p>We will update INFO 224 on how we conduct our audit inspections.</p>

Audit quality measures and indicators	<p>ASIC's inspection findings are a significant output measure and an important indicator of audit quality. However, we only review a limited number of audits and focus on higher risk areas in each audit.</p> <p>When we release our next audit inspection program report at the end of 2019, we will publish a report with a broader range of audit quality measures and indicators to supplement our audit firm inspection findings. The measures and indicators that we report will evolve over time as more information becomes available. Based on our review of the measures and indicators published by foreign audit regulators and their measures of audit quality to date we believe that our reporting will be world's best practice. However, while these audit measures will collectively assist in assessing audit quality, it is clear from our experience that audit quality cannot be reliably reduced to a single figure or formula.</p> <p>The measures and indicators we will publish are relevant to the recommendation in a PJC report issued on 13 February 2019 'that ASIC devise and conduct, alongside or within its current Audit Inspection Program, a study which will generate results which are comparable over time to reflect changes in audit quality': see PJC report, <i>Oversight of ASIC, the Takeovers Panel and the Corporations Legislation No.1 of the 45th Parliament</i>.</p>
Reporting findings to audit committees	<p>Recognising the responsibility of directors and audit committees to contribute to audit quality, we will consult on revising Regulatory Guide 260 <i>Communicating findings from audit files to directors, audit committees or senior managers</i> (RG 260) to provide that ASIC would routinely report findings from its audit inspection file reviews to the directors or audit committee of the entity audited. Presently this occurs on an exception basis.</p> <p>While we inform directors and audit committees that we are reviewing an audit to enable directors to ask questions of the auditor about any ASIC findings and how they were addressed, direct communication of the findings will ensure that the findings are fully and accurately communicated.</p> <p>Consultation on these proposals is expected to occur in the first half of 2020.</p>
Compliance audits	<p>While the main focus of the Inquiry is the audit of financial reports under the Act, the Act also requires auditors to report on:</p> <ul style="list-style-type: none"> (a) aspects of compliance with licence conditions, financial requirements, holding of client monies, etc., by AFS licensees (b) compliance plan audits for registered managed investment schemes. <p>As part of our audit inspection program, we will proactively review some AFS licensee audits in early 2020 and continue to assess other matters on a reactive basis.</p>
Enforcement	<p>We have implemented our 'why not litigate?' approach and the new Office of Enforcement. This may mean taking more enforcement actions against auditors for defective audits and auditor independence issues.</p> <p>In March 2019, the Australian Financial Reporting Council (FRC) released <i>Auditor Disciplinary Processes: Review</i> (FRC report). The FRC report included recommendations on ASIC's audit enforcement. Two of the FRC's recommendations concern ASIC's internal processes and have already been resolved.</p> <p>The FRC also recommended that 'ASIC should evaluate its criteria for audit enforcement actions and explain how the "why not litigate?" approach referred to in ASIC's recent audit enforcement review would apply to RCA (registered company auditor) misconduct matters. This includes considering whether more matters identified through file reviews in ASIC's audit firm inspection program should be referred to the CADB (the Companies Auditors Disciplinary Board).'</p> <p>We will review our criteria for taking auditor enforcement actions, and the types of outcomes we may seek, including the use of enforceable undertakings and referrals of matters to the CADB as part of our implementation of the new Office of Enforcement. This review is expected to have occurred by the end of 2019.</p> <p>We are currently liaising with the CADB on its proposed streamlined procedures for referring auditor conduct matters to the CADB.</p>

