

9 October 2019

Committee Secretary,  
Parliamentary Joint Committee on Corporations and Financial Services,  
P. O. Box 6100,  
Parliament House,  
CANBERRA, A.C.T. 2600.

Via email: corporations.joint@aph.gov.au

Dear Secretary,

**Re: Parliamentary Inquiry into Regulation of Auditing in Australia**

We welcome the opportunity to make a submission to the Parliamentary Inquiry into Regulation of Auditing in Australia (hereafter, the Inquiry).

We are the Editors-in-Chief of the journal Australian Accounting Review (AAR). The objective of AAR is to “stimulate and facilitate a dynamic and robust dialogue between academics, practitioners and policymakers on issues of mutual interest”. We believe in the importance of evidence-informed policy setting and consequently in this submission we summarize articles that have been published in AAR that are directly relevant to the Inquiry. Many of the issues to be investigated by the Inquiry have opposing arguments that sometimes stem from incomplete information or presumptions about states of the world. We believe that empirical evidence is therefore an important input to the Inquiry. We also acknowledge that empirical results are not always unambiguous.

We would have liked to have made our summary of research evidence from a wider base. However, due to the short time frame for making a submission, we have focused our submission on articles published in AAR. We believe this is an appropriate source because almost all studies that we summarise in this submission are Australian based. Furthermore, many of the studies provide a comprehensive literature reviews of relevant Australian and international research findings.

We do not comment on all issues raised by the Inquiry, but focus on those where the research published in AAR is relevant. We have arranged that all AAR articles cited in this submission can be downloaded free of charge.

We would be pleased to provide any further explanations and information you may require.

Yours faithfully,

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## **1. Introduction**

The aim of audit reform is to improve audit quality and consequently restore public trust in auditing. Typical market reforms include: (1) limiting audit tenure through audit firm, audit partner rotation, and re-tendering; (2) limiting non-audit services by the incumbent auditor, (3) joint auditing, and (4) empowering the audit committee to enhance audit quality (**Tan and Ho, 2016**).

### **Why empirical evidence is important**

Academic studies provide at least three forms of benefits to policy setters. First, studies provide evidence about current circumstances which help confirm or deny alleged problems in the audit market and audit services. Second, empirical evidence assists policy makers to predict the consequences of proposed regulatory changes. Third, studies provide evidence of the consequences of changes in regulation in Australia or other jurisdictions. For example, **Carey, Monroe and Shailer, (2014)** provide a review of how research into auditing informs policy makers. They note that academic research has had a strong influence on previous reforms to auditing such as those contained in CLERP 9 in 2004.

### **What we do**

In this submission we briefly describe key findings from published studies in AAR as they relate to some of the Terms of Reference Questions (ToRQ) that have been established for the Inquiry. On occasion, we provide additional commentary about the potential implications of that evidence.

### **Structure of submission**

In section 2 we provide some context about the Australian audit market that we believe will be useful background to the Inquiry's deliberations. Section 3 addresses ToRQs 1 to 5, 7, 8 and 12. Each ToRQ is identified and relevant research findings are then provided. Our submission concludes with a glossary of abbreviations.

## 2. Context: Description of the Audit Market

The audit market is an integral part of the smooth functioning of capital markets. It has a complex nexus of relationships and economic interactions (**Tan and Ho, 2016; Carson, Redmayne and Liao, 2014**). In this section we highlight a number of important features that might be useful background for the Inquiry: audit quality, international harmonization, audit sub-markets, market concentration, independence, and the audit expectations gap.

*Audit quality* is not an isolated concept. It is part of a supply chain that comprises interactions between management, governance (e.g., audit committees), auditors, financial statement users and regulators (IAASB, 2014). There is a strong relationship between external auditors and the audit committee. We specifically comment on this under ToRQ12 (related matters).

[Comment: This is important because the activities and interactions between the supply chain components can be complementary or substitutes. Therefore any regulation of auditing may well have flow-on effects with potential for unintended consequences].

