Australian Institute of Company Directors

18 Jamison Street,
Sydney NSW 2000

t: 1300 739 119
e: contact@aicd.com.au
aicd.com.au

ABN 11 008 484 197

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Director
Corporate Conduct and Analysis Unit,
Market Conduct and Digital Division
Treasury
Langton Cres
PARKES ACT 2600

via email: CCAU@treasury.gov.au

Dear Treasury,

Regulation of accounting, auditing and consulting firms in Australia

Thank you for the opportunity to provide a submission in relation to the regulation of accounting, auditing and consulting firms in Australia (**Consultation**).

The Australian Institute of Company Directors' (**AICD**) mission 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's membership reflects the diversity of Australia's director and senior leadership community, with more than 53,000 members from not-for-profits (**NFPs**), large and small and medium enterprises (**SMEs**) and the government sector.

The AICD's submission focuses on Audit Committee and director governance issues.

Our submission builds on previous AICD submissions, including to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the regulation of auditing in Australia in 2019, and is informed by engagement with directors, including two roundtables with Audit Committee Chairs and members held in June 2024.

The Auditing and Assurance Board (AUASB)'s December 2022 Research Report 9 Perceptions of Audit Quality by Audit Committee Chairs in Australia (**AUASB Research Report 9**) sets out insights on audit quality gleaned from interviews with ASX300 Audit Committee Chairs. Many of the points made in our submission reiterate and support the AUASB's findings.

Directors bear personal legal responsibility for, and have a strong focus on, financial reporting. Robust external audit services play a key role in enhancing the confidence of financial report users in the quality of the financial reports. It also provides directors with valuable and objective insights into aspects of an entity's financial reporting, controls and risk management.

The AICD supports boards' focus on high quality corporate reporting and audit by providing education and resources for directors and Audit Committees. In September 2022, in partnership with the AUASB, the AICD issued the Periodic Comprehensive Review of the External Audit Guide (**AICD Audit Review Guide**) to provide practical assistance to directors and Audit Committees undertaking a comprehensive periodic review of their auditor. Directors' financial reporting obligations are also a core element of the AICD's flagship director education courses - the Company Directors Course and Foundations of Directorship Course - and covered regularly in short courses, member webinars, events and director tools.

1. Executive Summary

Overall, directors consider that audit quality in Australia is strong,[1] and that the current regulatory framework is fit-for-purpose. A summary of our key points are as follows:

- Directors are acutely aware of, and focused on, discharging their non-delegable financial reporting duties. Directors take active steps to form their own view on the completeness and accuracy of the financial statements.
- The Audit Committee is an effective mechanism to bring director and board focus to the oversight of the financial reporting process. This includes oversight of mechanisms to maintain high audit quality and safeguard auditor independence.
- Undertaking annual and periodic comprehensive audit reviews allows for the assessment of audit quality. If directors are unsatisfied with their assessment, this may result in auditor replacement. Directors broadly support the current requirements for audit partner rotation and do not consider that mandatory audit firm rotation (as is mandated in the UK) will necessarily lift audit quality.
- Directors who serve on prudentially regulated entity boards have observed that additional governance requirements mandated by APRA, such as the separation of the Audit Committee from the Risk Reporting Committee and auditor reporting on internal controls, are seen as good governance practices that help to strengthen audit quality. Policy makers are encouraged to promote adoption of these practices where the characteristics of specific entities or sectors make this appropriate. The AICD does not, however, recommend new mandatory regulatory requirements for all entities.
- Directors are confident that existing regulatory requirements and governance practices safeguard auditor independence. Key governance practices engaged in by boards/ Audit Committees to preserve auditor independence include providing sufficient time for Audit Committee and board engagement with auditors in the absence of management, imposing caps on non-audit fees or engagements, having a detailed list of prohibited non-audit services, and/or requiring pre-approval of non-audit engagements by Audit Committees and/or the board.
- The dominance of the largest four audit firms ('Big-4') in the market does not, of itself, have a negative effect on audit quality. In the absence of addressing capacity constraints within the Australian audit market, mandatory audit firm rotation or requirements to allocate a portion of audit services to non-Big 4 audit firms, as is the case in the UK, are unlikely to alleviate competition issues but could unintentionally decrease audit quality and increase audit cost.
- While the AICD is encouraged by ASIC's recent focus on auditor compliance with quality and ethical standards,[2] a formal response to the Financial Reporting Council (FRC)'s November 2023 Audit Quality Report (including recommendations for improving ASIC's financial reporting and audit surveillance program), would be welcome.
- In the AICD's view, the current regulatory framework for external audit is sound. Additional requirements that are not proven to lift audit quality should not be imposed through regulation in circumstances where boards are increasingly overloaded as a result of the proliferation of financial and non-financial regulatory and reporting requirements. A strong evidence base must be presented before regulatory interventions are contemplated.