ASIC responses to PJC terms of reference

K. Term of reference 1: The relationship between auditing and consulting services and potential conflicts of interest

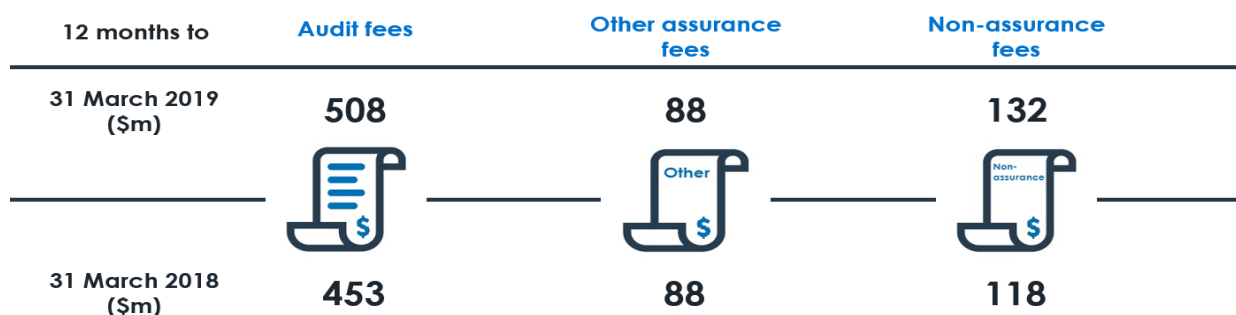
Background

46. Auditors are required to be independent from the entity they audit. An auditor's independence is impaired if the auditor is not, or a reasonable person with knowledge of all the facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgement in relation to the conduct of the audit.
47. Chapter 2M of the Act contains general provisions dealing with conflict of interest situations involving an auditor of a financial report, as well as specific provisions on financial, business and employment relationships.
48. In addition, the profession's APES 110 *Code of Ethics for Professional Accountants* (Code of Ethics) contains provisions on auditor independence including when auditors can provide non-audit services (e.g. tax advice or valuations) to the entities they audit. This focuses on threats to independence (self-interest, self-review, advocacy, familiarity and intimidation threats).
49. ASIC's activities on conflicts of interest include:
 - (a) considering possible auditor independence issues when reviewing audit files. In the 18 months to 30 June 2018, we identified three cases where we considered the provision of non-audit services was not consistent with auditor independence requirements, including where the firm's experts were treated as both the auditor's and management's experts
 - (b) reviewing policies, processes and approaches of the largest six audit firms to avoid potential conflicts of interest. These reviews are seeking evidence as to the existence of circumstances that might be perceived to compromise auditor independence and objectivity, or negatively affect audit quality
 - (c) reviewing fees for non-audit services disclosed in the financial reports of ASX 300 listed entities. The annual directors' report is required to include a statement as to whether the provision of non-audit services by the auditor compromised the auditor's independence. We are seeking an explanation from six audit committees as to how they were satisfied that the auditor's independence was not compromised by the size and nature of non-audit fees.
50. Whether the provision of non-audit services to audited entities compromises the auditor's independence may depend on the size of the fees payable and the nature of the non-audit services. While it can be difficult to find evidence that any conflicts of interest have been the cause of inappropriate choices by auditors on required audit evidence, accounting treatments and accounting estimates, conflicts may create a perception that the auditor's independence and objectivity are compromised.
51. Where we find a conflict, we will ask the auditor to address the situation. If the matter is not addressed, we will consider appropriate enforcement or other actions.

ASIC review of non-audit services

52. Based on our review of financial reports we have assessed the fee revenue as follows:

Note: Fees for consulting services are captured as part of 'non-assurance fees'.

Figure 3: Fee revenue from engagements at ASX 300

Source: Financial reports for years ended 12 months to 31 March 2019 and 31 March 2018.

53. The Code of Ethics adopts a threats and safeguards approach to the provision of non-audit services by an auditor. A comparison of this to the US laws on non-audit services to audited entities is set out in Appendix B.
54. Insolvency services may give rise to conflicts for auditors of banks or audited entities with investments in insolvent companies. The recent reintegration in some firms of insolvency firms back into full-service accounting practices is a development we are closely monitoring regarding potential conflicts.

L. Term of reference 2: Other potential conflicts of interest

55. Potential conflicts of interest may also result from matters such as:
 - (a) influence of company management in appointing auditors and setting audit fees
 - (b) long-standing relationships with the management of audited entities
 - (c) auditors relying on management's experts rather than using their own expert.
56. [INFO 196](#) provides guidance for audit committees and directors in addressing the potential risks to auditor independence from the process for appointing auditors and setting fees.
57. ASIC's consent is required for the resignation (not removal) of an auditor of a public company. To assist in protecting the auditor's independence, we do not give consent if it appears that the resignation could be related to a disagreement with management over an accounting treatment or estimate. We refuse consent where there are indications that the change in auditor is in circumstances where there is a disagreement with management on financial reporting or the auditor may issue a qualified or modified audit report.
58. The Act requires lead and review auditors of listed entities to be rotated off after five years, which brings fresh minds to the audit to challenge judgements on audit evidence, accounting treatments and accounting estimates.

M. Term of reference 3: The level and effectiveness of competition in audit and related consulting services

59. The Big 4 audit firms audit 95% of listed Australian entities by market capitalisation. There is a similar level of concentration in other major jurisdictions such as the United States, United Kingdom and Canada.
60. The UK CMA undertook a comprehensive study of the UK audit market in April 2019, and found similar market characteristics in the United Kingdom. Such a study has not been undertaken in Australia.
61. The size of the Big 4 audit firms may help them to invest in audit methodology, training, technology and quality initiatives.
62. ASIC will engage with the Australian Competition and Consumer Commission (ACCC) if we identify any audit competition issues that fall within the ACCC's remit.
63. Effective competition in the audit market would manifest in the provision of audit services valued by company directors, and ultimately investors. While the audit market in Australia is

concentrated on the supply side, this in itself is not an indicator of a lack of effective competition.

64. Other indicators of effective competition include quality audits, buyer countervailing power, audit market share changes and 'healthy' switching over time, and prices reflective of costs. Notably, the audit market is characterised by other factors that constrain the effectiveness of competition. These include demand and supply side drivers such as externalities (market integrity) that are addressed through government regulation, information asymmetries (investors as key users of audited information as compared to company officers), constrained choice (audit capability outside the largest audit firms, audit rotation and conflict of interest management), and modest barriers to entry. Taken collectively these reduce competitive pressures on auditors and detract from effective competition in the audit market. They also pose complex trade-offs in the relative merit of government policy seeking to raise audit quality.