Auditing standards in Australia are set within an *international* context. Since 2006, the AUASB has released Australian Auditing Standards based on the ISAs issued by the IAASB, in line with the strategic direction from the Financial Reporting Council. Furthermore, the AUASB and the NZAuASB have agreed on a common set of principles in relation to the standards that each board issues. This co-operation is a contribution to the creation of a Single Economic Market announced by the Australian and New Zealand Prime Ministers in 2009.

[Comment: We note that there is a similar review being undertaken in the UK (the Brydon Review). We believe the Inquiry might have been better to wait for the outcome of the Brydon Review and consider the relevance of these recommendations for Australia. Hence, the Inquiry needs to be mindful that any regulation will have spill over effects.]

The audit market comprises several *sub-markets*. The two major sub-markets are: (1) Public Interest Entities (PIE) and (2) private firms. Other sub-markets include public sector entities and not-for-profit entities. The PIE sector is characterised by high market concentration of the Big 4 auditors that have international connections and international audit processes. Competition among the Big 4, plus threat of entry of the next mid-size firms, may create sufficient contestability to prevent the exercise of market power for the supply of PIE audits (**Tan and Ho, 2016**).

[Comment: Regulation may cause spill-over effects to non-PIE audits. The scalability of audits to less complex entities is a currently a major international auditing issue (IAASB, 2019).]

An underlying fundamental problem of auditing is that its value is largely dependent upon the auditor being independent of management. However, this *independence* is at considerable risk of being compromised because the auditor is paid by the firm being audited.

Except for the audit report, much of the work undertaken by the auditor is unobservable from outsiders. Recent auditing standards have improved the audit report to include the reporting of Key Audit Matters (KAMs) and how they have been addressed by the auditor. Even with extended audit reports, there remains an *audit expectation gap*, where less sophisticated financial statements users misunderstand the relative responsibilities of the directors and the auditors, or over-estimate the outcomes achievable by an audit. The issue might be greater than the expectation gap and might well involve a loss in trust of auditors (**Howieson, 2013**).

### 3. Submission on Selected Terms of Reference Questions (ToRQ)

#### **ToRQ 1: The relationship between auditing and consulting services and potential conflicts of interests**

**Houghton and Jubb (2002)** review the risks associated with auditor independence and propose a mechanism to manage those risks. They propose each audit firm establish an Auditor Independence Board. Members should be experts in fields such as auditing, commercial law, professional services, accounting or auditing standard-setting, or accounting policy-making and should not be current or former partners or other employees of the audit firm. For every audit, the board would consider threats to independence in a contemporaneous and confidential fashion. The outcome of the deliberations would be a documented decision to proceed or not with an audit engagement or to determine controls and procedures to ensure an adequate level of independence.

#### **ToRQ 2: Other particular conflicts of interest – independence**

Long tenure is typically considered to decrease auditor independence. One of the potential solutions to this problem is to implement audit firm or partner rotation. Using ASX listed firms from 2008 and 2014, **Arthur, Endrawes and Ho (2017)** examine the effect of audit partner rotation on audit quality. As audit quality is unobservable, this type of study will typically examine accounting or accrual quality as a proxy. They summarise prior research and find mixed evidence on the effect of auditor rotation on audit quality. They also find:

- There are offsetting costs and benefits of audit partner rotation.
- Rotation from an industry specialist to a non-specialist audit firm reduces audit quality.
- Rotation from a non-specialist to a specialist auditor results in no change in audit quality, unless the audit firm is also an industry specialist.

#### **ToRQ 3: The level and effectiveness of competition in audit and related consulting services**

There is a concern that market concentration by the Big 4 audit firms creates a monopolist position that, in turn, results in adverse audit quality.

**Kend, Houghton and Jubb (2014)** report on 58 in-depth interviews with Australian assurance suppliers, assurance purchasers and users of financial reports. They conclude that most respondents perceive the competition in the audit and assurance market to be sufficient, and only users of financial statements expressed any real concern regarding this matter.

