

29 October 2019

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

Dear Sir/Madam

### **Inquiry into the regulation of auditing in Australia**

Thank you for the opportunity to provide a submission to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into the regulation of auditing.

The Australian Institute of Company Directors (**AICD**) has more than 44,000 members drawn from directors and senior leaders from large, medium and small business, government and the not-for-profit sectors. The mission of the AICD is to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society. The AICD achieves its mission through provision of governance education, resources and tools for members, practice guides, advocacy and membership services.

Our submission focuses on the board's interaction with external audit,<sup>1</sup> rather than responding to each of the Inquiry's terms of reference. It discusses:

- the role and relationship of the board in relation to external audit and audit quality;
- feedback from members on audit, including governance practices that support quality;
- areas which we believe warrant further consideration.

#### **1. Executive summary**

Boards place a high priority on quality independent audit. In addition to the critical importance of external audit in enhancing the confidence of investors, members and other end-users in financial reports, independent auditors can provide directors with valuable and objective insights into aspects of an entity's financial reporting, controls and risk management.

The AICD places a strong emphasis in its education and member resources on directors' obligations for the financial performance, oversight and reporting of the entities they govern. This includes the role of the board audit committee and external audit, where relevant,<sup>2</sup> including governance practices that can promote and support audit quality.

Our engagement with members on the Inquiry's terms of reference suggests that, in general:

- Directors remain confident in the overall quality and regulation of audit in Australia;
- External audit receives substantial attention at board level, and is a significant focus of the work program of board audit committees in larger entities;
- Governance practices to support auditor independence are widely applied, including board-applied limits/approval for non-audit services and rotation of audit partners;

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<sup>1</sup> References to 'audit' in this submission refer to external audit, unless otherwise stated.

<sup>2</sup> The AICD has a diverse membership, including members from smaller entities and others not required to establish audit committees or to appoint external auditors of financial reports.

- More complex financial reporting requirements, accounting standards and the need for assurance on a wider array of corporate reports contribute to a demanding environment for management and boards as well as external audit firms and standard setters;
- While market concentration in large audit firms is recognised, it is not perceived to be negatively impacting the capacity of firms to source quality independent audit services.

In the AICD's view, the current regulatory framework for external audit is sound. Accordingly, we are not advocating for substantial new or changed regulatory requirements.

Recognising the vital role that external audit plays, however, the AICD supports the ongoing focus on audit quality by all stakeholders – auditors and audit firms, boards and management, standard-setters, ASIC and the Parliamentary Committee and Parliament, amongst others.

We are aware of international developments related to audit quality and acknowledge the Committee's continuing attention to this important issue. We note that the Committee has previously recommended measures that would improve the evidence base available to stakeholders and government on audit quality. We encourage further investment in this work to ensure that any proposed reforms are evidence-based and relevant to our market.

## **2. The relationship between directors and external audit**

### *Responsibilities of directors*

Australian directors have significant obligations and duties, including primary responsibility and accountability for the quality of financial reporting by the entities they govern.

In fulfilling this accountability, directors should have sufficient financial literacy to understand and assess financial statements, be able to challenge and test the accounting treatments and judgements applied by management and oversee the entity's financial reporting processes.

As ASIC emphasises, a company must have its own systems and processes to produce high-quality financial reports. Directors must not rely on the auditor when forming their own opinion of the financial report, as this would undermine the objective of independent assurance.<sup>3</sup>

The purpose of the external audit is to enhance the degree of confidence of the intended users in the financial report. While many parties support audit quality – clearly audit firms, but also standard-setters including the Australian Accounting Standards Board, ASIC and other bodies (e.g. Financial Reporting Council (**FRC**)) – boards of entities requiring (or electing to have) external audit play a key role in the appointment, oversight, engagement and relationship with auditors, including safeguarding independence.

Members of public companies appoint the auditor at Annual General Meetings but, as it is not usually practical for members or shareholders to be directly involved in the assessment of auditors, engagement with auditors is generally undertaken by directors.

