Chapter 2

Audit quality

2.1 This chapter explores the ongoing concerns that the committee has with the quality of company auditing, particularly for large businesses. Given the relatively small number of companies that can undertake audits for large business, reasonable concerns about conflicts of interest are examined.

The function of auditing

2.2 A principal/agent problem exists with the corporate form of business. As Adam Smith recognised, a corporation using and managing other people's money could not be trusted to be as prudent with that money as they would be if it were their own.[1]

2.3 In addition, a profound and unavoidable asymmetry of information exists between the management of a company and the investors, or potential investors, in it. Of necessity, management has access to far more detailed information about the company and its operations than an ordinary investor can hope to have.

2.4 These are problematic issues not just for individual investors but also for the existence of open, fair and efficient markets and, ultimately, for capitalism itself. If investors do not have access to accurate, risk-weighted information about the prospects of a firm, the risks of corporate collapse may remain undisclosed and investors may be unable to make fully informed and rational investment decisions.

2.5 In the final analysis, if investors cannot properly assess the value of firms and investments, there is a risk of systemic failure, as happened in the Global Financial Crisis (GFC).

2.6 The function of an audit is to provide an independent review of the financial statements and compliance plans of the company or financial entity and certify that they are a true and fair view of the business. By rigorously examining corporate accounts, an audit should expose false accounting and detect business risks and potentially serious problems, thereby presenting an accurate picture of business fundamentals and reducing the asymmetry of information between the management of a company and investors.

2.7 This chapter begins by considering the core objectives for regulators in a 'light touch' regulatory system, the requirements of auditors, Australia's auditing arrangements, and concerns about the auditing system. It then considers various limitations of the auditing system including the inherent difficulties of the task, the structure of the industry, and associated conflicts of interest. The chapter concludes by canvassing some of the options for improving audit quality.

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1 Adam Smith, *An inquiry into the nature and causes of the wealth of nations*, 1776, p. 311.

A light touch system of regulation

2.8 The three core objectives for regulators defined by the International Organization of Securities Commissions (IOSCO) are:

- the protection of investors;
- ensuring that markets are fair, efficient and transparent; and
- the reduction of systemic risk.[2]

2.9 There can be a tension within the regulatory system for corporations between, on the one hand, promoting efficient, open and flexible markets in order to attract capital, create wealth, stimulate growth, and promote Australia as a global financial centre, and, on the other hand, the degree of regulation—which is intended to constrain behaviour—necessary to protect investors (particularly retail investors).[3]

2.10 Since the market-oriented reforms of the 1980s, Australia, like other English speaking countries, has opted for 'light touch' regulation. Consequently, it has relied on market forces to ensure honest behaviour towards shareholders and consumers.

2.11 The auditing arrangements described in the following sections form part of the gatekeeper framework of 'light touch' regulation in the financial services sector. The key gatekeepers in the financial services system include financial planners and financial advisers, custodians, research houses, trustees, responsible entities, directors, and auditors. The various gatekeepers have particular roles and responsibilities, exercised both separately and, in some instances, in concert.

2.12 At the outset, it is worth noting that auditors play a critical and unique role in the gatekeeper system. As has been previously recognised, gatekeepers such as financial planners and financial advisers, custodians, research houses, trustees, and responsible entities may all be part of large corporate conglomerates. By contrast, auditors should be external parties that stand alone. Their independence is essential to the proper functioning of the system. And yet, as this chapter reveals, this notion of independence is under question.

Requirements of auditors

2.13 Under section 307 of the *Corporations Act 2001* (Corporations Act), it is the auditor's responsibility to form an opinion about whether:

- the financial report being audited or reviewed complies with accounting standards and gives a true and fair view of the financial position and performance of the entity;

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2 International Organization of Securities Commissions, *IOSCO objectives*, https://www.iosco.org/about/?subsection=about_iosco (accessed 12 February 2019).

3 See evidence from Dr George Gilligan in Parliamentary Joint Committee on Corporations and Financial Services, *Statutory oversight of the Australian Securities and Investments Commission*, March 2012, p. 4.

- the auditor has been given all information, explanation and assistance necessary for the conduct of the audit;
- the entity has kept financial records sufficient to enable a financial report to be prepared and audited; and
- the entity has kept other records and registers required by the Corporations Act.[4]

2.14 The Auditing and Assurance Standards Board (AUASB), whose function is described below, has developed guidance as to how an auditor should operate. An auditor requires:

- independence;
- professional scepticism;
- professional judgement; and
- sufficient appropriate information on which to base an opinion with an acceptable level of risk.[5]

Australia's auditing arrangements

2.15 Auditing standards in Australia are governed by the *Corporations Act 2001*. Audits must be conducted in accordance with legally enforceable auditing standards that were introduced for financial reporting periods from 1 July 2006 following the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9).