[1] Also supported by AUASB research conducted in August – October 2022 as set out in the AUASB Research Report 9 on pages v and 5 .
[2] Including naming the targeting of gatekeepers facilitating misconduct (including auditors) as a 2024 ASIC priority (see ASIC Media Release 24-116MR), the announcement on 15 May 2024 that ASIC will be undertaking a new review of auditors' compliance with ethical and independence standards, and undertaking further work on auditor quality management systems in FY2024-2025 (see 30 June 2024 ASIC Focus Areas: 24-101MR). Also see Kate O'Rourke speech dated 16 May 2024 on ASIC's Financial Reporting and Audit Surveillance Program.

2. The relationship between directors, the Audit Committee and the external auditor

Directors have a non-delegable duty to oversee financial reporting. There are significant liability and reputational consequences for misleading, incorrect or inadequate disclosure, with directors required to make legally-binding directors' declarations.[3]

The auditor does not displace the board and management's accountability for the accuracy and completeness of the financial reports. Rather, auditors provide an independent view that the financial statements are/ appear to be free from material error and comply with the accounting standards.

While the Board as a whole has responsibility for overseeing financial reporting, having a separate Audit Committee is an effective mechanism to bring focus to overseeing the financial reporting process. This includes oversight of the 'three lines of defence'[4] and the external auditor. With financial reports requiring the application of increasingly complex accounting standards, a key part of the Audit Committee's role is to challenge management's financial reporting judgments and assumptions. This includes encouraging the auditor to ventilate any issues or concerns in the absence of management.

More broadly, Audit Committees are generally responsible for considering, reviewing and making recommendations to the board on:

- the appointment, removal and rotation of the external auditor;
- audit fees;
- the scope and adequacy of the external audit;[5]
- the independence and performance of the external auditor, including evaluation and periodic review of audit quality; and
- the auditor's provision of non-audit services.

The ASX Corporate Governance Principles (**ASX Principles**)[6] recommend that listed entities have an Audit Committee with at least three non-executive director members, with a majority being independent directors, and be chaired by an independent director. The requirement to have a dedicated Audit Committee, with specific functions and composition, is also prescribed in key sectors such as financial services.[7] Director feedback is that the value of the Audit Committee is such that even smaller entities which are not required to have an Audit Committee frequently adopt this practice.

3. Feedback from directors on audit quality and independence

To inform this submission, the AICD spoke with Audit Committee Chairs and members (primarily of larger listed entities) on key audit quality and governance issues. Key insights are set out below.

As a starting proposition, there is general director satisfaction with the level of audit quality in Australia. AUASB Research Paper 9 also made this finding.[8] There is strong director consensus that current regulatory requirements for auditor appointment, review, rotation and independence support high quality audit. As such, any future policy interventions need to be based on compelling evidence.

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[3] Under section 295(4) of the Corporations Act directors are required to declare that the financial statements and notes comply with accounting standards and give a "true and fair view" of the company's financial position and performance.

[4] Being (1) operational management and finance teams; (2) internal risk and compliance functions; and (3) internal audit. External audit serves as a fourth category outside of the organisation.

[5] Including facilitating the audit process by ensuring management and staff are accountable, supportive and helpful, and ensuring regular communication and engagement with the auditor (including in and outside of Audit Committee meetings).

[6] See Recommendation 4.1. All listed entities must comply with the ASX Principles on an 'if-not-why-not' basis. Compliance with the ASX Principles is also mandatory for all ASX300 companies and any entity included in the S&P All Ordinaries Index (the largest 500 companies by market capitalisation). APRA imposes similar mandatory audit committee requirements in its prudential standards for APRA-regulated entities.

[7] See APRA CPS 510, paras 73-89.

[8] AUASB Research Report 9 at pages v and 5 .

