Chapter 3

Concerns with the quality of auditing, and other related matters

Introduction

3.1 Another key theme of the December 2012 public hearing concerned the role of auditors. In his opening statement to the committee, ASIC's Chairman, Mr Greg Medcraft, raised concerns with the quality of auditors' performance in Australia.[1] In part, the Chairman's comments were made in the context of auditors' role in the recent collapse of the Victorian debenture issuer Banksia Securities Limited. However, Mr Medcraft also identified broader concerns with the auditing industry based on ASIC's audit inspection report for the period 1 January 2011 to 30 June 2012. The report found that there has not been an improvement in audit quality since the last report, for the 18 months to 31 December 2010. Indeed, there had been an increase in instances where auditors did not perform all of the procedures necessary to obtain reasonable assurance that the audited financial report was not materially misstated.[2]

ASIC's concerns with auditing quality and 'professional scepticism'

3.2 At the public hearing on 3 December 2012, Mr Medcraft foreshadowed the findings of ASIC's audit inspection report, due for release the following day. He told the committee that while ASIC's previous inspection report found that 15 per cent of the survey sample was inadequate, that figure had increased in the 2011–12 report. The Chairman provided the following interpretation of this result:

> …last year I indicated that a level of 15 per cent was already far too high in terms of having problems where it really was inadequate evidence to support an audit opinion. I think clearly we expect as a country that that number should be substantially less than 10 per cent and, in terms of audit quality, significantly less. These results, I find, being a former auditor and chartered accountant, very disappointing and frustrating. I consider what we are seeing now as second strike for the audit sector and it is clearly one I

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1 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 12.

2 ASIC, *Audit inspection progress report for 2011–12*, December 2012, p. 4.

> think the profession should consider itself on notice: it needs to lift its game.[3]

3.3 The report presented the following data and observations:

> We found that, in 18% of the 602 key audit areas that we 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. While the financial reports audited may not have been materially misstated, in these instances, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement…
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> Some audit firms inspected need to improve their quality control systems…
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> Further, we believe there are a number of actions that audit firms should consider to improve and maintain audit quality…[4]

3.4 In the report, ASIC identified three broad areas requiring improvement by audit firms. These relate to:

- 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.[5]

3.5 Concerned with these findings, the committee asked Mr Medcraft to explain what he believed was reason why many in the auditing profession were failing to deliver on the quality of work expected. He responded:

> We have talked to the firms about it and, clearly, it is a lack of scepticism. I think the institute would acknowledge that scepticism is a big issue in the audit firms and being critical. You are there as an auditor and you are meant to be sceptical about seeing what is presented to you.
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> It is a global problem. I think it probably comes down to a cultural problem in the profession. I can tell you that at IOSCO, at the global level, it is also troubling. I do think it has to go to, clearly, the training and the types of people that are coming into the profession. It is the belief that that is part of the issue. From my point of view, if we have a further deterioration next year, it builds a case for change. One in five is a very significant level. This

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3 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 12. See also ASIC's audit inspection findings for 2011–12, *Media release 12/301*, 4 December 2012, http://www.asic.gov.au/asic/asic.nsf/byheadline/12-301MR+ASICs+audit+inspection+findings+for+2011-12?openDocument (accessed 24 January 2013).

4 ASIC, *Audit inspection progress report for 2011–12*, December 2012, p. 4.

5 ASIC, *Audit inspection progress report for 2011–12*, December 2012, p. 4.

> is not a statistical outlier. This is one in five. This is about audit quality. I think the profession has to throw everything it can at it in the next 12 months to get that number to start trending down, otherwise we really are going to need to think about what else can be done.
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> There has been talk about rotation of audit firms, that bringing in a fresh set of eyes may be a solution. It is back to the profession itself to lift its game, frankly. It is a serious problem, and they recognise that.[6]

3.6 ASIC Commissioner Mr John Price also noted that the decline in auditing quality is evident in various international jurisdictions as well as in Australia. He suggested that in terms of arresting this decline, broader use of the larger firms' training programs would probably be useful. Mr Price also drew the committee's attention to the current economic cycle where 'companies are under cost pressures, and that is being passed on to auditors'. However, he added:

> I think companies need to realise and accept that they do need to pay a bit more for a quality audit and that a quality audit is important for market integrity issues more broadly.[7]