2.16 Australia's financial reporting system is established by Part 12 of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). One of the main objects of section 224 of the ASIC Act is to develop auditing and assurance standards that:

- provide Australian auditors with relevant and comprehensive guidance in forming an opinion about, and reporting on, whether financial reports comply with the requirements of the Corporations Act; and
- require the preparation of auditors' reports that are reliable and readily understandable by the users of the financial reports to which they relate.[6]

2.17 The AUASB is established by section 227 of the ASIC Act. It is under the strategic direction of the Financial Reporting Council (FRC), the body responsible for overseeing the effectiveness of the financial reporting framework. The AUASB is

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4 Australian Securities and Investments Commission, *Auditor independence and audit quality*, https://asic.gov.au/regulatory-resources/financial-reporting-and-audit/auditors/auditor-independence-and-audit-quality/ (accessed 12 February 2019).

5 Auditing and Assurance Standards Board, *Auditing Standard ASA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, December 2015, paras 14–17.

6 *Australian Securities and Investments Commission Act 2001*, ss. 224(aa).

responsible for developing Australian Auditing Standards, which in turn are based on the International Standards on Auditing.[7] Where there are gaps in the international framework, the AUASB develops principles-based domestic standards and guidance.[8]

2.18 Audit processes are overseen by ASIC. ASIC registers individuals as company auditors, and conducts inspections of audit firms, including, where appropriate, inspecting audit files and company financial reports.[9] The professional accounting bodies, including Chartered Accountants Australia and New Zealand, CPA Australia and the Institute of Public Accountants, enforce professional standards.[10]

2.19 The FRC receives information from these bodies on the quality of audits, what initiatives are being taken to ensure a high standard of auditing, and what changes to standards are necessary. It provides strategic advice to government on audit quality.[11]

ASIC's audit inspection program

2.20 ASIC is responsible for the surveillance, investigation and enforcement of the financial reporting and auditing requirements of the Corporations Act. As noted in ASIC's report for 2009–10, the aim of ASIC's audit inspection program is to:

> …promote high quality external audits of financial reports of listed entities and other public interest entities so that users can have greater confidence in these financial reports and Australia's capital markets.[12]

2.21 ASIC states that its audit firm inspections and auditor surveillances are 'key compliance tools aimed at educating and influencing the behaviour of registered company auditors and audit firms'.[13] Its focus is on 'audit quality and promoting compliance with the requirements of the Corporations Act, Australian auditing standards, and Australian accounting professional and ethical standards'.[14]

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7 Strategic Direction issued by the Financial Reporting Council to the Auditing and Assurance Standards Board on 6 April 2005, published in Auditing and Assurance Standards Board, *AUASB Functions and Processes*, September 2014, p. 5.

8 Professor Roger Simnett, Chair, Auditing and Assurance Standards Board, *Committee Hansard*, 16 February 2018, p. 13.

9 Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 16 February 2018, p. 11.

10 Mr William Edge, Chair, Financial Reporting Council, *Committee Hansard*, 16 February 2018, p. 12.

11 Mr William Edge, Chair, Financial Reporting Council, *Committee Hansard*, 16 February 2018, p. 12.

12 Australian Securities and Investments Commission, *Report 242—Audit inspection program public report for 2009–10*, June 2011, p. 6.

13 Australian Securities and Investments Commission, *Audit inspection and surveillance programs*, https://asic.gov.au/regulatory-resources/financial-reporting-and-audit/auditors/audit-inspection-and-surveillance-programs/ (accessed 12 February 2019).

14 Australian Securities and Investments Commission, *Report 242—Audit inspection program public report for 2009–10*, June 2011, p. 6.

2.22 ASIC reports on its audit inspection programs for an eighteen month period. It uses a risk-based method to select firms, engagement files, and audit areas for review.[15]

Enforcement

2.23 ASIC has enforcement powers, which it appears to have used sparingly, against auditors where deficiencies are found in their work. In the six years to February 2018, ASIC took action against 20 registered company auditors and 33 self-managed superannuation fund auditors. In 2016, ASIC cancelled the registration of 133 self-managed superannuation fund auditors who had not lodged annual statements with ASIC after repeated reminders.[16]

Concerns about audit quality

2.24 For some years now the committee has been commenting about the quality of auditing, generally echoing concerns raised by ASIC.

