



Parliamentary Joint Committee on Corporations and Financial Services

Regulation of Auditing in Australia: Final Report

November 2020

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ISBN 978-1-76093-142-1

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Chapter 1

Concluding comments

- 1.1 Since the committee tabled its interim report in February 2020, the world has changed in ways few could have anticipated. The seismic changes to Australia's economy precipitated by the COVID-19 pandemic, and various governmental responses to it, have had widespread impacts, including on corporate activity and auditing.
- 1.2 In this radically changed environment, independent and accurate external auditing is more critical than ever in helping determine efficient and effective capital allocation.
- 1.3 Importantly, the committee stands by the recommendations in its interim report of February 2020. However, before making some concluding comments on those recommendations, including some important caveats, the committee briefly addresses other matters relevant to the inquiry.
- 1.4 Firstly, the inquiry itself increased reporting transparency in the audit industry that had not previously been forthcoming. For example, prior to the inquiry, Australian Securities and Investment Commission's (ASIC) audit inspection reports had not been publicly available. During the course of the inquiry, EY, KPMG, PwC, Deloitte, Grant Thornton and BDO all published their ASIC audit inspection reports. Further, additional transparency oversight committees and reporting structures have been voluntarily instituted by some of the sector's leading companies.
- 1.5 Secondly, further clarity on organisational structures, remuneration and poor outcomes was placed on the public record. Given perceptions, trust and reality are intimately enmeshed in financial systems, answers to questions on notice provided during the inquiry elicited important information on matters pertinent to perceptions of the auditing profession, including:
 - auditor evaluation and remuneration, including financial penalties for audit partners who perform poorly in ASIC's audit inspection program;
 - information about corporate clients that have collapsed under the watch of the audit firms; and
 - the remuneration and tax arrangements of retired audit partners.
- 1.6 Thirdly, certain information was not forthcoming by the time the committee presented its interim report, including details on the concurrent provision of audit and non-audit services. This information has since been provided to the committee.
- 1.7 In terms of the recommendations themselves, and with the improved transparency resulting from the publication of the ASIC audit inspection

reports in mind, the committee recommended ASIC continually review its audit inspection methodology with the aim of producing reports of greater sophistication and clarity that take into account the contested nature of some of the professional judgments made by both auditors and ASIC inspectors. The committee will monitor ASIC's progress on this matter and, in turn, consequent progress towards publishing all future individual audit firm inspection reports on the ASIC website (recommendations 1 and 2).

- 1.8 With regard to auditor independence, both real and perceived, the committee reiterates its view that auditor independence is a key determinant of a robust audit regulatory framework and crucial in the process of building trust, confidence and stability in capital markets.
- 1.9 To this end, the committee made several recommendations (3, 4 and 5) directed at ensuring auditor independence:
- Establish defined categories and associated fee disclosure requirements in relation to audit and non-audit services.
 - Establish a list of non-audit services that audit firms are explicitly prohibited from providing to an audited entity.
 - The auditor's independence declaration be expanded to require the auditor to specifically confirm that no prohibited non-audit services have been provided.
 - Consider revising the APES 110 Code of Ethics to include a safeguard that no audit partner can be incentivised, through remuneration advancement or any other means or practice, for selling non-audit services to an audited entity.
- 1.10 Recommendation 3 was directed principally at the Financial Reporting Council (FRC), recommendation 4 proposed an amendment to the *Corporations Act 2001*, and recommendation 5 was directed to the Accounting Professional and Ethical Standards Board (APESB).¹ The committee expects that progress is being made to implement these recommendations and, where appropriate, will monitor developments at future ASIC oversight hearings.
- 1.11 Regarding auditor tenure, the committee remains of the view that:
- Introducing a requirement for disclosure of auditor tenure by corporate entities is a relatively simple and low-cost regulatory change that will have considerable benefits for stakeholder perceptions of Australia's audit market (recommendation 6).

¹ The committee notes the APESB recently published two revised documents: *Independence Guide – Fifth Edition*, May 2020, rewritten to reflect changes to the restructured *APES 110 Code of Ethics for Professional Accountants* which became effective on 1 January 2020; and *APES 110 Code prohibitions applicable to Auditors for all Audit and Review Engagements*, a high-level summary of the updated Code prohibitions, expanded to include all audit and review engagements, not just engagements with public interest entity audit clients.