3.1 Auditor rotation

Section 324DA of the Corporations Act requires the lead or review auditor[9] to rotate every five years for listed companies, listed registered schemes or registrable superannuation entities, which can be extended to seven years with director approval.[10] However, there is no requirement to periodically rotate the audit firm.

The Draft Fifth Edition of the ASX Principles includes a new recommendation (Recommendation 4.3), which AICD supports, which requires listed entities to disclose the tenure of the audit firm and audit engagement partner as at the end of the reporting period, when the appointment of the external auditor was last comprehensively reviewed, and the outcomes from that review.

The feedback from directors indicates broad support for the current requirement to rotate audit partners. However, most do not support a mandatory rotation of audit firms, as has been implemented in other jurisdictions such as the UK.[11] The reason for this is threefold.

First, there appears to be no proven link between an increase in audit quality and compulsory audit firm rotation. Whilst justification for mandatory audit firm rotation includes that it encourages ‘fresh thinking’ and strengthens auditor scepticism thereby lifting audit quality, feedback from directors is that this rarely occurs and when it does, it is so limited that it does not justify the significant cost involved. In fact, directors observe that engaging new auditors may initially result in a temporary decrease in audit quality and greater investment of time by management. This is generally because it can take auditors up to 12 to 18 months to familiarise themselves with the organisation.

Second, the capacity constraints in the Australian audit market and existing ASX200 use of the Big 4 for non-audit services mean that, to preserve auditor independence, there are only two/three viable audit firms to replace an incumbent audit firm. These same observations were made in the AUASB’s Research Report 9.[12] Directors’ feedback is that small/medium-sized audit firms (i.e. outside of the Big 4) may struggle to meet the scale and breadth of experience needed to service ASX200 entities. For instance, many of the ASX200 operate across jurisdictions, such that cross-jurisdictional capability is required. Further, feedback is that small-medium audit firms may not have the personnel or technology to meet the demands of an ASX200 client. Other jurisdictions, such as the UK, have sought to address this competition barrier by mandating the use of smaller firms to undertake a portion of the audit. However, Australian directors are not supportive of this approach.

Anecdotal evidence from the UK experience is that having multiple auditors can increase inefficiencies and costs. Further, in the UK experience, capability constraints and/or perceptions of the capacity of smaller audit firms to service large, listed clients (given their requirements) have meant that such firms are generally engaged only for the 'minor' or 'technical' aspects of the audit. This further prevents smaller audit firms from developing the relevant capabilities to reduce competition barriers. Overall, any policy interventions to improve competition should carefully consider unintended consequences and ensure that audit quality is not compromised.

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[9] Known as an individual who “plays a significant role in the audit,” defined further in s 9 of the Corporations Act.
[10] s 324DAA of the Corporations Act.
[11] The UK requires that companies rotate audit firms every 10 years, with an option to extend this to 20 years if the company goes to tender at 10 years.
[12] See page 8.

Third, directors report that mandatory audit firm rotation significantly increases costs. For instance, one director observed that a change in auditor led the organisation to double its audit costs in the first year of the new engagement due to the need for the new auditor to famarilise themselves with the organisation. Organisations have to bear these costs at a time when compliance costs to business are significantly increasing, including as a result of the proliferation of new (particularly non-financial) reporting obligations, such as modern slavery and the forthcoming introduction of mandatory climate reporting.

3.2 Auditor review

The AICD Audit Review Guide provides guidance to boards and Audit Committees undertaking a comprehensive review of their auditor. Key recommendations include:

- Audit Committees should undertake a comprehensive review of audit arrangements at least every five years, building on annual audit assessments;
- The review should cover independence, audit quality issues and any ASIC inspection and Professional Accounting Body (**PAB**) review findings (for more detail, see Annexure A of the AICD Audit Review Guide);
- The results should be communicated to the board, along with recommendations on how to address any areas of concern;
- If serious concerns have arisen (or for other reasons the Audit Committee wishes to test the market) the Audit Committee may recommend to the board that the audit be put out for tender; and
- The Audit Committee may also make other recommendations to bolster independence and audit quality, such as changes to policies on the hiring of audit firm staff or the provision of non-audit services.

Whilst directors consider that the AICD Audit Review Guide provides best practice governance at the entity-level, concerns exist as to the supervision and enforcement of audit quality by regulators at the economy-level (detailed in section 3.4 below).