2.25 In evidence to the committee in 2012, the then ASIC Chairman, Mr Greg Medcraft, stated that 15 per cent of audit files reviewed in the 2009–10 report on its audit inspection program had 'inadequate evidence to support an audit opinion'.[17]

2.26 At that time, Mr Medcraft expressed considerable disappointment and frustration that the audit quality inspection results were so poor. Mr Medcraft was firmly of the view that the number of audit files with insufficient evidence to support an audit opinion should be substantially less than 10 per cent.[18]

2.27 The issue of audit quality was thrown into sharp relief with the collapse of Trio Capital in 2010 and the collapse of Victorian debenture issuer, Banksia Securities Limited (Banksia), in October 2012.[19]

2.28 Mr Medcraft drew the committee's attention to the fact that the auditors had signed off the accounts of Banksia in September 2012, only a few weeks before the group collapsed.[20]

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15 Australian Securities and Investments Commission, *Audit inspection program report for 2017–18*, p. 2.

16 Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 16 February 2018, p. 11.

17 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 15.

18 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 15.

19 See, for example, Parliamentary Joint Committee on Corporations and Financial Services, *Statutory oversight of the Australian Securities and Investments Commission*, No. 1 of 43rd Parliament, February 2013, p. 15.

20 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 21 cited in Parliamentary Joint Committee on Corporations and Financial Services, *Statutory oversight of the Australian Securities and Investments Commission*, No. 1 of 43rd Parliament, February 2013, p. 18.

2.29 In the committee's inquiry into Trio Capital in 2012, both regulators and investors expressed frustration at the role of Trio Capital's financial statement and compliance plan auditors, particularly their inability to verify information.[21]

2.30 As part of its report into Trio Capital, the committee endorsed 'ASIC's forward program to improve the rigour of compliance plans, the auditing of these plans and the composition and governance of compliance committees'.[22]

2.31 However, the audit quality results in ASIC's inspection report for 2011–12 represented a further decline in auditing standards from those that ASIC had previously reported. In 2011–12, ASIC found that in 18 per cent of the 602 key audit areas that it reviewed across 117 audit files over firms of all sizes, auditors did not:

- obtain sufficient appropriate audit evidence;
- exercise sufficient scepticism; or
- otherwise comply with auditing standards in a significant audit area.[23]

2.32 Commenting on the findings from the 2011–12 report, Mr Medcraft stated that there was clearly a lack of professional scepticism that pointed to a cultural problem in the audit profession. Mr Medcraft expressed the view that unless the audit industry improved its standards, measures such as audit firm rotation would need to be considered.[24]

2.33 In a later report, the committee remarked that ASIC had put auditing firms on notice regarding the quality of financial statement audits, and noted the development by the biggest six audit firms in Australia to action plans to improve audit quality. This was in response to a request from ASIC that they address the three broad areas requiring improvement that had been identified in the inspection report for 2011–12:

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and
- the extent of reliance that can be placed on the work of other auditors and experts.[25]

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21 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 123.

22 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 154.

23 Australian Securities and Investments Commission, *Report 317—Audit inspection progress report for 2011–12*, December 2012, p. 4.

24 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 20 cited in Parliamentary Joint Committee on Corporations and Financial Services, *Statutory oversight of the Australian Securities and Investments Commission*, No. 1 of 43rd Parliament, February 2013, p. 17.

25 Parliamentary Joint Committee on Corporations and Financial Services, *Statutory oversight of the Australian Securities and Investments Commission: the role of gatekeepers in Australia's financial services system*, No. 3 of 43rd Parliament, July 2013, pp. 33–34.

2.34 With regard to its audit inspection program for 2015–16, ASIC stated:

> In our view, in 25% of the total 390 key audit areas that we reviewed across 93 audit files at firms of different sizes, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 19% of 463 key audit areas in the previous 18-month period ended 30 June 2015.[26]

2.35 ASIC's audit inspection program appears to show an ongoing deterioration in audit quality. In 2009–10, 17 per cent of audit files did not have adequate evidence, through to 18 per cent in 2011–12 and 19 per cent in 2014–15, to 25 per cent of cases where auditors 'did not obtain reasonable assurance that the financial report as a whole was free of material misstatement' in 2015–16. In 2017–18, this figure was 24 per cent.[27]

2.36 However, a decline in audit quality may not be the only conclusion that could be drawn from these figures. It is important to recognise that ASIC inspects audit firms and audit files that it believes to be of higher risk, and the size of its sample varies. The number of key areas audited also varies, and one might expect that more areas audited would produce more shortcomings. There is no attempt at randomisation and no suggestion that statistical comparisons can be made. It is, therefore, plausible that what may be happening is that ASIC is improving its targeting.[28]

2.37 Further, ASIC has pointed out that the existence of a faulty audit does not necessarily mean that there is anything wrong in the company's reports, or with the company's operations.[29]

2.38 Nonetheless, the persistence of the issues raises a question as to why the quality of audits is still a problem. Mr Medcraft told the committee in October 2017 that 'audit quality continues to decline, as reflected in our reports every 18 months. The audit firms themselves are concerned about it'.[30]

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26 Australian Securities and Investments Commission, *Report 534 Audit inspection program report for 2015–16*, June 2017, p. 4.