- A mandatory tendering regime, under which corporate entities may elect not to undertake a public tender process as long as the reasons for not doing so are disclosed to shareholders (recommendation 7), strikes the right balance between providing stakeholders with improved visibility of auditor-client relationships, without imposing significant regulatory burden or enforcing losses in client knowledge. In its interim report, the committee recommended a period of 10 years. The exact period of time is less important than the faithful implementation of this recommendation. The committee recognises there is an inherent trade-off between familiarity auditors develop with an entity over time, which may increase their competence and also threaten their independence at the same time. But audit arrangements that remain in place for many decades clearly undermine stakeholder confidence in the system as a whole.
- To be clear, this recommendation is not a statement from the committee that entities must change auditors every ten years. There may be very good reasons why an entity would wish to continue with the same auditor for more than ten years. It is instead a recognition that boards should not 'set and forget' arrangements with their auditor nor should shareholders be left with the impression that they have done so.
- The committee also recognises that its recommendation that this new regime begin in 2022 is not realistic in light of the time elapsed since the interim report and the changed economic circumstances. The committee recommends the government consider an appropriate timeline for implementation, taking into consideration the economic climate.
- The committee considers that a staggered implementation of the recommendation for a tendering regime would allow boards sufficient time to establish a strategic response to the recommendation and address concerns raised by the sector regarding current pressures and unintended consequences of a rapid implementation schedule.

1.12 Contention persists around the expectation gap between what users of financial reports expect an auditor to provide and what auditors are required to provide under statutory obligations with respect to the auditor's role in:

- preventing and detecting fraud and misconduct;² and
- assessing a company's economic viability as a going concern.

The committee will monitor the FRC's progress on a formal review into these matters (recommendation 8).

1.13 In terms of recommendation 9, the committee acknowledges that the markedly different economic conditions since February 2020 mean the Government will

² For example, the committee notes that German payments company, Wirecard, filed for insolvency in June 2020 amid allegations that its auditor, EY, failed to detect significant accounting fraud over a period of years.

need to consider both appropriate timelines and thresholds (for example, in terms of entity size and type) with respect to the requirement to establish and maintain an internal controls framework for financial reporting, as well as any related requirements placed on management and the external auditor. To be clear, while the committee does not resile from the importance of this recommendation, it recognises that now may not be the time to impose additional transitional costs on businesses that are, and should be, primarily focussed on surviving the current arduous economic conditions.

- 1.14 As noted in the inquiry, the roll out of digital financial reporting, which has been standard practice in the United States since 2009 and soon to be adopted in the European Union, has far-reaching potential. Digital financial reporting has the capacity to assist not just auditing, but the efficient and transparent functioning of financial markets more broadly. Machine-readable financial statements can be easily and accurately analysed not just by audit firms but other interested third parties including regulators and academics. This would, in some cases, replace the practice of manual data extraction which is expensive, slow, and prone to error.
- 1.15 In light of this, the committee considers it appropriate for the Government to undertake a review to identify and resolve any remaining barriers to the use of digital financial reports, with a view to making digital financial reporting standard practice in Australia in the near future (recommendation 10).

Chapter 2

Insolvency

- 2.1 Insolvency has become an area of heightened risk since the interim report. Responses to the COVID-19 pandemic at the domestic level by the Australian and state governments, and internationally by foreign governments, have had substantial economic and financial repercussions. For example, government-mandated shutdowns of certain parts of the domestic and global economy, imposed as a result of the pandemic, immediately affected otherwise solvent businesses.
- 2.2 In March 2020, the Australian Government introduced the Coronavirus Economic Response Package Omnibus Bill 2020.¹ Among other measures, the bill provided temporary insolvency and bankruptcy protections for financially distressed businesses, with further reforms announced in September 2020, to take effect from 1 January 2021.
- 2.3 Around the same time as the Government made temporary changes to the insolvency regime, the Australian Accounting Standards Board (AASB) and the Auditing and Assurance Standards Board (AUASB) issued joint guidance warning that the impact of COVID-19 is creating:
- significant uncertainty for supply chains and the global economy; and
 - in turn, risks that entities may not have encountered before.²
- 2.4 The joint guidance cautioned that:
- Auditors should be alert and exercise professional scepticism about the potential for these conditions to give rise to possible financial reporting misstatements.³
- 2.5 Specifically, the joint guidance set out particular matters that auditors should consider, including:
- management's assessment of the material impact of COVID-19 on the financial report;
 - whether sufficient disclosures of key assumptions have been provided;
 - whether the relevant disclosures and adjustments are materially correct; and
 - management's assessment of going concern in the financial report.⁴

¹ The *Coronavirus Economic Response Package Omnibus Act 2020* commenced on 25 March 2020.

² AASB–AUASB, 'The Impact of Coronavirus on Financial Reporting and the Auditor's Considerations', *Joint FAQ*, March 2020, p. 3.