N. Term of reference 4: Audit quality, including valuation of intangible assets

Audit quality

65. ASIC's audit inspection results show the need for improvements in audit quality and the consistency of audit execution. We believe our enhanced approach to the existing audit inspection program, set out in Section J, will allow us to gain greater insight into some of the root causes of audit failure and that increased transparency will provide another reason for firms to help us address our findings.

Impairment of intangibles and other non-financial assets

66. The largest number of findings in ASIC's financial reporting surveillances and audit inspections relate to impairment of intangibles and other non-financial assets. This remains an ASIC focus for companies and auditors: see [Media Release \(19-143MR\)](#) *Major financial reporting changes and other focuses* (17 June 2019) and [REP 607](#).
67. We are concerned that some auditors may not apply enough professional scepticism and sufficiently challenge management estimates. We have provided guidance on findings and focus areas through public audit inspection reports, financial reporting media releases and [Information Sheet 203](#) *Impairment of non-financial assets: Materials for directors* (INFO 203).
68. Audit firm initiatives to reduce findings on impairment of non-financial assets may include improved training and guidance, greater use of valuation experts, forming specialist focus groups to support audit teams, coaching of audit teams, quality reviews before completion of the audit, increased partner involvement, earlier audit reviews to minimise deadline pressures, post-completion quality reviews of impairment models, and increased accountability of audit partners for audit deficiencies.
69. Our review of the audit firm's root cause analysis and actions to address financial reporting and audit findings will focus on valuation of intangibles. This review will also cover the role of the audit committee.

O. Term of reference 5: Matters arising from Australian and international reviews of auditing

70. ASIC's findings from reviewing audit files continue to be consistent with those of other audit oversight regulators: see IFIAR, *Survey of inspection findings 2018* for listed public interest entity audits.
71. Following high-profile collapses of entities and questions about audit work, reviews of the regulation of audit have been completed or are underway in the United Kingdom. This included a review of the audit regulator—the UK Financial Reporting Council (UK FRC). Unlike ASIC, in addition to regulating financial reporting and auditors, and conducting financial reporting surveillance and audit inspection programs, the UK FRC also sets accounting, auditing, corporate governance and actuarial standards. The UK FRC is funded voluntarily by the accounting profession and relies on the powers of the accounting bodies whereas ASIC is funded by mandatory industry levies on companies and auditors and has statutory powers.

72. Individual policy reforms suggested in the United Kingdom or elsewhere may not necessarily be in the interest of audit quality in Australia. Importantly, we believe that there is no single solution to holistically improve audit quality. Rather, an evolving, dedicated focus is required on a continuing basis by all of the parties set out in Figure 2.
73. Any possible audit law reforms are a matter for government policy and need to be considered in the context of the Australian market.
74. Appendix C outlines some brief pros and cons of audit reform proposals being considered overseas.

P. Term of reference 6: Changes in the role of audit and the scope of audit products

75. Matters raised in an ongoing review of audit quality and effectiveness led by Sir Donald Brydon in the United Kingdom include:
 - (a) the need for, and audit requirements of, a directors' explicit statement regarding risk management and internal controls, and related audit requirements (see also paragraphs 40–42)
 - (b) assurance over a directors' statement of sustainability of the entity's business model
 - (c) assurance over financial and non-financial information outside the annual financial statements
 - (d) the role of auditors in determining whether the directors are complying with relevant laws and regulations
 - (e) transparency of communications between the auditor and the audit committee and resulting judgements
 - (f) the auditor's role in fraud detection and the requirements of auditing standards
 - (g) the possibility of auditors reporting on the culture of audited entities.
76. Proposals such as these are matters of government policy. However, as noted by the recent UK CMA report on audit, there is no simple answer to many of the issues regarding audit. It was also noted that any changes would need time to take effect, and that there are trade-offs inherent in any reform proposal that might be considered. We would argue the primary concern should be on measures that enhance audit quality and any reform proposals should be considered in that light.

Q. Term of reference 7: The role and effectiveness of audit in detecting and reporting fraud and misconduct

77. Under ASA 240 *The auditor's responsibilities relating to fraud in an audit of a financial report*, the auditor is responsible for obtaining reasonable assurance that the financial report taken as a whole is free from material misstatement, whether caused by fraud or error. Auditors are not required to detect every fraud.
78. Auditors have an obligation to report suspected contraventions of the Act to ASIC, including where they identify fraud or misconduct by management or an employee, breaches of directors' duties, financial services licences and requirements for compliance plans of managed investment schemes, among other things.
79. The notification provisions also require auditors to notify ASIC about contraventions such as not complying with the auditor rotation requirement, or where they issue a qualified audit opinion concerning non-compliance with accounting standards. In total, we received 847 notifications in 2018–19 (570 in 2017–18) from auditors. See Appendix D for more details.

R. Term of reference 8: The effectiveness and appropriateness of legislation, regulation and licensing

Enhancing the regulatory framework

80. Table 2 provides comments on various measures that may enhance the regulatory framework for audit quality and improve financial reporting. However, as noted in paragraph 72, we believe there is no single 'quick-fix' solution to holistically improve audit quality.