27 Australian Securities and Investments Commission, *Report 607 Audit inspection program report for 2017–18*, January 2019, p. 9; *Report 534 Audit inspection program report for 2015–16*, June 2017, p. 4; *Report 461 Audit inspection program report for 2014–16*, December 2015, p. 5; *Report 317 Audit inspection program for 2011–12*, December 2012, p. 4; *Report 242 Audit inspection program for 2009–10*, June 2011, p. 18.

28 These caveats have been made repeatedly by Australian Securities and Investments Commission (eg, ASIC, *Report 534—Audit inspection program report for 2015–16*, p.7) and by Financial Reporting Council (eg FRC, *Annual Report 2016–17*, p. 17).

29 Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 16 February 2018, p. 11.

30 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 27 October 2017, p. 21.

2.39 More recently, the committee expressed concern about the quality of auditing in its report on the 2016–17 annual reports of bodies established under the ASIC Act.[31]

2.40 In that report, with reference to the annual reports of the FRC and the AUASB (and the Australian Accounting Standards Board, AASB), the committee considered that the bodies had fulfilled their annual reporting obligations, but reserved its judgement about whether they had fulfilled their regulatory functions, due to concerns about audit quality.[32]

2.41 The committee discussed ASIC's report of its inspections of audit firms noted above and concluded that it was not satisfied with these outcomes:

> The committee recognises the critical importance of audit quality. The committee has had a long-standing interest in this matter and is particularly concerned that audit quality continues to deteriorate. This raises questions about ASIC's response over the past decade and the measures that ASIC, the FRC and the standards boards have taken thus far.[33]

Limitations of the auditing system

The inherent difficulty of the task

2.42 The information asymmetry referred to earlier between the management of a company and investors, or potential investors is very difficult to counter. Even for sophisticated investment companies, 'reading a set of accounts is like reading a mystery novel'.[34] Although it is the job of auditors to approach this task with professional expertise, scepticism and judgement, the difficulties are inherent.

2.43 As a result, many audits tend to focus on whether correct processes have been followed, and have to rely on assurances that financial reports are accurate and complete.

2.44 However, if a company chooses to deliberately conceal information and to mislead an auditor, or indeed has made errors it is unaware of, it may difficult for an auditor to detect issues.

2.45 Even the claimed existence of an offshore asset may be difficult to challenge. For example, in the inquiry into Trio Capital, the auditors cited the limitations on their role and pointed out that the primary responsibility for detecting fraud rests with the

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31 Parliamentary Joint Committee on Corporations and Financial Services, *Report on the 2016–2017 annual reports of bodies established under the ASIC Act*, July 2018.

32 Parliamentary Joint Committee on Corporations and Financial Services, *Report on the 2016–2017 annual reports of bodies established under the ASIC Act*, July 2018, paras. 3.20, 3.29 and 3.37.

33 Parliamentary Joint Committee on Corporations and Financial Services, *Report on the 2016–2017 annual reports of bodies established under the ASIC Act*, July 2018, para. 4.58.

34 A representative of Aberdeen Standard Investments quoted in House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion*, Report HC 769, 16 May 2018, p. 79.

responsible entity. Auditors noted that they can only obtain reasonable assurance that a financial report is free from material misstatement, whether caused by fraud or error.[35]

2.46 Further, in some circumstances, it is unlikely that an auditor will have the expertise to question some information. Valuations of some assets such as listed securities, which have a known market price, are relatively straightforward—though even here, the value is accurate only for a point in time. However, for more complex assets, such as unlisted securities and going concerns that are taken over, it is much more difficult to confirm a valuation. The misadventures of Bunnings and National Australia Bank in the United Kingdom (UK) show that even 'experts' with the best will in the world and the best information available cannot necessarily assess value accurately. Sometimes valuations are deliberately obscured. For example, valuations of securitised assets in the period before the GFC were notoriously opaque.[36]

2.47 CPA Australia has summarised the limitations on audits:

> Obtaining absolute assurance is not possible in financial statement audits for a number of reasons, including:
>
> - It would be impractical for the auditor to test and audit every transaction.
> - Financial statements involve judgements and estimates which often cannot be determined exactly, and may be contingent on future events.[37]

2.48 Thus, there are difficulties and uncertainties in the process of auditing which might surprise both investors and members of the public. As the committee has previously noted, there are a series of expectation gaps between what investors and the public expect of gatekeepers such as auditors, and what those gatekeepers are legally obliged to do, and what their roles involve in practice.[38] Furthermore, the existence of a system of checks may give investors a false sense of security.