**Carson, Redmayne and Liao (2014)** review the large body of international literature on the structure and competitiveness of the Australian audit market. Further, they estimate a series of market concentration metrics for all Australian listed companies for the period 2000-2011. They find:

- Market concentration and competitiveness differs across markets, based on client size.

- The market share of Big 4 audit firms in Australia is lower than many other countries and declined from 62.9% to 43.6% over the period.
- Big 4 firms have maintained their share of the large client market. Growth in medium and small clients has been experienced by large and medium non-Big 4 firms. The smallest audit firms have maintained static levels of market share.
- Only 35% of firms have audit tenures of 12 or more years. This compares to 67% of firms in the UK with tenure of 10 or more years.
- 58% of large clients have tenure greater than 12 years and 22% of small clients. Hence, any limitations on audit tenure will impact large clients disproportionately to small clients.

Overall the study concludes that with regard to audit supplier-concentration there is a highly segmented market and that the market is competitive but complex.

#### **ToRQ 4: Audit quality, including valuations of intangible assets**

Audit quality continues to be a matter of concern to regulators. In its most recent audit inspections program, ASIC (2019) noted that in “24% of the total 347 key audit areas that ASIC reviewed across 98 audit files, auditors did not, in our view, obtain reasonable assurance that the financial report was free from material misstatement.” Notwithstanding this report, a recent FRC-AUASB (2019) survey found that 92% of chairs of audit committees were very satisfied with the quality of their external auditor.

To identify factors that contribute to audit quality, **Kilgore, Radich and Harrison (2011)** survey 81 users of audit services drawn from the audit committee and financial analyst communities. They identify ten factors about audit firms and audit teams that were perceived to contribute to audit quality. In decreasing order of importance these ten factors were:

- audit firm size,
- partner/manager attention to the audit,
- whether the senior manager/manager is knowledgeable about the client’s industry,
- having a very knowledgeable audit team,
- good communication between the audit team and the client’s management,
- the audit firm’s industry experience,
- the audit partner being knowledgeable about the client’s industry,
- the provision of non-audit services,
- audit partner tenure, and
- the existence of an audit quality assurance review.

Their study illustrates the multi-dimensional nature of audit quality. They conclude that, in terms of audit quality, users of audit services perceive audit team attributes as being more important than audit firm attributes.

In a review of studies on audit reporting and the provision of going concern qualifications, **Carson, Fargher, and Zhang (2016)** find that auditor independence is a key factor associated with the likelihood of a client receiving a going concern report. Over the period

2005 to 2013 they observe an increasing trend of clients receiving reports with going concern opinions. They find that over 90 percent of companies receiving a going concern opinion do not fail within the subsequent year. Furthermore, relatively few firms fail without a going concern opinion.

**Coram, Mock, Turner and Gray (2011)** conduct an experiment with 16 financial analysts to understand how they use an unqualified audit report. Analysts value the presence of an audit report as a sign of the financial statements' reliability. However, once they had determined that the report was unqualified, they did not pay any attention to any other parts of the audit report. This result held even when the analysts were provided with the new 'longer form' audit report.

**Prasad and Chand (2017)** analyse 138 comment letters sent to the IAASB in 2013 in response to the IAASB's exposure draft for improvements in the content of the audit report. These improvements include, the provision of information about 'key audit matters', the disclosure of the name of the audit engagement partner, and the presentation of both the audit opinion and the basis for that opinion before all other sections of the audit report. Although most financial statement preparers were against the proposals, there was support from auditors and users of those financial statements. New disclosures about key audit matters were perceived to improve the informational value of the audit report but only if those disclosures do not become 'boiler plate' over time. The respondents to the IAASB's exposure draft, however, were less convinced that the proposals would improve the quality of audits as there were concerns about increased audit costs being borne by small audit firms potentially leading to less competition in the audit market.