Table 2: Enhancing the regulatory framework

Superannuation financial reporting and audit	<p>Currently no Australian regulator undertakes surveillance of the financial reports of regulated superannuation entities (RSEs) or inspects the audits of those financial reports. RSEs held \$1.8 billion of assets in 26 million member accounts at 30 June 2018; see APRA <i>Annual superannuation bulletin</i>, June 2018, p12.</p> <p>The Government has provided ASIC with additional funding in this area and we support the current priority to give ASIC the powers to regulate financial reporting and audit for regulated superannuation entities, and compliance audits.</p>
Remediation power	<p>We would benefit from the ability to require auditors to remediate deficiencies on individual audits and across the firm. A remediation power was supported by the FRC report and agreed to in principle by the Government in their response to the FRC report.</p> <p>A power enabling ASIC to compel auditors to remediate deficient audits on a timely basis would enable the market to be properly informed as to whether the financial report was materially misstated. Consideration might also be given to an ability to remove firms from specific audits if remediation does not occur as required.</p> <p>The existing legislative process for issuing public reports on audit deficiencies can take more than a year.</p>
Company management of internal controls	<p>Good corporate financial reporting controls will assist with audit quality. Discussion may be useful on whether measures similar to those set out in paragraphs 40–42 would help in the Australian context.</p>
Digital financial reporting	<p>Many parties recognise the potential long-term benefits of digital financial reporting by listed companies and other entities preparing financial reports under the Act.</p> <p>Digital financial reports (DFRs) can be read like a PDF document but also allow users, auditors and regulators to readily extract information electronically for analysis, comparison and risk assessment. This risk assessment data would allow ASIC to more effectively target areas of risk, to facilitate deployment of resources to assess those risk areas.</p> <p>Companies may need to produce DFRs to compete for capital in global markets given the increasing requirement for DFRs in other countries. A number of Australian companies with securities listed in the United States are now required to lodge DFRs with the US Securities and Exchange Commission. The European Union will require DFRs for all companies listed on European exchanges from years commencing 1 January 2020.</p> <p>While companies have been able to voluntarily lodge DFRs with ASIC since 2010, no DFRs have been lodged to date. Companies do not lodge the reports because analysts have not updated their systems to use the reports, and analysts are not updating their systems because no entities produce the reports.</p> <p>Consideration on how to best encourage the adoption of digital financial reporting may be warranted.</p>

S. Term of reference 9: The extent of regulatory relief provided by ASIC through instruments and waivers

81. Table 3 shows the extent of ASIC relief relating to audit for the three years to 30 June 2019 (the number of applications refused or withdrawn is shown in brackets).

Table 3: Relief given by ASIC in relation to audit for the three years to 30 June 2019

Type of relief	No. of applications granted (No. refused or withdrawn) 12 months to 30/6/2019	No. of applications granted (No. refused or withdrawn) 3 years to 30/6/2019
Relief from disclosing in the annual Auditor's Independence Declaration a minor inadvertent investment in the audited entity held by a relative of a partner not involved in the audit (s307C)	3 (10)	8 (10)
Declaration reducing the 12-month period before an officer of an entity can become a partner of the firm that audits the entity or a related body corporate, where the person was not in a position to influence the financial position or results of the entity (s324CL(2))	0 (0)	3 (0)
Relief extending the five-year period for rotation of auditors of listed companies (s324DA)	0 (0)	0 (2)
Relief from the requirement to audit the financial report : <ul style="list-style-type: none"> • proprietary companies—under ASIC Corporations (Audit Relief) Instrument 2016/784 • proprietary companies—individual relief where an entity is unable to rely on the conditions of ASIC Corporations (Audit Relief) Instrument 2016/784 • registered managed investment scheme in liquidation 	910 (not applicable) 7 (13) 0 (0)	2,392* (not applicable) 22* (54) 1 (0)

* Generally includes relief for the same proprietary companies in each of the three years.

T. Term of reference 10: The adequacy and performance of regulatory, standards, disciplinary and other bodies

ASIC

82. Figure 4 shows ASIC's inspection resources and coverage for audit inspections (proactive file reviews and reviews of audit firm quality controls) compared to the latest available information for other major regulators.
83. ASIC coverage of our regulated population through our inspection programs is substantial, and is more extensive than some comparable peer regulators, given our resourcing. Recently, the Government provided additional funding to ASIC for our audit work.
84. Refer to Section J above for our new audit inspection and enforcement initiatives.

Figure 4: Comparison of audit inspection resources

Area	ASIC	Canadian Public Accountability Board	US Public Company Accounting Oversight Board	UK Financial Reporting Council
No. of inspection staff	15	28	Over 500	40
Entities in remit	2,300 listed & 30,000 unlisted	2,800 mutual funds & 4,500 other entities	13,800 entities	1,960 entities
Firms auditing PIEs	120	273	590	50
Audits reviewed per year	60	139	700	139

85. On 9 October 2019, the UK FRC announced that it is recruiting 80 additional staff to meet increased supervisory responsibilities, including boosting its enforcement and audit inspection teams.