The Banksia collapse

3.7 In May 2012, ASIC raised concerns in relation to certain disclosures made in the financial statements and prospectus of the rural Victorian finance company Banksia Securities Limited. As a result, in June 2012, Banksia released a supplementary prospectus.[8]

3.8 However, in October 2012, Banksia was placed into receivership. The active accounts of thousands of retail investors in debentures were frozen. The same month, ASIC established an internal taskforce to examine the failure of Banksia and the regulation of the wider Australian and listed debenture sector. The taskforce, headed by Mr Price, has made some early recommendations to Treasury.[9]

3.9 The committee understands that Banksia's receiver, McGrathNicol, is (at the time of writing) investigating potential breaches of the law by the auditors. Mr Anthony McGrath was reported as saying:

> There were a set of accounts that were signed off in September that said the company was in a surplus position to the tune of $24 million," Mr McGrath

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

7 Mr John Price, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 20.

8 McGrathNicol, *Banksia Securities Limited, Receivers and Managers' report to debenture holders*, 7 December 2012, p. 20.

9 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 12.

> said. "Today, we are telling debenture holders that they are in deficit of around $200-$300 million - that's quite a significant change.[10]

3.10 At the public hearing, Mr Medcraft's opening statement commented on the Banksia collapse in the context of the role of auditors. The Chairman 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. He noted that ASIC had identified Banksia as a 'high risk' and had done 'a surveillance some months ago' to bring the matter to the attention of the trustee. However, he added that:

> It was not really our job to go in and detect these things—you have gatekeepers called trustees and auditors—but we are trained to be proactive to the extent of the funding we have available to us, both in terms of going and looking and trying to be proactive publicly where we see problems.[11]

3.11 Mr Medcraft again emphasised that the system—through its use of gatekeepers—is meant to be 'self-executing'.[12] It relies on disclosure and the important role of gatekeepers. ASIC's role is one of surveillance. In the context of debentures, the Chairman told the committee that ASIC had been expressing its concerns publicly 'for some time' that these investments are 'high risk'.[13] He argued that there is a need to 'lift the regulatory intensity' to ensure that consumers can be confident and informed when they are investing in these 'shadow banks'.[14]

The committee's previous concerns with auditors

3.12 In its May 2012 report into the collapse of Trio Capital, the committee pointedly criticised the role of the Trio's auditors, WHK and KPMG. The report stated:

> It is of concern to the committee that auditors' approval of financial statements does not necessarily mean that the actual assets underlying the financial statements exist. Further, an auditor's assessment of a compliance plan and the work of the compliance committee as 'effective' essentially only means that they exist. Clearly in the case of Trio, the requirement for

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10 Georgia Wilkins, 'Negligence and conflict claims in Banksia collapse', *Sydney Morning Herald*, 15 December 2012.

11 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 21.

12 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 21.

13 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 22.

14 Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission, *Committee Hansard*, 3 December 2012, p. 12.

> the auditors to demonstrate 'professional scepticism' about the information given to them was insufficient to prevent the loss of investors' funds.[15]

3.13 In its submission to the inquiry, ASIC was also highly critical of the auditors' role and outlined areas for future regulatory consideration. These are:

- the obligation of auditors to report on the adequacy of compliance plans;
- whether a particular compliance plan measure achieves its objectives;
- reliance on other auditors;
- audit independence and competence declarations;
- how the auditor satisfies themselves that the responsible entity has complied with its obligations in all material respects as required under ASAE 3100;[16] and
- audit approach and testing methodology.[17]

3.14 The committee's report endorsed ASIC's suggestion of an approval process for compliance plan auditors so that the regulator has the powers to remove or impose conditions on such approval. It also supported ASIC's proposal to review the effectiveness of compliance plans and, if necessary, require more detail to be provided in these plans.[18]

Auditors of SMSFs

3.15 ASIC has recently been given responsibility for the registration of auditors of self-managed superannuation funds (SMSFs).[19] ASIC Commissioner Mr Greg Tanzer told the committee:

> Auditors will be subject to an obligation to register from July 2013 and to meet the competency requirements ASIC will set, on which we are currently consulting. The registration that you are speaking of, from 31 January 2012, is a voluntary preregistration. Auditors are able to register with ASIC from 31 January in anticipation of the date by which they are

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

16 See Auditing and Assurance Standards Board, *Standard on Assurance Engagements ASAE 3100 Compliance engagements* http://www.auasb.gov.au/admin/file/content102/c3/asae_3100_9-09-08.pdf (accessed 31 January 2013).