³ AASB–AUASB, 'The Impact of Coronavirus on Financial Reporting and the Auditor's Considerations', *Joint FAQ*, March 2020, p. 3.

- 2.6 The committee acknowledges that an effective insolvency system helps the movement of capital and jobs from less to more productive businesses, and allows businesses to be wound up efficiently while ensuring creditors and employees are paid fairly. However, the thrust of the committee's interim report was directed at the auditing of large complex entities.
- 2.7 To the extent that supply chain uncertainty and associated risks resulting from COVID-19 may have a material and financial impact on large entities, the committee welcomes the AASB and AUASB auditor guidance to apply sceptical rigor to management's assessment of going concern, including appropriate consideration of banking covenants and future cash flows.
- 2.8 Given the inherent complexity and challenges applying to the impairment of assets, the committee's interim report encouraged the AASB to continue to press the International Accounting Standards Board to undertake a fundamental review of the standard applying to the impairment of assets. While the committee recognises the risks in implementing potentially substantive changes to standards during a crisis, the committee considers that a review of the standards applying to asset impairment is prudent and that the relevant bodies advising government about any potential changes will be mindful of appropriate implementation timeframes. The committee will monitor developments in this area.
- 2.9 The committee will continue to take an interest in developments in the auditing industry through its regular ASIC oversight hearings.

Senator James Paterson
Chair

⁴ AASB–AUASB, 'The Impact of Coronavirus on Financial Reporting and the Auditor's Considerations,' *Joint FAQ*, March 2020.

Additional comments by Labor

- 1.1 Labor Members remain concerned about ongoing reports of workplace cultural practices that dissuade internal or external whistleblowing. In the workplace settings of both the major firms and major companies to whom they supply assurance services, confidential disclosure of unethical and coercive behaviour and sexual harassment continue to be reported to Senators (and Members of Parliament). The need for cultural reform to address these instances will remain a focus of members of this committee in their oversight of ASIC. Safe workplaces are vital to ensure the independent professionalism of each member of an audit team so vital to the quality of audit on which Australians rely.

Mr Steve Georganas MP
Deputy Chair

Senator Deborah O'Neill
Committee member

Mr Patrick Gorman MP
Committee member

Senator Louise Pratt
Committee member

Dissenting report by the Australian Greens

- 1.1 You'd be forgiven for expecting a parliamentary inquiry into the regulation of auditing to come and go with little fuss. But this wasn't really an inquiry into auditing. This was an inquiry into four firms: KPMG, Deloitte, PricewaterhouseCoopers (PwC) and EY (formerly Ernst & Young). These four firms—the Big-4—rule the roost the world over. Their dominance is absolute and peerless. They are entrusted by the biggest corporations and wealthiest individuals to provide audit and advice. They are both master and servant. They are all seeing and all knowing. They are the gatekeepers of global capitalism. It is no stretch to suggest that, as a block, the Big-4 are the most powerful oligopoly in modern times.
- 1.2 The Big-4's dominance in Australia is just as great as anywhere. Their audit work accounts for 95 per cent of market capitalisation. They earn over 99 per cent of the audit fees paid by the companies that make up the ASX200. They are the recipients of hundreds of millions of dollars of government contracts each year. And, in return, they are now amongst the biggest political donors to both the major parties.
- 1.3 So how did these accountants become so powerful? By being more than accountants. In Australia, as in most of the rest of the world, the Big-4 are no longer simply bean counters. Auditing makes up only about a quarter of their revenue. The real money is in consulting. Consulting to large corporations, including as the masterminds of multinational tax minimisation schemes. And consulting to governments who are only too keen to be told what they want to hear.
- 1.4 In this way, the Big-4 have been the handmaidens of neoliberalism. With one hand helping companies minimise their contribution for the public good, while with the other hand enjoying the fruits of the privatisation and outsourcing of public services.
- 1.5 Yet, despite all their dominance—or because of it—they're not actually very good at their core job. Around one-in-four audits fail to meet the standard required,¹ namely to obtain 'reasonable assurance about whether the financial report as a whole is free from material misstatement'.² Each and every failure is, prima facie, a breach of the law. Yet, the Big-4 continue to provide audit services and continue to enjoy the guaranteed revenue stream that is compulsory auditing by public companies.

¹ Australian Securities and Investments Commission, *Audit quality measures, indicators and other information: 2018–19*, Report 649, December 2019, p. 5.

² Auditing Standard ASA 700, *Forming an Opinion and Reporting on a Financial Report*, December 2018, p. 10.