Auditing and ethical standards

86. The quality of auditing standards that apply in the audit of financial reports and ethical standards that apply to auditors is important to the quality of financial reports.
87. Auditors are required by the Act to comply with auditing standards and ethical standards (including auditor independence requirements). The Australian standards are consistent with standards developed internationally by the standards setting boards of the International Federation of Accountants (IFAC). IFAC represents professional accounting bodies internationally.
88. The auditing standards are made in Australia by the Auditing and Assurance Standards Board (AUASB) which is a government body. The ethical standards are made by the Accounting Professional Ethics Standards Board, which is funded by the three largest professional accounting bodies who also appoint the Board members.
89. While auditing standards are relatively principles-based, we continue to encourage the International Auditing and Assurance Standards Board (IAASB) and the AUASB to improve the guidance in the standards. Areas suggested for improvement include financial instrument valuation, sampling, setting materiality, substantive analytical procedures, management experts and use of the auditor's own experts, internal controls, service organisations, and substantive testing where risk is low and there is controls reliance. We support the IAASB's projects to improve standards on risk assessment, group audits and quality management.

U. Term of reference 11: The effectiveness of enforcement by regulators

90. In the last six years, ASIC action has resulted in the deregistration or suspension of 21 auditors to address concerns with the quality of audits by registered company auditors, either through referrals to the CADB or enforceable undertakings. A further three auditors voluntarily cancelled their registrations after ASIC raised concerns with audit quality. Another matter has been decided by the CADB but is on an appeal to the Federal Court.

91. CADB actions are protective rather than punitive and concern the fitness of an auditor to conduct audits. Enforceable undertakings have also been accepted by ASIC where these achieve a suitable protective outcome without the need for CADB referrals.
92. The *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* increased some of the maximum penalties for audit misconduct and created a new fault-based criminal offence to sit alongside an existing strict liability offence. For example, the new fault-based criminal offence for a registered company auditor who fails to conduct audits in accordance with auditing standards (s307A) 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 anticipate that these reforms to penalties, as well as our 'why not litigate?' approach to enforcement, will mean court action will be considered appropriate in more cases. We are actively reviewing current financial reporting and audit matters, where we have concerns, to see whether court action is appropriate as a public deterrent.
93. See Section J for our new audit inspection initiatives, including our approach to enforcement.

Appendix A

Audit inspection process

Our audit firm inspections cover the largest six national firms, and other firms that audit the financial reports prepared under the Act by listed entities and other public interest entities.

In our inspections we review key audit areas in the audit working papers for selected audit engagements. We also assess key aspects of audit firm quality control systems over audits of financial reports.

Following our review of audit files:

- (a) we advise the audit firm about the areas where we consider the auditor did not obtain reasonable assurance that the financial report as a whole was free of material misstatement
- (b) we ask the firm to identify and commit to remedial actions to address our findings
- (c) where we are not satisfied with the audit firm's response to our findings, we will challenge the adequacy of the proposed remedial actions for both individual audits and firm action plans.

Where we have queries or concerns in relation to an audit firm's quality controls or auditor independence, we raise these with the firm.

We also issue reports or letters to each of the larger firms summarising our findings across files over each 12-month period to 30 June.

We provide feedback to firms following each file review. This provides firms with the opportunity to address our findings on a timely basis.

Our public audit firm inspection reports include statistics showing the proportion of key audit areas reviewed where ASIC considered the auditor did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. We do this to facilitate understanding of the extent of our findings and the importance of audit firms addressing the root causes of those findings.

Our inspection process and how we measure and report findings

Table 4 outlines how we measure file review findings and report the findings in our public audit inspection reports. The table also covers key aspects of our inspection process.

Table 4: Our inspection findings and processes

Area	Our approach
Inspection findings	<p>We publish percentages and details about where we consider audit firms did not obtain reasonable assurance that the financial report as a whole was free of material misstatement.</p> <p>The key audit areas that we review in our inspections remain broadly consistent, as are the key audit areas where findings are reported.</p>
Subjectivity	<p>The findings from our audit file reviews concern an auditor's compliance with principles-based auditing standards.</p> <p>Audits necessarily involve the application of professional judgement, which is subjective. Accordingly, at times different individuals will reach different views on whether the audit work performed was sufficient. We do not include instances where we consider that individuals could reasonably reach different judgements in our percentage measure.</p> <p>There are cases where auditors disagree with our findings from reviews of individual audit files. Mostly the auditor asserts that the necessary work was performed but not documented, rather than disagreeing with our findings about work that should have been performed or the judgements that should have been reached.</p>

