28 October 2019

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

Dear Sir / Madam

Submission to the inquiry of the Parliamentary Joint Committee on Corporations and Financial Services into Regulation of Auditing in Australia.

The Australasian Council of Auditors General (ACAG) welcomes the opportunity to provide this submission to the Inquiry of the Parliamentary Joint Committee (the Committee) on Corporations and Financial Services into Regulation of Auditing in Australia. This submission represents the views of all Australian state and territory based ACAG Members.

ACAG is an association established over 60 years ago. It facilitates the sharing of information and intelligence between Auditors General in a time of increasing complexity and rapid change. ACAG members are the Auditors General of all Australian States and Territories, New Zealand, Fiji and Papua New Guinea as well as the Commonwealth Auditor General.

The overriding objectives of ACAG as articulated in its Constitution are:

- to provide arrangements for the sharing of information between members
- support the development of effective and efficient auditing methods and practices by members
- represent externally, where appropriate, on matters affecting members, the collective opinion of the Auditors General on financial accounting and auditing standards and legislative audit and related issues including submissions to Australian standard setting bodies and parliamentary committees.
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Whilst we recognise the Parliamentary Inquiry is directed towards the practices of auditors conducting audits of financial statements in the private sector, ACAG members saw value in informing the Committee of the practices within the public sector.

The insights within this submission are drawn from the practices and experience within Australian public sector audit offices. Public sector audit offices deliver a range of assurance services including audits of financial statements, compliance audits, performance audits and information technology audits. Each of the public sector audit offices provide financial statements audit services either directly, by engaging private sector firms as Audit Service Providers (ASPs), or a combination of both.

Independence of the Auditors General function in Australia

The roles and responsibilities of Auditors General are established by legislation in each jurisdiction. All Auditors General report to Parliament. Whilst the legislation differs between jurisdictions, all legislation requires the independence of the Auditor General to be maintained (from both the government of the day and the audited entity) and that the Auditor General either abide by Australian Auditing Standards or have regard to those standards.

The legislative imposition for some Auditors General to serve a fixed term with ineligibility for re-appointment – and restrictions to further employment – is also designed to strengthen the independence of the role of the Auditor General.

Importance of independence

Globally, the International Organisation of Supreme Audit Institutions (INTOSAI) has issued declarations on public sector audit independence, specifying eight core practice-focused principles generally recognised by Supreme Audit Institutions (SAIs) as 'essential requirements of proper public sector auditing'. In summary, these eight principles are:

1. Existence of a constitutional/statutory/legal framework.
2. Independence of SAI heads, including security of tenure and legal immunity in the discharge of duties.
3. A sufficiently broad mandate and full discretion in the discharge of SAI functions.
4. Unrestricted access to information.
5. The right and obligation to report on the SAI's work.
6. Freedom to decide the content and timing of audit reports and to publish and disseminate them.
7. Existence of effective follow-up mechanism for SAI recommendations.
8. Financial and managerial/administrative autonomy with appropriate resourcing.

Audit independence is considered to be vital for all modern audit activities, regardless of the economic sector in which the auditee organisation operates. Indeed, the Auditing Standard ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* requires all auditors, regardless of sector, in Australia to comply with relevant ethical requirements, including those pertaining to independence.

The purpose of an independent audit is to enhance confidence in financial reporting. Just as in the private sector, it is in the interest of the public sector to ensure the independence of the Auditors General and ensure that real and perceived conflicts of interest are adequately managed and mitigated as they relate to Auditors General, personnel of audit offices and their ASPs.

This submission has addressed, where relevant, the Committee's Terms of Reference in the order published.

Terms of Reference 1: the relationship between auditing and consulting services and potential conflicts of interests

In order to preserve the independence of Auditors General, and to avoid a situation where a potential conflict of interest may arise, audit offices do not provide non-audit services. Legislative mandates of Auditors General complement this by prescribing the agencies subject to financial statement audits – meaning relative stability to audit office operations without the need to grow revenue by conducting other services that could risk compromising their independence. Legislative mandates also preserve independence as Auditors General cannot be removed as the auditor by the audited entity because of adverse audit findings; that is, Auditors General can operate without fear or favour.