1.6 And this gets to the central question for this inquiry: what impact is the Big-4's consulting work having on the quality of their audit work?

1.7 Professor Allan Fels gave the committee a concise explanation of the problem:

Auditing is critical to the operation of a market system. Shareholders, investors, consumers, suppliers, the government and the community depend upon its integrity. If audits fail or are compromised, billions of dollars can be lost and trust in the economic system can be weakened. It is especially important in this situation that auditors should not have, nor appear to have, conflicts of interest, whether actual or potential. Yet they do when they undertake consulting alongside auditing. This should not be tolerated.³

1.8 And:

It's a simple conflict of interest. Someone is tasked with providing an independent, error-free audit of a big business; it's a very important role. If that auditor is also performing services for the person they're auditing, there may be a conflict of interest—they may be compromised—because they want to continue providing those profitable services, and that could be threatened with unfavourable audits.⁴

1.9 Professor Fels suggested remedy was equally concise:

Major audit firms like the big four—Deloitte, EY, KPMG and PwC—should, in my opinion, be prohibited from doing consulting whether for firms they audit or not.⁵

1.10 The Australian Greens agree with Professor Fels. Structural separation is the surest solution to the inherent conflict of interests that arise when a small cabal that has a monopoly over auditing gets three times the revenue for providing non-audit work, not just for the same companies, but for the same industries in the same corporate regimes all around the world. These conflicts are institutional, and they are global.

1.11 Recommendations 3, 4 and 5 of the Interim Report regarding auditor independence—which have not been expanded upon in the Committee's Final Report—fail to address the magnitude of the problem. They fall into the same trap as that taken in response to other examples of vertical integration in financial services, that of seeking to regulate and manage the conflicts.

1.12 This is fanciful. Regulators simply don't have the resources to identify, let alone prevent, the myriad of ways that globally dominant vertically integrated firms benefit from providing a comprehensive package of services to large, multinational corporations.

³ Professor Alan Fels AO, Private Capacity, *Committee Hansard*, p. 1.

⁴ Professor Alan Fels AO, Private Capacity, *Committee Hansard*, p. 2.

⁵ Professor Alan Fels AO, Private Capacity, *Committee Hansard*, p. 1.

- 1.13 What's more, as noted in the Committee's Final Report, it's only because the spotlight has been shone on this issue that small progress towards greater transparency has been made. But once the spotlight moves on, as it did the moment the coronavirus pandemic arrived, there is no chance that public attention can be relied upon to ensure audit standards are upheld.
- 1.14 The Big-4 must simply be broken up. Failing that, they should, at the very least, be prevented from doing any non-audit work for clients that they audit.

Recommendation 1

- 1.15 That any firm that provides audit services for a significant proportion (for example, more than 5 per cent) of companies capitalised or operating in Australia be prevented from providing non-audit services.**
- 1.16 Another major concern with the Interim Report is the inadequate recommendations regarding reform of the standards setting and regulatory regime for audit work.
- 1.17 There are five government bodies with responsibility for standard setting and regulation:
- Australian Securities and Investment Commission (ASIC) with broad regulatory oversight;
 - Companies Auditory Disciplinary Board, a disciplinary body that reports to ASIC;
 - Financial Reporting Council (FRC), an advisory body;
 - Australian Accounting Standards Board, a standards setting body; and
 - Auditing and Assurance Standard Board, a standards setting body.
- 1.18 This system creates a tangle of responsibilities. The committee heard contradictory and insufficient explanations as to who does what and who is responsible to who. The level of complication and the ensuing confusion only serves to benefit those with the resources to understand and monitor all of the complexities, namely the Big-4. And current enforcement practices could best be described as timid.
- 1.19 Of further concern with the recommendations in the Interim Report regarding reform to regulation and standard setting is the level of reliance on the FRC to lead this reform given the failure of the FRC to deal with its own conflicts of interest. The Chair of the FRC, Mr Bill Edge, is a former partner with PwC. It was confirmed through the inquiry that Mr Edge continues to receive annual payments as part of PwC's retirement payment plan. Literally, he is being paid by one of companies he advises the government on how to regulate. What's more, he doesn't consider this to be a conflict interest. This level of blindness is astounding, and it speaks volumes to the extent to which the Big-4 are in control.

Recommendation 2

1.20 That the regulatory regime for auditing be simplified, with a single body being responsible for accounting, auditing and assurance standards; and another body being responsible for enforcement, currently ASIC.