Area	Our approach
	<p>We are open to the possibility that we do not have all the facts, that there may be differing views on the requirements of auditing standards, or differing judgements. We have extensive due process with the firms and within ASIC to address any such concerns and ensure that findings do not include matters where, for example, reasonable professionals could differ in their views.</p> <p>Ultimately, the value from inspections is for ASIC to express an informed and independent view on findings from reviews of audit files.</p> <p>Disagreement by auditors with our findings can be influenced by possible impacts on remuneration and reputation, and potential liability. There are similar levels of disagreement by auditors with findings in the firms' own quality reviews of audit files.</p> <p>We have discussions with the largest six firms—collectively and individually—about audit methodology questions and interpretations of both accounting and auditing standards. Where standards are unclear, we refer these matters to the relevant international standard setter.</p>
Documentation versus audit evidence	<p>If audit work is not documented, our presumption is that the work has not been performed (in the absence of evidence to the contrary). This approach is also applied by other audit regulators internationally and by most audit firms in their internal quality review programs.</p> <p>We apply professional scepticism to assertions that work has been performed but not documented by the auditor. Significant testing, analysis and challenging of estimates and accounting policy choices are generally not possible without some documentation.</p> <p>Auditing standards require sufficient documentation so that another professional can understand the work performed and the basis for the conclusions reached by the auditor.</p>
Risk-based approach	<p>Our reviews of audit files do not cover all areas of an audit, or all subsidiaries and divisions in a corporate group. Typically, three to four key audit areas are covered and, for corporate groups, only one major operating component is covered.</p> <p>We select audit engagements and key audit areas for review in our audit inspections using a risk-based approach. This means that we generally select some of the more complex, demanding and challenging audits, and some more significant or higher risk areas of the financial reports. Some have suggested that this approach could result in the percentages reported being greater than would be the case with random reviews. On the other hand, more experienced partners and staff are usually allocated to such audits, and there are generally more extensive firm reviews and consultation processes for these audits and the key audit areas.</p>
What is measured?	<p>The overall percentages of findings in our public reports relate to cases where the auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. In our view the auditors did not obtain sufficient appropriate audit evidence, exercise sufficient judgement or otherwise comply with auditing standards.</p> <p>The percentages do not include findings on audit planning, understanding the business, risk assessment, reliance on internal controls, non-substantive analytical procedures, supervision and review, auditor independence, firm quality control systems, training of partners and staff, related party transactions, journal entry testing, reviews of legal expenses and legal representation letters, and subsequent event reviews. However, these can be important areas for improvement by firms.</p> <p>Where we consider that a risk of misstatement would not be material to the overall financial report, or where the risk that it would materially affect the overall financial report is remote, the finding is excluded from our percentage measure.</p>

Area	Our approach
Surveillances and investigations	<p>In addition to audit firm inspections, we conduct a financial reporting surveillance program and undertake audit surveillances where there is a concern about a specific audit or auditor.</p> <p>Where there are known material misstatements in financial reports, identified from our financial reporting surveillances or other activities, the relevant audit area is excluded from review in our audit inspections. We still ask firms to undertake root cause analysis and take appropriate remedial actions. These matters may also be the subject of a separate auditor surveillance and possible enforcement action.</p> <p>The findings and overall findings percentages in our public audit firm inspection reports do not include matters arising from any of these auditor surveillance or enforcement activities.</p> <p>The outcomes of these activities are reported in separate media releases and reports on enforcement activity. The outcomes of surveillance and enforcement activity may also inform our general areas of inspection focus and the timing of future audit firm inspections.</p>
Enforcement action	<p>The objective of our inspections is to improve and maintain audit quality. We expect audit firms to make changes and to undertake work in response to our findings. We consider whether to take enforcement action to achieve a broader public deterrent.</p>
ASIC inspection staff	<p>ASIC's Financial Reporting and Audit team (FR&A) conducts our audit inspection work. Team members have an average of 15 years of audit experience. We also continue to use experienced retired audit partners from the largest firms to conduct some audit file reviews.</p>
ASIC process to settle findings	<p>Our audit file inspections focus on key audit evidence and judgements. Our file reviews concentrate on the substance of audit work conducted and whether sufficient appropriate audit evidence was obtained to support the auditor's conclusions.</p> <p>All findings from inspections of individual audit firms are discussed with the firm to ensure we have fully understood all relevant facts and have taken into account all relevant audit work.</p> <p>Our audit file reviews are subject to quality review by a second experienced reviewer who also attends key meetings with the relevant firm to discuss any findings. There is consultation with relevant experts within FR&A and findings are discussed with the audit partner and manager, the firm's audit quality team and other relevant audit firm partners and staff.</p> <p>Our draft comment forms on individual file reviews and drafts of our 12-monthly reports to each of the inspected audit firms, enable those firms to challenge our preliminary findings and to undertake remedial action addressing those findings. Firms may escalate concerns with findings for review within FR&A.</p> <p>We consult with an external panel reviews on the method of measuring and reporting aggregate findings from our inspections. The panel has considered our measurement and reporting methodology and agrees with our approach. The panel also discusses the conclusions reached on a small number of our more challenging inspection findings where significant judgement is required and generally concurs with our findings.</p>
Consistency with foreign audit regulators	<p>We ensure that the findings reported from audit file reviews are consistent with those reported by foreign audit regulators. We have:</p> <ul style="list-style-type: none"> • seconded staff from foreign audit regulators • discussed our methodology for classifying findings with other regulators • conducted joint inspections with international regulators • had peer regulators review the classification of our findings, and • conducted case studies with other regulators.

Further information on ASIC's audit firm inspection process can be found in [INFO 224](#) and [REP 607](#).

Appendix B

Comparison of Australian and US approach to non-audit services

In the United States, the *Sarbanes-Oxley Act of 2002* (SOX) prohibits auditors from providing specified non-audit services to audited entities. SOX also prohibits any other service that the Public Company Accounting Oversight Board (PCAOB) determines, by regulation, is impermissible. The PCAOB has issued Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees.