3.3 Auditor independence

To meet statutory auditor independence requirements and promote best practice governance, boards and Audit Committees take various steps to safeguard auditor independence, including:

- caps on non-audit fees/engagements by auditors;
- detailed lists of prohibited non-audit services;
- pre-approval of non-audit engagements by Audit Committees and/or boards;
- providing sufficient time for Audit Committee and board engagement with auditors (including to discuss Key Audit Matters) without management present; and
- oversight by Audit Committees of the resourcing, expertise and approach adopted by auditors, including variations from audit engagement (more common in listed entities).

Directors view these measures as promoting robust auditor independence, without necessitating the introduction of any new regulatory requirements.

3.4 The role of regulators in upholding audit quality and independence

We are encouraged by the recent focus on audit quality issues by ASIC. This includes naming the targeting of gatekeepers facilitating misconduct (including auditors[13]) as a 2024 ASIC priority,[14] the announcement on 15 May 2024 that ASIC will be undertaking a new review of auditors' compliance with

[13] Note ASIC's Deputy Chair, Sarah Court, having stated on 29 May 2024 that *"Misconduct by gatekeepers such as auditors is an enforcement priority for ASIC in 2024. Independence is a fundamental duty of an auditor, and we will continue to take action where registered company auditors fail to meet their independence requirements"* – see ASIC Media Release 24-116MR.
[14] See 30 June 2024 ASIC Focus Areas: 24-101MR.

ethical and independence standards, and undertaking further work on auditor quality management systems in FY2024-2025.[15] Directors are also broadly supportive of ASIC's new approach of communicating the results of audit review findings with directors and Audit Committees.[16]

However, directors identified two areas requiring additional focus by regulators.

First, despite ASIC's recent focus on auditor quality, there are still concerns as to the effectiveness of its financial report and audit surveillance program, especially in light of the Financial Reporting Council (FRC)'s November 2023 report into Audit Quality (**FRC Report**). The FRC Report, which made 15 recommendations under six broad themes, expressed some concern over the reduction in the number of audit files reviewed by ASIC and ASIC's current practice of only reviewing audit files when financial reports are known or suspected to be misstated.[17] The FRC considered that ASIC's audit review program should review more audit files on an annual basis[18] and engage in more proactive auditing.[19] To our knowledge, ASIC has not publicly responded to the FRC Report. A response could increase transparency and market confidence in the robustness of the financial reporting regulatory system.

Second, some directors consider that the lack of consistency between the governance requirements of APRA and ASIC-regulated entities creates varied governance practices and expectations. Broadly, APRA-regulated entities are perceived as having more specific governance requirements than ASIC-regulated entities. For instance, APRA mandates additional requirements, such as the separation of the Audit Committee from the Risk Committee[20] and mandatory auditor reporting on internal financial controls.[21]

Although not specifically required under the Corporations Act, many non-financial entities have adopted APRA's approach to separate the Audit Committee and the Risk Committee. Many directors value this approach because it encourages the Risk Committee to focus on the adequacy of risk and controls and allows the Committee to be more proactive and forward-looking in its consideration of emerging financial and non-financial risk. Where there is a consolidated Audit and Risk Committee, some directors are concerned that the Committee tends to be dominated by the finalisation of half-year and year-end financial statements and reports, leaving less time for the proactive consideration of future financial and non-financial risks. However. the decision as to whether to consolidate the Audit and Risk Committees should be considered and made by directors based on the specific circumstances of the organisation.

4. Next Steps

If you would like to discuss these matters further, please contact Christian Gergis, Head of Policy at cgergis@aicd.com.au or Anna Gudkov, Senior Policy Adviser at agudkov@aicd.com.au.

Yours sincerely,

Louise Petschler GAICD
General Manager,
Education & Policy Leadership

[15] Ibid. See also Kate O'Rourke speech dated 16 May 2024 on ASIC's Financial Reporting and Audit Surveillance Program.
[16] See ASIC Regulatory Guide RG260.
[17] FRC Report at page 6.
[18] Ibid page 4.
[19]Recommendation 1 was that "ASIC's program of reviewing audit files only when financial reports are known or suspected to be misstated, should be augmented with a program that selects audit files on a risk and rotational basis for review, with the overall objective to review all auditors over an established time period."
[20] Prudential Standard CPS 510 and HPG 510.
[21] Prudential Standard APS 310, 3PS 310 and SPS 310.