Structure of the audit industry

2.49 The structure of the audit industry gives rise to two further issues, namely:

- the concentration of major company auditing in a few hands; and
- the diversified nature of the operations of the big four accounting firms and associated conflicts of interest.

First, the industry is dominated both locally and globally by four big firms: PricewaterhouseCoopers (PwC), KPMG, Deloitte and Ernst and Young (EY).

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35 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, p. 121.

36 See, for example: Gregory Jones and Graham Bowrey, *NSW Local Council investment exposures*, 2010, University of Wollongong, Research Online, p. 8.

37 CPA Australia Ltd, *A guide to understanding auditing and assurance: listed companies*, October 2014, p. 7.

38 See Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the collapse of Trio Capital*, May 2012, pp. 123–124.

2.50 The big four accounting firms audit 97 per cent of United States public companies and all of the top 100 corporations in the UK. Richard Brooks argues that the big four accounting firms 'are the only players large enough to check the numbers for these multinational organisations, and thus enjoy effective cartel status'. Furthermore, Mr Brooks argues that because there are no serious rivals to undercut the big four, and because audits are a legal requirement almost everywhere, the arrangement effectively becomes 'a state-guaranteed cartel'.[39]

2.51 The dominance of the big four accounting firms therefore raises questions about the extent to which effective competition operates within the audit industry with respect to the auditing of major corporations.

2.52 In addition, it appears that there are substantial barriers to entry into the top tier auditing market, thereby rendering greater competition unlikely, if not impossible. While the committee is not aware of a detailed study in Australia, it notes the findings of the UK parliamentary inquiry into the collapse of Carillion, a large diversified firm with numerous big and vital government contracts. Its Carillion report found that the market for audit services was dominated by the big four audit firms and there were barriers to market entry:

> Substantial entry is unlikely to be attractive, due to significant barriers, including the perception bias against mid-tier firms, high costs of entry, a long payback period for any potential investment, and significant business risks when competing against the incumbents in the market.[40]

2.53 Secondly, these big four companies are integrated professional service providers. As such, the revenue that the big four accounting firms derived from auditing is less (and in some cases substantially less) than a quarter of total revenue, and has declined even further over the last four financial years (see Table 2.1). In 2017–18, the percentage of audit revenue at the big four accounting firms in Australia was as follows:

- Deloitte — 13.7 per cent;
- EY — 21 per cent;
- KPMG — 20 per cent; and
- PwC — 17.4 per cent.

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39 Richard Brooks, 'The financial scandal no one is talking about', *The Guardian*, 29 May 2018, https://www.theguardian.com/news/2018/may/29/the-financial-scandal-no-one-is-talking-about-big-four-accountancy-firms?CMP=share_btn_link (accessed 12 February 2019).

40 House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion*, Report HC 769, 16 May 2018, p. 80.

Table 2.1: Audit work as a percentage of total big four revenue

Audit work as a percentage of total big four revenue

		Total reported revenue ($m)	Revenue from audits of financial statements ($m)	Revenue from audits of financial statements (% of total revenue)
DELOITTE	FY14	1174	225	19.2
	FY15	1355	236	17.4
	FY16	1541	251	16.3
	FY17	1771	261	14.7
	FY18	2030	278	13.7
EY	FY14	1133	318	28.1
	FY15	1286	338	26.3
	FY16	1486	352	23.7
	FY17	1624	352	21.6
	FY18	1785	375	21.0
KPMG	FY14	1120	269	24.0
	FY15	1210	278	23.0
	FY16	1370	301	22.0
	FY17	1500	315	21.0
	FY18	1640	328	20.0
PWC	FY14	1573	354	22.5
	FY15	1731	364	21.0
	FY16	1920	369	19.2
	FY17	2120	396	18.7
	FY18	2350	409	17.4

Source: Edmund Tadros and Vesna Poljak, 'Auditors 'compromised' by providing consulting work: ASIC', *Australian Financial Review*, 24 January 2018, https://www.afr.com/business/accounting/auditors-compromised-by-providing-consulting-work-asic-20190124-h1agav (accessed 12 February 2019).

