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To:

The Director
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Submission: Regulation of accounting, auditing and consulting firms in Australia

This submission has been prepared by Professors Peter Carey and George Tanewski, who are both accounting academics employed in the Department of Accounting, Deakin Business School, Deakin University, Victoria. Professor Carey specialises in reporting and auditing research, with a focus on audit markets and audit quality. Professor Tanewski's research specialises in disclosure matters related to financial reporting and corporate governance with a focus on private companies and the SME sector. He is also director and research leader in the IPA-Deakin SME Research Centre.

It is a pleasure to take this opportunity to provide a contribution on the regulation of accounting, auditing, and consulting firms in Australia. Our submission is primarily focused on addressing questions 11 to 15, that is, questions related to the ***Enforcement and Standard Setting*** dimension of the consultation questions under consideration. We firmly believe that the only way to achieve a high standard of audit quality in Australia is to have strong enforcement and meaningful standard setting. While policy responses around 'Governance', 'Professional standards, regulations and laws', and 'Transparency, public information and reporting' (i.e., questions 1- 10) may positively influence audit quality, their impact dwindles against the importance of ***Enforcement and Standard Setting.*** We believe that the fundamental threats to audit quality in Australia currently are:

1. Lack of 'real' enforcement (i.e., current enforcement lacks 'strong teeth'), and
2. Lack of values and principles (i.e., poor audit culture) in audit firms which is unlikely to be corrected without appropriate regulatory oversight.

In previous submissions we made to the Parliamentary Inquiry into the 'Regulation of accounting, auditing and consulting firms in Australia, in August 2023, January 2024 and in February 2024, we raised concerns about audit culture and recommended that the distorted revenue-driven compensation culture should be altered in audit firms by introducing alternative compensation schemes and via appropriate training. Our previous recommendation still stands, and in this submission, we argue that it is precisely because of poor culture that audit firms are now faced with allegations of misconduct. Indeed, as Jenkins et al. (2008) point out in their synthesis of audit culture: "The Sarbanes-Oxley Act of 2002 (SOX) and the demise of Arthur Andersen LLP serve as reminders of the consequences of fostering a culture that values revenue generation over quality service" (p. 46). Furthermore, as part of its investigations into audit culture in the US in 2000, the Public Company Accounting Oversight Board's (PCAOB) Panel on Audit Effectiveness observed that audit senior and manager focus group participants frequently indicated that ''engagement partners and firm leaders treat the audit negatively—as a commodity'' (POB 2000, 99).

We believe it is precisely this 'commodity-based' value that has permeated the cultures of big accounting firms, leading them from delivering professional services in a professional manner, to emphasising growing revenues and profitability to the extent that firms overemphasize profitability to the detriment of quality. As Zeff (2003) noted in his article on the evolution of the accounting profession in the US, the profession's excessive emphasis on profitability and competition has caused partners in large accounting firms to lose their focus on audit quality. Research into corporate culture and employee satisfaction has long recognized that employee satisfaction can be an outcome of a firm's organizational culture (e.g., Lund, 2003). Carey et al. (2024) recently investigated the relationship between audit staff satisfaction and audit quality in the private (unlisted) company client setting. Consistent with social psychology theory that staff satisfaction leads to enhanced employee motivation and performance, Carey et al. found audit staff satisfaction in the private client setting is positively and significantly associated with audit quality when measured using discretionary accruals, abnormal working capital accruals and tax aggressiveness. The researchers also found the relationship between employee satisfaction and audit quality in the private client setting is more pronounced in the case of non-Big4 audits. This is consistent with the notion that Big-4 audit

quality is more influenced by external factors such as reputational pressure than internal staff satisfaction. Carey et al. (2024) demonstrate that under conditions of greater pressure on auditors to compromise audit quality (higher levels of NAS and longer auditor tenure), audit staff satisfaction moderates the potential negative effects on audit quality of NAS and auditor tenure in the private client setting. Hence, audit firms need to urgently change the current distorted revenue-driven compensation culture by introducing alternative arrangements that are focussed on audit employee satisfaction and well-being and on audit quality. An important element to enhancing firm culture is to focus on enhancing staff satisfaction and employee well-being. There is evidence (see Elizabeth Broderick & Co. 2023 independent review into workplace culture at EY Oceania) that auditors work hours are well above the average and that audit employee satisfaction is low.