17 ASIC, *Submission 51 to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into the collapse of Trio Capital*, p. 42.

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

19 *Superannuation Laws Amendment (Capital Gains Tax Relief and Other Efficiency Measures) Act 2012*

> required to be registered, which is 1 July. We are currently developing the competency requirements…We expect to issue an information sheet in the next little while which will set out the process for registering from 31 January and to be accepting those registrations from that date.
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> …The competencies are currently out and being consulted on. In fact, we started consulting with the audit bodies a couple of months ago. The standards are very much based on the competency standards that the joint accounting bodies put out back in 2008. The consultation period finished on 30 November, just last week. We expect to finalise those in the next week or so.[20]

3.16 On 10 December 2012, ASIC released guidance to assist auditors of SMSFs to register. In January 2013, it released a guide explaining how to apply for registration as an approved SMSF auditor, the types of registers of SMSF auditors maintained by ASIC and the transitional arrangements for the registration of existing approved auditors of SMSFs.[21]

3.17 Also in December, ASIC released proposed competency standards for approved SMSF auditors. ASIC explained that these standards are based on pre-existing standards issued by The Institute of Chartered Accountants in Australia, CPA Australia and the Institute of Public Accountants. The standards also apply to members of the Superannuation Professionals' Association of Australia to ensure continuity in requirements for most SMSF auditors.[22]

3.18 The committee also notes that the voluntary preregistration process for SMSF auditors was established on 31 January 2013. An ASIC officer was quoted in a media release as saying:

> This is a key step in the Stronger Super Reform process. The register and associated competency standards will improve the quality of SMSF audits.

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20 Mr Greg Tanzer, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, p. 18.

21 Australian Securities and Investments Commission, 'Registration of registered superannuation fund auditors', *Regulatory Guide 243*, January 2013, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg243-published-24-January-2013.pdf/$file/rg243-published-24-January-2013.pdf (accessed 31 January 2013).

22 Australian Securities and Investments Commission, 'ASIC releases SMSF auditor registration guidance and competency standards', *Media release*, 10 December 2012, http://www.asic.gov.au/asic/asic.nsf/byheadline/12-308MR+ASIC+releases+SMSF+auditor+registration+guidance+and+competency+standards?openDocument (accessed 31 January 2013).

> The ability to identify registered SMSF auditors is critical in underpinning confidence for SMSF trustees.[23]

Committee view

3.19 The committee shares ASIC's concern at the apparent decline in auditing standards in Australia. Auditors play a crucial role as gatekeepers of the Australian financial system. When they fail to exercise the requisite professional scepticism in their work, investors and superannuants can suffer significant consequences. The Trio Capital experience is but one example. The failure of auditors to raise the necessary flags to avert corporate collapses results in lower investor confidence.

3.20 The committee commends ASIC for its work to date to identify some of the dimensions of the low quality of auditing work in Australia, and to highlight publicly the need for improvement. It is incumbent on professional associations, standard setting bodies such as the Financial Reporting Council (FRC) and the Auditing and Assurance Standards Board (AUASB), and the large auditing firms to reaffirm a commitment to the highest professional standards and to take action to remedy areas of weakness. The committee strongly supports efforts to this end.

3.21 The committee will continue to closely monitor developments in this area. As the committee has previously noted, it is concerned that there is a divergence between auditors' statutory requirements and the actual performance of their duties. It also continues to be concerned that auditing standards are falling below the public's expectations of the profession.

3.22 The committee intends to call the AUASB and the FRC to attend the first oversight hearing of 2013. At that hearing, it intends to discuss with these bodies ASIC's concerns with the application of professional standards. The committee will seek the FRC's advice about the work of the FRC Audit Quality Taskforce and the AUASB's views on Australia's adherence to the standards established by the International Auditing and Assurance Standards Board.

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23 Australian Securities and Investments Commission, 'SMSF auditor register is here', *Media release*, 31 January 2013, http://www.asic.gov.au/asic/asic.nsf/byHeadline/13-013MR%20%20SMSF%20auditor%20register%20is%20here?opendocument (accessed 31 January 2013).