2.54 The big four accounting firms offer, alongside audit services, research, human resources, strategic planning, government advice, marketing and a wide variety of other services.[41]

2.55 While the big four firms are growing rapidly, they are not publicly listed, so there is less available information about them compared to other firms of similar size.

2.56 There is at least a theoretical conflict of interest where an auditor is selected by the directors of a company and is paid by that company, but the investors which rely on the independence and accuracy of the audit report have no input into the selection of the auditor. Indeed, there is potential for a serious conflict of interest where an audit firm sees an unfavourable audit as reducing its chances of further work with the company being audited. It is important to remember that, given the current nature of the audit industry, further work is not restricted to auditing and may include the whole gamut of services provided by the big four accounting firms to their clients.

2.57 The Carillion Report noted that a big accounting firm could have several different relationships with a major company at the same time. It also noted that in the UK 'two-thirds of chief financial officers of large listed and private companies were Big Four alumni', so their influence was magnified.[42]

2.58 A former forensic investigator with ASIC, Mr Glen Unicomb, was recently quoted as saying that:

> …he believed the 'big four' accounting firms — PwC, Deloitte, EY and KPMG — risked being exposed to pressure to approve reports to protect lucrative advisory relationships…Mr Unicomb said today's business model for accounting firms was potentially conflicted, given the balance between a traditional pipeline of external audit work with a separate advisory arm which attracted big fees.[43]

2.59 Mr Brooks argued that the big accounting companies should be examined by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission):

> 'They don't just audit, they advise on financial transactions. They advise on financial products. They package up derivative products,' he said.
>
> 'They are right in there and they are heavily conflicted.

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41 Daniel Ziffer, quoting Stuart Kells in 'KPMG, Deloitte, PwC and EY diversifying to have 'fingers in all sorts of pies'', *ABC News*, 10 April 2018, http://www.abc.net.au/news/2018-04-09/kpmg-deloitte-pwc-ey-diversify-and-become-more-powerful/9634774 (accessed 12 February 2019).

42 House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion*, Report HC 769, 16 May 2018, p. 79.

43 Peter Ryan, ''Big four' accounting firms should face banking royal commission to prove independence, former ASIC investigator says', *ABC News*, 5 October 2018, http://www.abc.net.au/news/2018-10-05/big-four-accounting-firms-should-face-royal-commission/10339504 (accessed 12 February 2019).

'We are relying on them to tell us everything is sound. You can't review that industry without looking at the auditors.'[44]

Stability of audit relationships

2.60 It is common for the same audit company to audit a particular firm for many years running. The UK Carillion inquiry noted that KPMG had been auditing Carillion for all 19 years of the company's existence.[45]

2.61 This stability can have advantages, because the audit company becomes familiar with the complexities of the firm's operations and financial statements. Changing auditors can result in a loss of knowledge and consequent deterioration in quality of audit.[46]

2.62 On the other hand, stability can lend itself to complacency, personal relationships which can obscure objectivity, an unwillingness to find an error that was overlooked the previous year, and even corruption. It is also a barrier to entry for new firms to the industry.[47]

2.63 It was noted above that Mr Medcraft, then Chairman of ASIC, saw rotation of auditors as one solution to poor audit quality.[48] Some countries in the European Union have policies of audit firm rotation.[49] In Australia, there is a requirement for rotation of the audit partner, but not the audit firm, roughly every five years.[50]

2.64 The need for auditors to be independent was stressed above. It is a necessary, though not sufficient, condition for professional scepticism. Clearly, independence can be jeopardised by recognising that the other business of the firm can be affected by the outcome of an audit, as discussed above. Also as suggested above, it can be lessened by familiarity in a longstanding, stable relationship.

2.65 The process of auditing can also reduce the exercise of scepticism:

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44 Richard Brooks, quoted by Steve Cannane, 'Banking royal commission: 'Big four' accountancy firms 'heavily conflicted, should be under inquiry spotlight', *ABC News*, 25 June 2018, http://www.abc.net.au/news/2018-06-25/banking-inquiry-should-investigate-accountancy-firms-brooks-says/9904592 (accessed 9 October 2018).

45 House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion*, Report HC 769, 16 May 2018, p. 79.

46 Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 27 October 2017, p. 21; Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 16 February 2018, p. 19.

47 House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion*, Report HC 769, 16 May 2018, p. 79.

48 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 20.

49 Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 27 October 2017, p. 21.