With regard to the treatment of intangible assets, **Guthrie and Pang (2013)** study the extent to which 287 Australian firms over the period 2005 to 2010 complied with mandatory requirements under accounting standards to test goodwill for impairment. Among other things, they examine the pattern of audit qualifications regarding going concern and firm's associated treatment of goodwill. They conclude that disclosures by Australian firms regarding the testing of goodwill for impairment did not receive sufficient attention from auditors.

#### **ToRQ 5: Matters arising from Australian and international reviews of auditing**

**Davis and Hay (2012)** study submissions from 158 respondents to the 2009 New Zealand proposals to move from self-regulation of auditing. Of the results, there are two features that seem relevant to the Inquiry:

- Users of financial statements either do not have strong interest in audit issues or do not voice their concern over proposals. Only 2 out of the 158 respondents was identified as a user, and
- Charities and not-for-profit entities have different concerns to other respondents.

[Comment: The Inquiry might need to seek out views from financial statement users. Charities and not-for-profit are being recognised as an increasingly important sector that might have different reporting and assurance needs. Hence, care must be taken with regard to spill-over consequences to this sector.]

**O’Leary, Boolaky and Copp (2013)** report on an Australian survey of 65 executive directors and 23 audit committee members with regard to the respondents’ views on reforms to audit committees proposed in 2011 in the UK. The three reforms are:

- that audit committee members would provide more information in their audit committee report;
- this would form part of the annual financial report; and
- audit committee members would consult principal investors as to the external auditor appointment.

External auditors would be required to comment on the completeness of the audit committee report. Both types of respondent were predominantly opposed to the proposed legislation (failing to see how it could improve current stewardship) and indicated they would be less comfortable in their current roles. The authors conclude that the proposals may deter good corporate citizens from retaining or seeking director or audit committee roles.

After the Global Financial Crisis (2007–08), the UK began reforming its corporate governance and audit regime. **Kend and Basioudis (2018)** examine the benefits and costs of the new UK and EU audit regulations and whether or not there is scope and benefits for Australia to further reform its regulations related to audit and assurance services. The authors interview seven respondents described as key players in the reforms to audit in the UK (regulators, auditors, audit committee chairs). The following recommendations for corporate and audit reform in Australia were made:

- 1) Consider the extended auditors’ report to allow auditors more scope to explain their work and judgements;
- 2) Audit reports should contain disclosures of materiality thresholds considered useful for shareholders and potential investors;
- 3) Boards should disclose viability statements in their annual reports, with an outlook between three and five years consistent with the UK reforms, and auditors are to review and report on these statements;
- 4) Consider mandatory firm rotation up to 20 years, with compulsory public tendering required within the first 10 years;
- 5) Consider a 70% cap on non-audit services of total group-level audit fees, and other restrictions on such services, to open up the market to a wider group of firms and therefore promote more competition in the market for audit and assurance services; and
- 6) Consider expanding the role and function of ASIC to include standard-setting oversight, monitoring, enforcement and direct input and oversight over the corporate governance of listed companies.

[Comments: The following comments reflect the current status of each of these proposals in Australia or internationally:

1. Key Audit Matters have been introduced in Australian audit reports.
2. There is some voluntary reporting of materiality thresholds in Australian audit reports. This has been considered in the IAASB audit reporting project but not



required. It possibly will be reconsidered as part of the IAASB's post-implementation review of audit reporting.

3. Not considered in Australia.
4. This was considered when CLERP 9 reforms were legislated. It is not currently under consideration.
5. Not considered in Australia. The IESBA has a current project looking at the rules for non-audit services.
6. Not considered in Australia.]

### **ToRQ 7 The role and effectiveness of audit in detecting and reporting fraud and misconduct**

**Gay, Schelluch and Reid (1997)** report the results of a questionnaire from 137 financial statement users on their perceptions with regard to the 'expectation gap'. Specifically, they examine users' perceptions of auditor's responsibilities for prevention, detection and reporting of fraud, other illegal acts and errors, and ascertain whether these perceptions are consistent with auditing standards (AUS 210) and with other empirical studies.