In contrast to the US approach of prohibiting certain non-audit services, the Code of Ethics allows auditors to consider safeguards that enable them to provide non-audit services to audited entities.

Table 5: Requirements concerning the provision of non-audit services to audited entities

United States	Australia
<p>An auditor is prohibited from providing the following non-audit services to an audited entity, including its affiliates:</p> <ul style="list-style-type: none"> • bookkeeping • financial information systems design and implementation • appraisal or valuation services, fairness opinions, or contribution-in-kind reports • actuarial services • internal audit outsourcing services • management functions or human resources • broker–dealer, investment adviser, or investment banking services • legal services and expert services unrelated to the audit • assistance in planning, or providing tax advice on, certain types of potentially abusive tax transactions to an audited entity • tax services to certain persons employed by an audited entity. <p>Subject to certain limited exceptions, the audit committee must approve any other services before they can be provided by the auditor.</p>	<p>The following non-audit services are identified as having the potential to pose a threat to an auditor's independence:</p> <ul style="list-style-type: none"> • management responsibilities • administrative services • preparing accounting records and financial statements • valuation services • taxation services • internal audit services • IT system services • litigation support services • legal services • recruiting services • corporate finance services. <p>Auditors may provide these services to audited entities where, for example:</p> <ul style="list-style-type: none"> • audited entities make all judgements and decisions that are the responsibility of management • the subject matter or the service fee has an immaterial effect on financial statements • there is a member who was not involved in providing the service review, the audit or valuation work performed, and • the personnel providing such services do not participate in the audit.

Appendix C

Policy reforms already adopted or being considered internationally

Table 6: Some pros and cons of policy reforms considered internationally

Reform proposals	Pros	Cons
Annual reports by management and auditors on internal controls for larger listed entities, similar to the US requirements introduced under SOX: <i>Sarbanes-Oxley Act of 2002</i> , s302 and 404; and PCAOB Auditing Standard No. 2201 <i>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i>	<ul style="list-style-type: none"> • Evidence in the United States suggests the annual reports by management and auditors on internal controls have led to improved internal controls for processes supporting financial reporting, and to improved financial reporting and audit. • The reports and underlying processes are likely to result in increased confidence in audited financial reports and assist companies in accessing capital. 	<ul style="list-style-type: none"> • There are costs associated with preparation of such reports. However, these associated costs need to be weighed against the benefits, particularly for large listed entities.
Auditors prohibited from providing consulting services to their audited listed entities	<ul style="list-style-type: none"> • It reduces any actual or perceived conflicts of interest and enhances confidence in the independent audit and reliability of financial reports. • It has been implemented voluntarily by firms in the United Kingdom for the FTSE 350. 	<ul style="list-style-type: none"> • It may increase complexity in changing auditors in some cases, as potential auditors may be conflicted through provision of consulting services. • For some types of services, synergies might be lost that may lead to inefficiencies in the provision of audit services to the audited entity. • For some types of services, there may be a more limited pool of consulting firms for companies to choose from.
A functional split of audit services and other services provided by audit firms	<ul style="list-style-type: none"> • A functional split allows audit to be the core focus of a firm, which may increase the focus on audit quality in the absence of competing, potentially lucrative and growing service lines. • A split removes the possibility of any perceived lack of independence should there be reliance on subsidisation of audit by other services. 	<ul style="list-style-type: none"> • It may negatively affect audit quality as firms will no longer have ready access to, and quality control over tax, valuation and other experts to support the audit. • Internal service providers may better understand requirements for the audit. • The existence of other services may provide audit staff with work opportunities in other areas and increase the ability of audit firms to attract and retain staff.
Remove capping of liability for auditors	<ul style="list-style-type: none"> • Increasing the financial risk to an auditor where their work is deficient may enhance an auditor's focus on potential harms to investors. 	<ul style="list-style-type: none"> • Without capping of liability, audit may be less profitable and less attractive as a career to staff and partners.
Mandatory audit firm rotation for larger listed entities over 10 to 15 years	<ul style="list-style-type: none"> • It addresses the perception of loss of independence due to long-standing professional association with an audited entity. 	<ul style="list-style-type: none"> • A new audit firm will need to invest more time in the first audit to understand the business, assess risks and design appropriate audit responses, which may impact audit quality.