50 Mr William Edge, Chair, Financial Reporting Council, *Committee Hansard*, 16 February 2018, p. 18.

> Professional scepticism is often an issue around the complexity of the rules, the accounting standards and the auditing standards that need to be applied. It's not necessarily because of your familiarity with the client; it's more that you're so focused on the rules, the different calculations and the different disclosure modes that sometimes you're not taking a moment to sit back.[51]

2.66 Finally, it has also been suggested that not enough resources are devoted to audits. As the Chair of the FRC told the committee, if a company sees an audit as a commodity and pays the lowest audit fee it can, it will get a poor standard of audit.[52] Mr Medcraft put it even more bluntly:

> The fundamental driver of [poor audit quality] is, frankly, they [the audit firms] don't get paid enough to do the job…Whenever they compete, they cut fees…If you lower the fee, often the audit quality suffers.[53]

Potential solutions

Changing the task

2.67 An auditor's task would be easier if financial reports were made more transparent. The AASB states that it designs accounting standards (which shape reporting) with auditability in mind. The standards are principles-based, so that interpretations sometimes require professional judgement. But the AASB does not believe that audit quality issues arise from ineffective accounting standards.[54]

2.68 The FRC believes that Australian accounting standards are 'world's best practice'.[55] ASIC is of the view that principles-based standards lend themselves less to gaming than specific rules.[56]

2.69 Nonetheless, all the bodies involved are constantly working to improve the standards. In particular, the AASB is about to issue a new revenue standard and is reviewing impairment testing of goodwill.[57]

2.70 That said, the quality of an audit ultimately depends on the accessibility and transparency of the company information underlying the financial statements. If this

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51 Mr William Edge, Chair, Financial Reporting Council, *Committee Hansard*, 16 February 2018, p. 22.

52 Mr William Edge, Chair, Financial Reporting Council, *Committee Hansard*, 16 February 2018, p. 23.

53 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 27 October 2017, pp. 21–22.

54 Ms Kris Peach, Chair, Australian Accounting Standards Board, *Committee Hansard*, 16 February 2018, p. 12.

55 Mr William Edge, Chair, Financial Reporting Council, *Committee Hansard*, 16 February 2018, p. 17.

56 Mr Doug Niven, Senior Executive Leader, Financial Reporting and Audit, Australian Securities and Investments Commission, *Committee Hansard*, 16 February 2018, p. 15.

57 Ms Kris Peach, Chair, Australian Accounting Standards Board, *Committee Hansard*, 16 February 2018, p. 13.

information is not available, it will be difficult for any auditor, no matter how diligent or skilled, to be comprehensive and thorough. Consequently, it would appear that, along with the continued education of auditors and the updating of audit standards, there needs to be greater education of company executives and staff to ensure that the information underlying financial statements is more accessible and transparent.

Incentives for auditors

2.71 The committee heard that one measure that is known to work is a remuneration policy where the finding of a deficiency in an audit has an impact on the income of the partner in the auditing firm.[58] More generally, the culture of the organisation has a big influence on audit quality. ASIC believes the big firms are now sending strong messages from senior management about the importance of audit quality, and are also bringing in coaching, review processes, and internal accountability measures.[59]

2.72 While there are penalties after the event for poor audits, this appears to be fairly rare. Were ASIC to enforce appropriate penalties for misconduct, this would send a strong message to the audit industry and drive standards higher.

2.73 Where audit firms accept the lowest competitive price and then skimp on the product, one solution could be to have government set the price and engage the auditor. This would also reduce the conflict of interest where an auditor may be concerned about the renewal of their contract with the firm. Apparently, this solution was canvassed after the Enron debacle.[60]

Structure of the industry

2.74 The dominance of the big four accounting firms in the Australian auditing market—and indeed markets for other sources—is at least worth examining. It may be that there is sufficient competition in the provision of services, and that barriers to entry are not as high as has been suggested. Alternatively, greater rotation of auditors, and of audit firms, has been discussed above and would be worth further investigation.

2.75 There is also an argument for structural separation to end the provision of a variety of services alongside auditing by the same firm. This might be done by mandating audit-only firms, or making a rule that a firm cannot purchase other products from the firm that does its audit (although this could also set up perverse

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58 Mr John Price, Commissioner, Australian Securities and Investments Commission and Mr William Edge, Chair, Financial Reporting Council, *Committee Hansard*, 16 February 2018, p. 22.

59 Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 16 February 2018, p. 22.

60 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 27 October 2017, p. 21.
Note: in the wake of the Enron fraud, Arthur Anderson and Co, a major accounting firm, was convicted of obstructing justice and lost its licence.

incentives). These questions are being considered in the UK in the wake of the Carillion collapse.[61]

Committee view

2.76 The committee has been concerned for some years about audit quality in Australia. While rigorous audits should provide a fair and accurate picture of business fundamentals, the committee acknowledges the important roles that other gatekeepers in the financial system, such as directors, must play in keeping companies honest and transparent.