Listed company directors have additional statutory obligations including disclosure requirements where auditors provide non-audit services (including, specifically, statements confirming that directors are satisfied that provision of non-audit services have not compromised independence requirements). Non-audit services are essentially defined as services other than services related to the conduct of an audit. This unhelpful definition

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<sup>3</sup> ASIC Information Sheet 196 *Audit quality - The role of directors and audit committees*.

creates issues around reporting and disclosure which we will address later in our submission. Directors are also required to publish the auditor's declaration of independence under s.307C of the Corporations Act in their directors' report.

Section 324DA of the Corporations Act also requires an audit partner to rotate every five years for listed companies which can be extended to seven years with director approval.

#### *Audit committees*

In larger companies, the usual practice is for a board to have an audit committee (or a combined risk and audit committee). The fourth edition<sup>4</sup> of the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations (ASX Principles)* recommends that a board of a listed entity should have an audit committee which, inter alia, reviews and makes recommendations on the following matters:

- the appointment or removal of the external auditor;
- the fees payable to the auditor for audit and non-audit work;
- the rotation of the audit engagement partner;
- the scope and adequacy of the external audit;
- the independence and performance of the external auditor; and
- any proposal for the external auditor to provide non-audit services and whether it might compromise the independence of the external auditor.

The ASX Principles require, on an if-not why not basis, that the audit committee has at least three members, all of whom are non-executive directors and a majority of whom are independent and is chaired by an independent director who is not the board chair.

Compliance with the audit committee requirements of the ASX Principles is mandatory for all ASX300 companies and any entity included in the S&P All Ordinaries Index (the largest 500 companies by market capitalisation) must also have an audit committee.<sup>5</sup> While the ASX Principles apply to all ASX companies they serve as a guide to other companies on good practice. APRA has a similar audit committee requirement in its prudential standards which is mandatory for APRA-regulated entities.<sup>6</sup>

Overall, we believe the ASX Principles guidelines support board oversight of external auditors and strike the right balance between prescription and principles-based guidance.

For the purposes of this submission, when discussing the role of directors in the audit process, we will refer to the audit committee, as one is most likely to be in place in the public companies in which the Parliamentary Committee will likely have interest. However, the points we make will apply equally to directors in entities where there is no audit committee, noting that in less complex entities the audit is likely to be less complicated and time consuming and the interaction is likely to be less frequent and more informal.

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<sup>4</sup> The fourth edition was released on 27 February 2019 and takes effect for a listed entity's first full financial year commencing on or after 1 January 2020. The third edition of the ASX Corporate Governance Principles contains broadly similar terms to that contained in the fourth edition. The AICD is a member of the ASX Corporate Governance Council.

<sup>5</sup> ASX Listing Rules, Chapter 12.7.

<sup>6</sup> *Prudential Standard CPS 510 Governance*.

#### *Board audit committee*

The audit committee has a key role in the entity's relationship with the external auditor and in promoting audit quality. The importance of this role is emphasised in the International Auditing and Assurance Standards Board publication *A Framework for Audit Quality* as well as in the relevant ASIC guidance.<sup>7</sup>

The AICD with the Auditing and Assurance Standards Board and The Institute of Internal Auditors-Australia produces a publication to assist audit committees: "*Audit Committees: a guide to good practice*".<sup>8</sup> The Guide provides an indication of some of the functions, set out below, that an audit committee should carry out with respect to the auditor which includes:

- appointment and renewal of the auditor;
- facilitating the audit process by ensuring management and staff are accountable, supportive and helpful;
- communicating with the auditor, including:<sup>9</sup>
  - requiring the auditor to attend the audit committee with or without management present; and
  - direct and frequent contact between the Chair of the audit committee and the auditor;
- maintaining and reviewing auditor independence and objectivity; and
- evaluation and assessment of the audit including quality, timeliness and the proper exercise of professional scepticism.

#### *Interests of Directors*

It is in the interest of directors for there to be a high quality, independent audit that provides end-users with some additional confidence in the veracity of financial statements. Directors must not rely on auditors in making their opinion on financial statements, but they will use their relationship with the auditor as an external set of eyes to support governance oversight. Good auditors act as thought leaders and a strong relationship with an auditor and judicious use of their professional scepticism assists directors in their supervision of management.