Reform proposals	Pros	Cons
	<ul style="list-style-type: none"> • Firm rotation brings fresh minds to challenge adequacy of audit evidence, accounting treatments and estimates. • A new auditor will not be concerned about challenging treatments accepted in the past. • A new auditor will invest time to become familiar with the business and conduct a quality audit. • Firms will make the investment necessary to ensure that audit quality is maintained where audits change hands. • It may address perceptions that partners are less willing to challenge accounting treatments and estimates due to the risk to their remuneration and reputation within a firm should the challenge result in the loss of the audit. 	<ul style="list-style-type: none"> • Mandatory firm rotation would increase the number of audit tenders by companies. The process undertaken by an audit firm in tendering for audits involves significant time by the firm and can divert audit resources from conducting quality audits. • The small number of large firms may limit choice of auditors, particularly for large banks. Audit firms may also be unable to tender because they provide significant non-audit services to the entity. • A long-term relationship with the audited entity's management can facilitate cooperation and information sharing to enhance the effectiveness of the audit function. • Partner rotation might be sufficient to bring a fresh mind to an audit. • There is often a turnover of auditors and client staff over time anyway. • Uncertainty around future audit engagements may affect a firm's ability to undertake long-term resource planning. • The loss of a major client may result in the loss of key staff and expertise within a firm.
Joint audits of larger listed companies by a large audit firm and a small audit firm for larger listed entities	<ul style="list-style-type: none"> • It may create opportunity for smaller firms to grow, thus increasing choice in audit markets. 	<ul style="list-style-type: none"> • A lack of clarity on responsibilities between joint auditors may lead to ineffective coordination and to gaps and overlaps in audit work. • The larger firm may undertake most of the audit work and may also have greater influence in the audit. • Each firm may be perceived to have an incentive not to challenge management on accounting treatments or estimates so as to win additional work.
Regulator to appoint auditors and/or set audit fees	<ul style="list-style-type: none"> • It would remove any actual or possible inappropriate pressure on an auditor because of management influence over appointment of the auditor and setting of fees. 	<ul style="list-style-type: none"> • It would require substantial regulatory resources and be a 'world first experiment'. • It raises capability and moral hazard issues. • There may be a perception that a regulator has a conflict in selecting auditors who they must then regulate.

Reform proposals	Pros	Cons
Regulator to oversee audit committee role in appointing auditors and setting audit fees	<ul style="list-style-type: none"> Responsibility is placed on the directors to represent investor interests and bring to bear their knowledge of the entity and its business operations. It reinforces the role of directors in supporting audit quality on an ongoing basis. 	<ul style="list-style-type: none"> It would require additional regulatory resources that would increase costs to companies and ultimately investors. It raises capability and moral hazard issues.
Auditors to detect immaterial fraud	<ul style="list-style-type: none"> Close any expectation gap as to the auditor's role to detect immaterial fraud. In some cases, data analytics may help in detecting immaterial fraud. 	<ul style="list-style-type: none"> The scope of audit work would need to be significantly expanded. This would involve significant costs that would ultimately be borne by investors.
Assurance on non-financial information (e.g. integrated reporting, sustainability reporting)	<ul style="list-style-type: none"> It would increase user confidence in non-financial information disclosed. 	<ul style="list-style-type: none"> Premature in the absence of a sufficient reporting framework against which an audit can be conducted. Auditors may be unable to provide positive assurance on certain forward-looking and other information. Audit may limit innovation if companies become too focused on how readily information can be audited when developing reporting for non-financial information.
Audits of culture at companies	<ul style="list-style-type: none"> It would increase user confidence in information disclosed. 	<ul style="list-style-type: none"> Premature as there is no reporting framework against which the audit can be conducted. It is difficult to assess the mindset of individuals and how they are embodying the culture of the company.
Increase 'cooling-off' period for partner rotation to five years	<ul style="list-style-type: none"> The current two-year cooling-off period in the Act might allow a partner to continue to be a 'shadow' auditor, particularly given handover periods. It would align the Act with the new requirements in the Code of Ethics. 	<ul style="list-style-type: none"> It may be more difficult to plan rotation in smaller audit firms.

Appendix D

Reporting by auditors

Auditors are required to report suspected contraventions that come to their attention under s311, 601HG and 990K of the Act. Guidance on this reporting obligation is provided in [Regulatory Guide 34 Auditor's obligations: Reporting to ASIC](#) (RG 34). Non-significant contraventions that are dealt with by drawing them to the attention of the directors or including them in the auditor's report are not required to be reported under s311 and 601HG.

Table 7 summarises the areas in which auditors reported suspected contraventions of the Act in the two years to 30 June 2019.

Table 7: Breaches that auditors reported to ASIC over the two years to 30 June 2019

Area of breaches	Listed entities 2018–19	Listed entities 2017–18	Unlisted entities 2018–19	Unlisted entities 2017–18	All entities 2018–19	All entities 2017–18
Lodgement of financial reports	50	22	162	154	212	176
Compliance with accounting standards (mainly relates to material adjustments of prior-period errors) or true and fair view requirement	33	21	95	74	128	95
Audit opinion—Qualified opinion, disclaimer of opinion or emphasis of matter paragraph	39	30	39	54	78	84
Auditor rotation	0	1	0	0	0	1
Directors' duties	12	9	18	19	30	28
Fraud/misconduct by management/employee	2	3	7	2	9	5
AFS licensee obligations reported under s311*	80	21	239	94	319	115
AFS licensee obligations reported under s990K*	124	43	807	403	931	446
Compliance plan audit under s601HG	0	0	86	96	86	96
Others	10	12	61	50	71	62
Total	350	162	1,514	946	1,864	1,108
For comparison only—the number of financial reports prepared under the Act	2,271	2,247	31,263	29,938	33,520	32,209

Source: Notifications lodged to ASIC by auditors under s311, 601HG and 990K of the Act.

* There will be some overlap between the AFS licensee matters reported under s311 and s990K. Auditors report matters under one of these two provisions or under both provisions.