In order to fulfil their mandates to parliament, audit offices often engage private sector firms as ASPs to assist in the delivery of their audit services. The extent and reasons to engage ASPs vary across jurisdictions. Some engage ASPs as a contestability mechanism – as a method to commission services to demonstrate efficient and effective use of public resources. Others are driven by the need for additional resources during peak audit periods or the need to utilise specialised expertise not available within their own offices.

All audit offices engage their ASPs through a commissioning or competitive tendering process, and most use a range of firms from small regional firms through to the Big 4 professional services firms. The allocation of financial statements audits to ASPs is primarily determined by the capability and capacity of the ASP to provide the audit services rather than the cost of the audit. Importantly, in all cases it is the responsibility of the audit office to manage, monitor and review the independence and work quality of ASPs. The Auditors General – or their delegate – remain responsible for the audit opinion issued.

Not unexpectedly, situations will arise where an ASP will request approval from an audit office to provide services to a public sector entity that are additional to the audit that the ASP is performing for the audit office. In the limited circumstances where this occurs, audit offices have processes in place to evaluate and approve or reject requests. Some do not allow an ASP to provide any non-audit services to entities they audit. Others may only permit complementary assurance-related services (such as the ASP auditing grant acquittals that are not audited by the Auditor General). Others may only permit the ASP to provide non-audit services when the services are not prohibited under ethical standards and guidance issued by the Accounting Professional & Ethical Standards Board and appropriate safeguards are in place to ensure that the provision of non-audit services will not present a risk to the Auditor General or the ASP that their independence is (or is perceived as) impaired.

Terms of Reference 2: other potential conflicts of interest
All audit offices have policies which address conflicts of interest and the independence of the audit office and the professional independence of audit staff. For instance, audit offices have policies in place to manage the rotation of senior members of audit teams. Audit offices adopt and monitor compliance with professional standards issued by standards boards which deal with conflicts of interest and independence.

Terms of Reference 4: audit quality, including valuations of intangible assets

Audit quality
Auditors General are committed to audit quality and they demonstrate this in many ways as outlined in their annual reports and transparency reports — published on their websites.

Each audit office has adopted a definition of audit quality and all generally encapsulate the principles of compliance with standards, relevant ethical requirements and other applicable legal and regulatory requirements and the provision of timely, accurate and relevant audits performed in accordance with the Auditor General's mandate.

Audit office Quality Assurance Frameworks for all audit and assurance work performed are based on AUASB Auditing Standard ASQC1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Service Engagement*. Incorporated into each audit office's quality framework is a system of quality control and monitoring programs that provide assurance that each office complies with applicable AUASB and professional standards and relevant regulatory requirements in its audit work, and that all financial audit and performance audit reports issued are compliant and appropriate in the circumstances. This framework is applied to any ASPs engaged by audit offices.

It should be noted that the audit offices are each subject, through their legislation, to a review of the practices and performance within the audit offices on a regular basis. These reviews are undertaken by an independent reviewer, often appointed through the Public Accounts Committee (or equivalent) or the Governor/Administrator of the jurisdiction.

Audit offices also voluntarily undergo external peer reviews utilising the Governance and Audit Framework for Self-Assessment and Quality (the Framework) developed and agreed by ACAG. The Framework was developed through the review of comparative models, which included the Australian Business Excellence Framework, the Australian Stock Exchange Principles of Good Corporate Governance, the Supreme Audit Institutions, Global ISO Program and the Australian Auditing Standards specific to quality control. Audit offices may also participate in alternative quality frameworks such as the INTOSAI Performance Measurement Framework (PMF) to provide a useful adjunct to other quality initiatives[1].

Audit offices also periodically engage in other quality assurance processes including (but not limited to) benchmarking quality processes against audit offices in other jurisdictions and private sector firms.

The financial statements of each audit office are also subject to independent audit by an audit firm or individual that is independent of the audit office and has no actual or perceived conflicts of interest in undertaking the audit.

Auditing complex accounting matters

In relation to the complexity associated with the valuation of intangible assets, it must be acknowledged that audited entities, in all sectors, are entering into more complex arrangements, resulting in financial statements that include balances that are, and will be, subject to greater judgement and estimation. Examples of areas of increased complexity include fair value measurement; revenue models; provisions for rehabilitation; long-tail claims. The sufficiency and appropriateness of evidence to support the judgements and estimations varies considerably and consequently, also requires auditors to have the appropriate skill and expertise, or access to the appropriate skill and expertise, in order to apply an appropriate level of knowledge, professional judgement and scepticism in the audit process.

