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

Dear Sir / Madam

Regulation of auditing in Australia

I welcome this opportunity to make a submission to the Committee on the Regulation of auditing in Australia. In preparing this submission I have been mindful of the need to keep matters concise and have aggregated comments relevant to multiple terms of reference where possible. I have also tried to emphasize empirical evidence rather than anecdotes.

1. Auditing and consulting services: Conflicts of interest and competition (TOR1-3).
Any review of the firms providing auditing and consulting services must necessarily consider the nature of audit firms and the clients they service. Historically the largest providers of audit and consulting services were the Big 8. This has consolidated to the Big 4 – Deloitte, EY, PwC and KPMG. This consolidation was driven by the increasing size and complexity of the large, often multinational clients of these firms. Simply put, a smaller audit firm would not have the resources, staff or infrastructure to audit a large corporation and this has driven the industry consolidation. This is equally applicable to the provision of non-audit services to clients. This was not an issue 50 years ago when firms were generally smaller, less complicated and limited in the scope of their operations and this would be confirmed by looking at the general purpose financial report for a then large corporation such as Pioneer Concrete Services Ltd. However, with this consolidation come concerns and these have been considered extensively in the academic literature. The papers I reference below are examples only, and are largely focused on the Australian audit industry.

Has increasing concentration in the audit market reduced competition? There are numerous studies considering whether there are audit fee premiums for the large audit firms which might be considered evidence of limited competition, or declines in competition. For example, Craswell, Francis, and Taylor (1995) considered whether there were audit fee premiums for large audit firms. In this paper it was maintained that an audit fee premium would be a reflection of audit quality, although it is equally possible that this would arise if the market for audits of large firms was less competitive than the audit market generally.

While they find evidence of audit fee premiums for large audit firms, in Ferguson, Francis, and Stokes (2003) they find that this is more a reflection of office factors and industry specialisation. Critically, this more recent result is inconsistent with the market for large firm audit services being less competitive than the audit market generally. This literature is voluminous and Craswell et al. (1995) has been cited over 1,700 times with the results increasingly finding specialisation and audit quality explanations for audit fee differences rather than competition explanations. However, an underlying concern with these papers is that they assume all audit firms have similar costs and cost structures. This is doubtful and this is now starting to attract scrutiny. Focusing more narrowly on the collapse of Arthur Anderson in Australia where these problems are less acute and which ostensibly reduced competition, Hamilton, Li, and Stokes (2008) find no evidence of diminished competition and higher audit fees. There is the possibility that the effects of industry concentration spill over into the provision of non-audit services, but Kinney JR., Palmrose, and Scholz (2004) find that firms who provide audit services and tax services are able to do so more efficiently or at lower cost. This is likely due to client knowledge and what are commonly labelled spill over effects. There is no price impact for other non-audit services.

Is audit quality undermined by the provision of non-audit services? Ruddock, Taylor, and Taylor (2006) find no evidence of the provision of non-audit services reducing accounting conservatism, which is commonly used as a measure of accounting quality and audit effectiveness. Furthermore, in more recent periods in the United States there is no evidence of the provision of non-audit services impacting audit quality (Lisic, Myers, Pawlewicz, & Seidel, 2019).

While not mentioned in the terms of reference or above, there are potential concerns about audit quality with increased auditor tenure. However this is already addressed with mandatory auditor rotation (Lennox, Wu, & Zhang, 2014). Hence it is not an issue.

In conclusion, the structure of the audit industry has been considered extensively in the literature. While there might be perceptions of problems and concerns about a lack of competition and conflicts, there is no rigorous empirical evidence of this. Problematically regulatory intervention into the market might lead to higher costs and less expert audit and non-audit services. Ironically, these effects would likely be most pronounced for smaller corporations (often in regional areas) which often rely on auditors for a range of non-audit services where knowledge of the audit client business is critical in the provision of quality, cost effective services.

2. Auditing quality: Scope and judgement (TOR4-7).

Concerns about audit quality are frequently expressed, and there are instances of perceived ‘failure’. However, corporate failure should not be attributed to auditors, this is the responsibility of managers and directors. The concern here should be limited to ‘financial reporting’ failures and this is jointly attributable to managers, directors and auditors. This has a number of dimensions.

What is the scope of the audit? Historically the scope of the audit has been limited to the audit of the financial statements. This does not include endorsement of a corporations business model. Nor does it include detecting fraud or misconduct, unless it materially impacts the financial statements. Extending the audit to include this would significantly expand the scope and increase the costs of audits. This would impact large firms and small firms, including those where this is less problematic and there is no economic rationale. This is more appropriately considered a function of management and directors and there is evidence that they address this (Krishnan, 2005), and where necessary appoint internal auditors (Carcello, Hermanson, & Raghunandan, 2005) who do not need to be independent and who can develop the necessary corporate knowledge to perform this task efficiently. Problems of scope are largely perception, and there is empirical evidence that this is generally addressed by alternative mechanisms such as internal auditors where problem arise. The cost of regulated 100% compliance would be uneconomic, and additional regulation would impose additional costs on many businesses for no benefit.