There can also be consequences, particularly in listed companies, for directors who are not seen to manage the relationship with the auditor properly. For example, the two largest proxy advisers ISS and CGI Glass Lewis will both recommend against the re-election of an audit committee chair where non-audit fees paid to the audit firm exceeds audit fees.<sup>10</sup>

### **3. Feedback from directors on audit regulation**

The AICD undertook consultation with its members on the Inquiry's terms of reference, including consultation with the AICD's Reporting Committee,<sup>11</sup> short member surveys and discussions at various member forums, and discussions with audit committee chairs (primarily of larger listed entities). Some common themes from discussions are noted below.

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<sup>7</sup> Supra note 3.

<sup>8</sup> We would of course be happy to provide a copy of the publication to the Parliamentary Committee if requested.

<sup>9</sup> ASIC RG260 *Communicating findings from audit files to directors, audit committees or senior managers* also provides useful guidance.

<sup>10</sup> For ISS see <https://www.issgovernance.com/file/policy/active/asiapacific/Australia-Voting-Guidelines.pdf>; for CGI Glass Lewis see [https://www.glasslewis.com/wp-content/uploads/2016/08/Guidelines\\_Australia.pdf](https://www.glasslewis.com/wp-content/uploads/2016/08/Guidelines_Australia.pdf) (noting they will review if fees exceed 50% and may not recommend against).

<sup>11</sup> For details of the AICD Reporting Committee please see <https://aicd.companydirectors.com.au/about/policy-committees>

*Audit regulation working well*

On the whole, AICD members were of the view that the audit system is working well. More than half of respondents in survey feedback agreed or strongly agreed that the current system of regulation was appropriate with approximately 30% disagreeing. Listed company directors reported a high degree of confidence in audit quality.

*Systems are in place to monitor auditor independence and audit quality*

There are a range of ways in which boards, and audit committees, work to safeguard auditor independence and promote audit quality. These include:

- caps on non-audit fees/engagements by auditors;
- pre-approval of non-audit engagements by audit committees;
- close oversight of the relationship between auditor and management (primarily the CFO) to promote fruitful cooperation without compromising independence. The general experience of directors is that audit firms themselves are alert to potential conflicts of interest and are adept at working with boards to manage them, noting that it is the audit firm's reputation that is most at risk if they do not do so adequately;
- providing sufficient time for audit committee and board engagement with auditors (including to discuss Key Audit Matters) without management present;
- oversight by audit committees of the resourcing, expertise and approach adopted by auditors including variations from audit engagement (more common in listed entities);
- periodic rotation of audit partners, including by entities not statutorily required to do so; and
- periodic tendering and audit firm rotation (in our limited survey response, over half of respondents reported that they had changed audit firms in the past ten years).

*Rotation of audit partners supported*

Directors are supportive of the exiting legislative requirement to rotate audit partners. They report that there can be benefits from bringing a fresh set of eyes to the audit (including possibly gaining better insight into specific issues). It was noted that these benefits can also come from a change in audit firm, although this also brings risk (from lack of detailed understanding of the firm's operations and reporting). Directors did not support mandatory audit firm rotation, noting the disruption, cost and risks would be elevated by an imposed time-period that would not be responsive to particular market or firm factors. Directors were opposed to any proposal to have a regulator or third party appoint auditors noting the practical difficulties<sup>12</sup> with such a proposal and the principle that shareholders and boards should be responsible for making this decision in the best interests of the company.

*Audit fee*

There were varying reports on whether the audit fee has increased or decreased over the last ten years with no clear trend emerging. There was no evidence reported that audit firms have been reducing audit fees in order to win non-audit consulting work.

#### **4. Areas for further consideration**

*General comments*

The AICD remains concerned that there is a lack of strong evidence to form a view on some of the claims about audit quality and poor conflicts of interest management. We note that the Parliamentary Committee has previously requested that ASIC and the FRC work together to produce a comprehensive report on audit quality. We also note that ASIC's inspection report

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<sup>12</sup> Some of those have been set out in the ASIC submission to this Parliamentary Inquiry.

is due at the end of this calendar year. The AICD would like the benefit of some of this evidence to help develop a more informed view on whether there is a need for reform.