Professional services firms, including Big 4 audit firms such as KPMG, EY, PwC and Deloittes and many non-Big 4 audit firms, are experts in internal control systems and corporate governance. We firmly believe that by initiating changes to corporate legal structures such as partnership versus corporate structure, or firm governance, or control processes is unlikely to make a significant difference to audit quality. We believe that the overriding issue and concern is audit firm culture and its effect on audit quality. As stated in our previous submissions and related reports, an audit firm culture that primarily focuses on profits and growth can detrimentally work against high quality auditing. So, how does Treasury shift the focus from the myopic profit orientation to greater professionalism? Treasury cannot change an audit firm's internal key performance indicators! However, a dedicated regulator similar to the US's Public Company Accounting Oversight Board (PCAOB) can work closely with audit firms to strengthen audit culture through training and monitoring, to help move audit firms' internal systems away from a focus on profits first towards professionalism and high audit quality. We believe that this has the potential to enhance audit quality in Australia and hence we provide the following recommendations:

Recommendation 1 - To enhance the external monitoring and oversight of auditors and audit firms, Treasury cannot rely solely on market mechanisms to deliver high quality audits and create a strong auditor culture of integrity and independence. To date ASIC has demonstrated that it cannot be relied on as a regulator to enhance audit quality largely because of its overly

legalistic approach to regulation which does not adequately consider the importance of professionalism and professional judgement. An oversight body that is staffed by appropriately qualified accountants and auditors, not lawyers, should be created. External monitoring and oversight should be significantly strengthened. Strong financial penalties and possibly even stronger criminal sanctions should be vigorously enforced on auditor leaders and audit firms for poor cultural outcomes, and this would likely spur positive change in the audit industry. Moreover, a well-resourced regulator that works independently and externally to ASIC and is funded by ASIC's current levies on the business community, would likely enhance audit quality, as it has done so successfully in the USA since the establishment of the PCAOB in 2002. Hence, we strongly recommend the creation of a specialist regulatory body following the model successfully adopted in the USA, that is, creation of a Public Company Accounting Oversight Board, similar to the PCAOB body under the Sarbanes-Oxley Act of 2002 (SOX). Supporting our recommendation is consensus from recent research that investigates the influence of the PCAOB on audit quality. This recent research shows that the PCAOB has greatly enhanced audit quality in the USA (see literature review on PCOAB's positive impact on audit quality in **Appendix A**).

The PCAOB is a private-sector not-for-profit corporation created to oversee and monitor accounting professionals who provide independent audit reports. Following the USA, the Australian PCAOB's responsibilities would include:

a. registering public accounting firms.
b. establishing audit, quality control, ethics, independence, and other standards relating to audits of public company audits. Overseeing audit firm culture.
c. conducting inspections, investigations, and disciplinary proceedings of registered accounting firms, and
d. enforcing compliance with the Corporations Act.

Recommendation 2 - An important element of the US's Sarbanes-Oxley Act of 2002 (SOX) is section 404, which requires external auditors to report on the accuracy of the company management's assertion that the internal controls in place on financial reporting are operational and effective. The evidence presented within the Parliamentary Joint Committee

on Corporations and Financial Services – Interim Report (2020) suggests that this policy clearly enhances overall audit quality in the USA, and we believe it would similarly enhance audit quality in Australia. While this policy was initially heavily criticised in the USA because of concerns about its likely cost, criticism has largely vanished in the past decade because the market has realised the system is working well as evidenced by the current absence of widespread audit failures such as the collapse of Worldcom, Enron, Waste Management etc., which dominated the headlines in the early 2000s. It appears that the benefits of mandating internal control reviews under SOX404 outweigh the costs in the USA. Accordingly, Treasury should consider following this policy and require external auditors to report on internal controls over financial reporting following SOX 404 in the USA.

Recommendation 3- Key to audit quality is to embed a culture of professionalism and high ethical standards via good leadership. Audit firm's leadership needs to embed the following mechanisms into the audit firm's culture and systems to ensure high quality auditing:

1. appropriate incentives/rewards for its auditors, and
2. adequate training via coaching and mentoring and resourcing for auditors.