Is there a problem with the judgements made by auditors? Judgement is critical in preparing and auditing financial statements. Increasing business complexity has adversely impacted the accounting standards issued by the Australian Accounting Standards Board in terms of the readability, understandability and ease of application. These standards guide the preparation of financial reports and dictate the extent to which judgements in the preparation of financial statements and by auditors are required. This is unavoidable and highlights an increasing need for expertise not additional regulation. Furthermore, there is no evidence that adopting more prescriptive accounting standard which limit judgement would address this issue. Accounting standards issued by the Financial Accounting Standards Board in the United States, while generally consistent in terms of intent, are more prescriptive than Australian accounting standards (following international accounting standards) which require more judgment. Focusing on lease accounting where the differences are pronounced Henderson and O'Brien (2017) find no evidence that more prescriptive accounting standards with less judgement results in different or better financial reporting outcomes. Arguably, more prescriptive accounting standards provide a 'road map' to avoidance, and consistent with this there is evidence in Donelson, McInnis, and Mergenthaler (2012) that more prescriptive accounting standards are associated with reduced litigation. However, this does not impact the litigation outcomes. The ineffectiveness of prescriptive accounting standards was also clear during the global financial crisis. They did little to constrain asset securitization transactions (Freeman, Wells, & Wyatt, 2014) or identify problematic accounting practices for these transactions (Freeman, Wells, & Wyatt, 2017). Arguably the prescriptive accounting practices for 'Repo 105' transactions provided the road map for Lehman Brothers (amongst others). There is no empirical evidence that restricting judgements in the preparation of financial statements, including those of auditors, would do anything to enhance the quality of financial reports.

There is no empirical evidence supporting changes to the scope of audits or trying to put limits on the exercise of judgement by auditors. Attempts to do so would inevitably impose additional costs on business and it is doubtful that there would be a benefit.

3. Adequacy of legislation, regulation and licensing (TOR 8-12)

There are already requirements for the registration of company auditors and there are a range of quality assurance processes undertaken by regulators and professional bodies. For example, the Australian Securities and Investments Commission (ASIC) has an audit inspection program and issues reports (e.g., Report 607, Audit Inspection Program Report for 2017/18, ASIC, January 2019). While this is probably operating adequately, there is scope for the findings to be better analysed and reported. Critically, extending this process is unlikely yield better outcomes. More likely it will further confirm the overwhelming majority of audits and auditors are conducted competently, which is what the ASIC report mentioned above actually said. If there were to be any changes in the review of audits and auditors, it should be facilitation of the better targeting of deficient audits and auditors for review.

Are there alternative or additional measures that might be prescribed which would better identify deficient audits and auditors? A challenge for ASIC and the professional bodies when reviewing financial statements (or others generally using financial statements) is the accessibility of the information. Financial information is provided as text with variable formats and reviewing these financial statements requires manual extraction of data which is time consuming, expensive and subject to error. Prescribing the presentation of financial statements in an electronic format, or a format which facilitates electronic extraction would greatly enhance the ability to review and use of information in financial statements. This would provide increased transparency of financial statements and enable better targeting of resources by regulators and professional bodies. A more efficient review process. There is scope for this with the International Accounting Standards Board having a taxonomy for tagging information in financial statements that would facilitate the computerised extraction of financial information. This is referred to as xBRL (eXtensible Business Reporting Language) reporting. This type of reporting is already required by the Securities and Exchange Commission in the United States and there is evidence that the increased transparency arising from xBRL reporting led to a reduction in earnings management and improvement in financial statement quality (Kim, Kim, & Lim, 2019). Not surprisingly, there is also evidence of lower information processing costs for users of financial statements (Dong, Li, Lin, & Ni, 2016), increased analyst forecast accuracy (Liu, Wang, & Yao, 2013) and improvements in the information efficiency of capital markets (Efendi, Park, & Smith, 2014). This is the future of financial reporting.

Prescribing xBRL is a practical and there is empirical evidence of it being an economically efficient mechanism for increasing transparency in financial statements, allowing analysis and review of financial statements and enhancing financial reporting quality. There would be costs of implementing xBRL reporting, but these are constrained by the opportunity to adopt the taxonomy already developed by the International Accounting Standards Board and the programming solutions and experience developed in the United States. There would be costs to preparers of financial reports, but these should not be ameliorated by firms using software such as Caseware to generate financial reports already, and this could be easily and cost effectively incorporated into these programs. Offsetting these costs to preparers are the benefits to regulators who can better target the limited resources available for review of financial statements. There would also be significant benefits for users in relation to the extraction of information from financial statements. Many of these users presently send financial statements overseas (commonly the Philippines) to have the data extracted (multiple times and with error).

Finally, xBRL reporting is in its infancy in countries adopting international accounting standards (i.e., outside the United States) and if Australia was early to mandate it would provide significant opportunities / advantages for the financial services and technology industries to develop the technology to facilitate xBRL reporting and products using information from xBRL reports in an international accounting standards environment.

Yours faithfully

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