With respect to TOR5 of the Committee, we note that the Competition and Markets Authority in the UK has proposed significant reform to the audit market and the UK government is currently consulting on those proposals with a report due by the end of this year. We also note that the Brydon review into the quality and effectiveness of audit is due to report by the end of this year. In our view, it would be prudent to await the findings of the UK consultation and the Brydon report to assist with any deliberations in Australia.

Further, if the UK government implements any of the wide-ranging reforms recommended by the Competition and Markets Authority then it would be sensible to monitor the effect of those reforms before recommending their implementation in Australia.

#### *Rotation of audit firms*

The AICD does not support mandating the rotation of audit firms given the evidence does not support such a regulatory intervention. The issue was recently examined in a report by Willekens, Dekeyser and Simac (2019) for the European Parliament researching the effect of EU rules on mandatory firm rotation.<sup>13</sup> Their review found that “most research studies do not find support for the argument that longer tenure periods are associated with impaired audit quality” and that “some studies report lower audit quality in the early years of tenure”.<sup>14</sup>

The leading study supporting that contention is a survey of US firms from Johnson, Khurana and Reynolds (2002), which found that short audit-firm tenures of two to three years are associated with lower-quality financial reports while there was no evidence of reduced financial-reporting quality for longer audit-firm tenures of nine or more years.<sup>15</sup>

#### *Additional assistance to audit committees on good practice*

While the *Audit Committees: a guide to good practice* publication provides useful guidance to audit committees on their proper function, the AICD believes there is scope for more detailed guidance on governance of external audit. For example, a range of different practices exists for tendering including the frequency of tendering as well as approaches to provision of non-audit services. We consider these matters are best contained in guidelines produced by bodies such as the AICD rather than regulation, given the board of directors should remain vested with the primary responsibility of determining what is appropriate for their organisation and the lack of evidence justifying one-size-fits-all regulation.

#### *Definitions of audit, non-audit and audit-related work and disclosure*

The current definitions of what is audit work, audit-related work and non-audit work are unclear. Limited assistance is provided by the statutory definition in the Corporations Act. These definitions are of critical importance to directors who are under a statutory obligation to disclose expenditure of those amounts, as already discussed. Notwithstanding this obligation, based on AICD’s discussions with directors and auditors, the classification of non-audit work can vary depending on the entity and the audit firm. There is no common definition, as we understand it, among the largest four audit firms.

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<sup>13</sup> Willekens, M., Dekeyser, S., and Simac, I., *EU Statutory Audit Reform: Impact on Costs, Concentration and Competition*, Study for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, 2019.

<sup>14</sup> *Ibid.* p. 28.

<sup>15</sup> Johnson, V. E., Khurana, I. K. and Reynolds, J. K. (2002) ‘Audit-Firm Tenure and the Quality of Financial Reports’, *Contemporary Accounting Research*, 19(4), pp. 637–660.

The AICD believes that this is an area where further regulatory guidance to assist companies and audit firms classify their work, including other types of assurance work, would be beneficial. This will assist in better reporting of how payments are made from companies to audit firms and for what kind of services.

*Good practice in governance*

As already stated, the AICD notes that evidence may emerge from the Parliamentary Committee and various reports published in the interim, that shed further light on audit practice and audit quality in Australia. The AICD will consider this evidence and determine whether there is a need to issue fresh guidance to company directors about their relationship with auditors and good practice or indeed whether regulatory reform is warranted.

**5. Next steps**

We hope our comments will be of assistance. If you would like to discuss any aspect of this submission further, please contact Christian Gergis, Head of Policy, at [cgergis@aicd.com.au](mailto:cgergis@aicd.com.au) or David McElrea, Policy Adviser at [dmcelrea@aicd.com.au](mailto:dmcelrea@aicd.com.au).

Yours sincerely



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