Senator Nick McKim

Committee Member

Appendix 1

Submissions, answers to questions on notice, correspondence

Submissions

- 30.1** Grant Thornton Australia Limited, Supplementary to submission 30
- 32.1** Australian Accounting Standards Board, Supplementary to submission 32
- 112** Joint submission from Jeremy Kriewaldt Lawyers and Goodman & Co.

Answer to Question on Notice

- 105** BDO Australia - Answers to questions on notice 2 to 6 – public hearing 7 February 2020 (received 14 February 2020)
- 106** Westpac - 2017 CPS 220 - Public hearing 7 February 2020 (received 26 February 2020)
- 107** Westpac - Senator O’Neill - EY Engagement partner for CPS220 - Written questions 13 February 2020 (received 27 February 2020)
- 108** Westpac - Senator O’Neill - Review and feedback of Westpac stakeholders - Written questions 13 February 2020 (received 27 February 2020)
- 109** Westpac - Senator O’Neill - Westpac’s use of LitePay and child exploitation - Written questions 13 February 2020 (received 27 February 2020)
- 110** Westpac - Senator O’Neill - Previous audit of AML-CTF processes - Written questions 13 February 2020 (received 27 February 2020)
- 111** Westpac - Senator O’Neill - Communications with AUSTRAC regarding child exploitation - Written questions 13 February 2020 (received 27 February 2020)
- 112** Westpac - Senator O’Neill - Westpac capital raising - Written questions 13 February 2020 (received 27 February 2020)
- 113** Westpac - Senator O’Neill - Failure of the Transaction Monitoring System - Written questions 13 February 2020 (received 27 February 2020)
- 114** Westpac - Senator O’Neill - Cross-jurisdictional issues and AML scandal - Written questions 13 February 2020 (received 27 February 2020)
- 115** Westpac - Senator O’Neill - The Share Purchase Plan - Written questions 13 February 2020 (received 27 February 2020)
- 116** Westpac - Senator O’Neill - Remediation in relation to AML scandal - Written questions 13 February 2020 (received 27 February 2020)
- 117** Westpac - Senator O’Neill - Key risk role officers - Written questions 13 February 2020 (received 27 February 2020)
- 118** Westpac - Senator O’Neill - 2020 CPS220 provider - Written questions 13 February 2020 (received 27 February 2020)
- 119** Westpac - Senator O’Neill - Work by Promontory Group, EY, PwC, Deloitte, KPMG - Written questions 13 February 2020 (received 27 February 2020)

- 120 Australia Prudential Regulation Authority - Senator O'Neill - Requirement for GCRA declarations in CPS220 reviews - Written questions 13 February 2020 (received 28 February 2020)
- 121 Australia Prudential Regulation Authority - Senator O'Neill - Will GCRA declarations be in CPS220 reviews - Written questions 13 February 2020 (received 28 February 2020)
- 122 Australia Prudential Regulation Authority - Senator O'Neill - Westpac GCRA breaches - Written questions 13 February 2020 (received 28 February 2020)
- 123 Australia Prudential Regulation Authority - Senator O'Neill - Primary recipient of CPS220 - Written questions 13 February 2020 (received 28 February 2020)
- 124 Australia Prudential Regulation Authority - Senator O'Neill - Communications with Westpac regarding AML risks in CPS220 - Written questions 13 February 2020 (received 28 February 2020)
- 125 Australia Prudential Regulation Authority - Senator O'Neill - Requirement for banks to lodge CPS220 with APRA - Written questions 13 February 2020 (received 28 February 2020)
- 126 Australia Prudential Regulation Authority - Senator O'Neill - When APRA was informed about Westpac AML breaches - Written questions 13 February 2020 (received 28 February 2020)
- 127 Australia Prudential Regulation Authority - Senator O'Neill - APRA actions following Westpac 2017 CPS220 - Written questions 13 February 2020 (received 28 February 2020)
- 128 Deloitte - Senator O'Neill - Retirement plan - Written questions 3, 4, 7 14 May 2020 (received 18 June 2020)
- 129 PwC - Senator O'Neill - Retirement plan - Written questions Q22-01-Q22-07 14 May 2020 (received 18 June 2020)
- 130 EY - Senator O'Neill - Retirement plan - Written questions Q22-01-Q22-07 14 May 2020 (received 18 June 2020)
- 131 KPMG - Senator O'Neill - Retirement plan - Written questions 1-7 14 May 2020 (received 18 June 2020)
- 132 EY - Senator O'Neill - Cuts to staff pay and hours - Written questions Q26-01-Q26-07 21 May 2020 (received 25 June 2020)

Correction to evidence

- 3 Grant Thornton Australia Limited regarding evidence given at a public hearing in Canberra on 7 February 2020 (received 24 March 2020)