A further challenge associated with the audit of complex transactions, balances and arrangements, is a need for more skilled and experienced auditors and specialists resulting in higher costs of undertaking the audit. There are also costs associated with developing and implementing an audit methodology that responds to these increasingly complex arrangements. These higher costs are not always understood or appreciated by the entity subject to audit and are difficult to anticipate and capture in response to Exposure Drafts released by standard setters. As a result, the true costs of implementing or revising standards to uphold or increase audit quality cannot be easily quantified or assessed against the benefits of additional audit requirements.

1 The PMF provides SAIs with a benchmarking for assessing performance against established international good practice for external public auditing. Other jurisdictions, such as New Zealand, have performed and published detailed assessments against this Framework.

Terms of Reference 6: changes in the role of audit and the scope of audit products
Differences in mandate across jurisdictions may lead to some confusion as to the opinions each Auditor General is responsible for providing. There is often an expectation that the Auditor General, when auditing the financial statements of a public sector entity, is also:

- auditing expenditure against probity principles
- reviewing the governance arrangements
- assessing delivery of programs
- assessing compliance with key legislation and central agency policy directives
- assessing financial controls
- assessing financial prudence.

The extent to which Auditors General can and do fulfil these expectations varies – and can often be a matter of whether their mandates permit the conduct of these activities.

The potential adoption of integrated reporting by public sector entities and improved reporting of service performance information could lead to greater expectations being placed on Auditors General to provide assurance over non-financial reporting. Where Auditors General are given the mandate, providing assurance over non-financial reporting information adds further value for the parliament by enhancing the credibility, accountability and transparency associated with reported public sector performance results.

The impact of new technology on audits is still emerging. New technology offers the promise that audit could move away from the sampling of transactions and instead look at most or all of them. Data analytics, which has been an audit technique in various forms for many years, could be more widely applied to identify trends or anomalies and flag areas for further investigations and study. The use of such technology could "free" auditors up from the more mechanical aspects of audit and enable them to focus on the anomalies and issues, applying due professional scepticism and judgement to identify any matters of concern. That said, this may introduce additional cost and a new audit expectation gap - creating a greater expectation that auditors will now identify all anomalies given that we can audit the full population rather than a sample.

Terms of Reference 7: the role and effectiveness of audit in detecting and reporting fraud and misconduct
There is an audit expectation gap in both the private and public sector arising from the perception that a financial statements audit should detect fraud occurring within an entity.

As noted in the UK Independent Review into the Quality and Effectiveness of Audit, fraud is a broad legal concept and the auditor does not make legal determinations as to whether or not fraud has occurred. The *Corporations Act 2001* makes no explicit reference to any responsibility of the auditor with respect to fraud.

There is a perception that a financial statements audit should detect fraud occurring within an entity. It is the responsibility of the audited entity to design and implement controls to prevent and detect fraud. The auditor has a responsibility to understand those controls however cannot realistically obtain assurance that fraud has not been committed either against an audited entity or within the audited entity. The Australian Auditing Standards acknowledge it is not specifically the auditor's role to detect fraud and misconduct. ASA 240 requires the auditor "*to identify the risk of material misstatement due to fraud*". Furthermore, there are obligations on the auditor to report fraud and misconduct if detected under various pieces of legislation including anti-corruption legislation operating within jurisdictions.

There is, and has been for some time, an expectation gap in relation to the responsibilities of the auditor in this regard. It is likely this expectation gap will remain irrespective of work done to raise awareness of the auditor's and management's responsibilities. It is not reasonable to expect the financial audit process to identify all fraud and error, nor even material fraud where the fraud is complex and involves a number of parties acting in collusion.

In conclusion, all Australian audit offices are committed to their role of enhancing public sector financial management, performance and accountability, and achieving their purpose by being entities that are independent and responsive and provide value added audit services to the parliaments they serve.

ACAG appreciates the opportunity to provide a submission and trusts the insights are useful. Should you require any further information, please do not hesitate to contact our Executive Director, Rachel Portelli on 0418 179 714 or at rachel.portelli@acag.org.au

Yours sincerely

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