They find a significant expectation gap exists in Australia between users of financial reports and auditing standards. They conclude that:

- Users have "unreasonable expectations" of auditor's responsibilities for preventing of fraud and detection of illegal acts.
- Standards are deficient in relation to the detection of material fraud.

The study supports the Middleton Report recommendations that highlighted the need to educate the public about the auditor's responsibilities and the limitations of the audit process.

[Comment: Although this study is rather old, there is reason to suspect that the 'audit expectation' gap still exists.]

**Howieson (2013)** explores the lack of public trust in auditors as a component of the audit expectation gap. Evidence-based practice (as promoted in the medical profession) is explored as an alternative to regulation, which typically adopts a 'one-size-fits-all' approach and can inappropriately restrict professional judgement when it is needed.

### **ToRQ 8 The effectiveness and appropriateness of legislation, regulation and licensing**

**Bradbury, Ma, and Scott (2018)** examine the explanations given for not having an audit committee in Australia's 'comply or explain' corporate governance regime. They find the reasons that firm provide for not having an audit committee are related to internal factors limiting the ability to supply an audit committee. They find these explanations are consistent with underlying firm characteristics (asset size, board size, lack of complexity). This is important because the underlying issue is whether there is a market failure of the 'comply or explain' regime, or whether a 'one size fits all' would be more effective.

In reviewing studies which have examined the impact of CLERP 9's reforms on auditor independence, **Carey, Monroe and Shailer (2014)** conclude that there is little evidence of the impact of the regulatory changes on auditor behaviour (independence in fact) and perceptions (independence in appearance). Previous mention was made in ToRQ 5 of the findings of Davis and Hay (2012) which warned of the negative consequences of some New Zealand proposals for audit reform.

**Jung and Kim (2019)** show the potential impact of regulation on the audit market structure. In their review of prior literature, they find that the increase in litigation risk, caused by strengthened regulations, increases audit quality. They examine this issue for 445 Korean savings bank-year observations over the period 2009-2015. They find the proportion of Big 4 auditors significantly decreases after the savings bank crisis. This result is consistent with the large audit firms withdrawing from riskier clients in response to increased litigation risk. Furthermore, there is no evidence that increased litigation risk improved audit quality (in terms of loan loss provisions).

### **ToRQ 12. Any related matter – Board governance**

**Hay, Stewart, and Botica-Redmayne (2017)** provide a synthesis of Australian and New Zealand research about the interaction between corporate governance and auditing. They conduct a literature search for articles published between 1990 to December 2015, which results in a sample of 67 studies. The topics they address are:

- Formation and structure of audit committees (16 studies),
- Audit committee and accountability (18 studies),
- Audit committee and firm performance (6 studies),
- Audit committees and external audit (10 studies),
- Audit committees and internal audit (8 studies),
- Internal audit (8 studies),
- Internal auditing and outsourcing (3 studies), and
- Internal and external auditing (8 studies).

They conclude that, despite the extensive research, there is insufficient evidence at the current time to show that better corporate governance has favourable (as intended) outcomes. They also comment that this is not surprising in view of the complex interrelationships involved. However, there are some results that are reasonably consistent across studies:

- Audit committees are associated with the supply of available board members (rather than demand characteristics), and
- Audit committees are complements for external auditing (not a substitute).

#### **4. Glossary of Abbreviations**

ASIC	Australian Securities and Investments Commission
AUASB	Auditing and Assurance Standards Board (Australia)
AUS	Auditing Standard
CLERP	Corporate Law Economic Reform Program
FRC	Financial Reporting Council
IAASB	International Auditing and Assurance Standards Board
IESBA	International Ethics Standards Board for Accountants
ISAs	International Standards on Auditing
KAMs	Key Audit Matters
NZAuASB	New Zealand Auditing and Assurance Standards Board
PIE	Public Interest Entities
ToRQ	(Parliamentary Inquiry) Terms of Reference Questions

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