2.77 The committee also acknowledges that the problem of audit quality is an international one, and that there is debate about both the severity of the problem, and the potential solutions.

2.78 Before addressing some of the bigger and more fundamental questions, the committee considers that the conflicting views on audit quality enunciated by the FRC and ASIC require further examination. The FRC disputes the view put forward by ASIC that audit quality in Australia is unacceptably poor. However, one of the fundamental points of dispute appears to be the risk-based nature of ASIC's audit inspection program and the inferences and conclusions that may be reasonably drawn from the results over time. To this end, the committee considers that it would be useful if ASIC, perhaps in consultation with the FRC, were to 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.

Recommendation 1

2.79 The committee recommends 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.

2.80 Acknowledging that issues around the measurement of audit quality may benefit from being more precisely articulated does not, however, detract from the seriousness of the various conflicts of interest that are apparent in the audit industry. For example, the traditional view of the audit firms is that they operate as independent outsiders scrutinising the accounts of major corporations. In effect, however, the big four audit firms have become corporate insiders embedded within the business world. The risk here, of course, is that the big four audit firms now fail to fearlessly scrutinise the accounts and risks of the corporations that they audit because it may be detrimental to the pursuit of their wider business interests.

2.81 Furthermore, it is precisely this diversification into a whole raft of other professional services, and the attendant conflicts of interest, that calls into question the view that a lack of competition in the audit industry is the root cause of poor audit

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61 Hans van Leeuwen, 'UK regulators ramp up pressure on Deloitte, EY, KPMG and PwC with new probes', *Australian Financial Review*, 10 October 2018, https://www.afr.com/business/accounting/uk-regulators-ramp-up-pressure-on-deloitte-ey-kpmg-and-pwc-with-new-probes-20181009-h16fho (accessed 12 February 2019).

quality. It seems to the committee that this may be too simplistic an understanding of the problem.

2.82 Indeed, it has been argued that the audit industry is more competitive than generally portrayed, and that auditing is unprofitable but is used as a loss-leader to procure more profitable consulting, IT, and other professional service work. One implication to be drawn from this arrangement is that if an auditor produces a report that clearly identifies inaccuracies in a company's financial statements, or identifies previously undisclosed risks pertaining to the audited entity, there is no guarantee that a senior executive in the audit firm will support the auditor's findings because it may risk the audit firm's ongoing business across a whole range of other professional services.

2.83 And therein lies the dilemma. The incentive to overlook risks in an audit is inherent when the audit firm is conflicted because it relies so heavily on the sale of its other professional services to the same corporations that it audits. In this regard, the committee notes the findings of the UK parliamentary committee, namely that conflicts of interest cannot be managed but must in fact be removed. Hence the recommendations of that inquiry that the audit firms be required to divest themselves of their other businesses and be required to provide audit services only.

2.84 This is not, however, to suggest there are no problems with the market dominance of the big four per se. Indeed, following the criminal conviction of Arthur Anderson and Co for obstructing justice in the wake of the Enron fraud and the company's consequent loss of its licence, it could be argued that there are now too few accounting firms for any more to fail. In and of itself, this is a parlous state of affairs and perhaps explains the lack of scrutiny directed at the big four accounting firms in the wake of the GFC when major corporations, such as Lehman Brothers, were bought out and others salvaged with taxpayer funds despite their books having been audited by the big four accounting firms.

2.85 In terms of solutions, the committee reserves its judgment on the view expressed by ASIC that the big accounting firms are now sending strong messages from senior management about the importance of audit quality, and are also bringing in coaching, review processes and internal accountability measures.

2.86 However, it appears to the committee that the fundamental question at this juncture is whether the deep-rooted problems in the audit market can be resolved by more robust practices aimed at managing conflicts of interest, or whether action is required to remove those conflicts of interest.

2.87 In this regard, the committee notes that the competition watchdog in the UK, the Competition and Markets Authority, is currently consulting on some key proposals including forcing the big four accounting firms to legally separate their audit staff from the rest of their business, greater regulatory oversight of the company directors who select auditors, and requiring large listed companies to each use two audit firms. The committee also notes that the Competition and Markets Authority is still considering breaking up the big four accounting firms, or introducing caps on the number of large listed companies that they can audit.

2.88 Subject to the findings of the Royal Commission, the committee considers that the structure of the audit industry and associated conflicts of interest in Australia merit serious review, with particular reference to market dominance and conflicts of interest arising from the range of other activities also conducted by the major firms in the industry.