While these mechanisms are largely market-based and self-regulated by audit firms, we recommend that Treasury establish a regulatory oversight body following the US model of a Public Company Accounting Oversight Board's-type organisation to target and develop industry-wide indicators that relate to organisational culture and leadership, such as reduced working hours, leadership behaviours, cultures that prioritise staff wellbeing, organisational processes & systems, etc., and sets a timeframe for achievement of these targets. More importantly, the regulator should work closely with experts in these target areas to publish a range of practical strategies, initiatives and guidelines aimed at reducing long work hours and overwork in the industry. Further, parliament could identify and remove regulatory/legislative barriers that contribute to auditors' overwork, for example, by extending the lodgement date for private entities by 30 days (or 60 days) to reduce time pressure on the profession.

Recommendation 4 - Treasury should not "blanket ban" all consultancy services but instead ban only those services that risk damaging audit firm culture and audit quality, and this recommendation was based on a cost benefit analysis. We believe that the cost of banning

all services will outweigh the benefit, whereas a selective ban on incompatible services such as tax planning services, will likely achieve a benefit in excess of the cost. A blanket ban on all non-audit services could create significant costs to the audit firm, because some audit services work hand in hand with the audit function and are good for audit quality (i.e., they have positive knowledge spillovers), whereas others (e.g., tax planning services) are not. We have long been concerned about services such as tax planning which often involve finding 'creative' ways of getting around the rules, and this certainly does not sit well culturally with conducting an 'independent' audit. Similarly, consulting on remuneration and recruitment provides opportunities for a loss to the auditors' independence and objectivity. Consulting on business strategy also might blur the line between client and auditor. In contrast, consulting that is focused on enhancing the quality of corporate reporting, or the quality of a client's information systems, work well with audit and is clearly consistent with the objectives of external auditing. The rationale here is that such services not only provide benefits to the client, but they include strengthening the external auditors understanding of their client's business and systems, which is essential for enhancing high-quality auditing. The most obvious example of a consulting service supporting the goal of external auditing is the provision of internal audit services. Internal audits, which evaluate the audit client's internal controls, including corporate governance and accounting processes, allow the auditor to enhance their overall understanding of the client's business.

This recommendation is informed by recent research that Carey et al (2024) published in the highly ranked *European Accounting Review,* which finds the negative impact of non-audit services on audit quality on a sample of German companies is only observed when staff satisfaction is low. Findings are interpreted as suggesting that when there is a poor audit firm culture (as reflected by staff satisfaction), non-audit services can negatively influence audit quality. Banning NAS is not an appropriate policy choice because it does not get to the core of the problem. The core issue that regulators should focus on is the management of audit firm culture. Hence our reticence to comment on questions 1-10, which we believe will have only a superficial effect, at best, on audit quality.

In support of our recommendations, we now provide (see page 7) a snapshot literature review on the PCOAB's positive impact on audit quality. While the research literature on the PCAOB's

impact on audit quality is extensive, we only provide a snapshot literature review from highly ranked journals.

Appendix A – Research-based snapshot literature review on the PCAOB's positive impact on audit quality

The Sarbanes-Oxley Act of 2002 (SOX) created the Public Company Accounting Oversight Board (PCAOB) in the US and assigned it responsibility to regulate all auditors of US-listed companies and auditors with a "substantial role" in the audit of a US SEC registrant. It came into existence in 2003 to oversee the work product of firms auditing public companies. The PCAOB is charged with the following responsibilities:

(1) The conduct of inspections of registered public accounting firms to assess compliance with laws, rules, and professional standards.

(2) The issue of guidance and rules to enhance the quality and transparency of audits,

(3) To enforce compliance with laws, rules, and professional standards through disciplinary proceedings,

(4) To develop and maintain an active international program to promote cooperation and coordination with foreign securities regulators and accounting standard setters,

(5) To conduct research to improve the effectiveness of the audit process and promote investor protection,

(6) address various emerging risks to the integrity of the financial reporting process.

The PCAOB is funded through support fees paid by companies that must be audited by PCAOB-registered auditors. Its fundamental purpose is to improve auditor quality. While the auditing profession in the US has been harshly critical of the inspection program, claiming that it is largely ineffective, and the early academic literature on the PCAOB generally found little evidence that inspections improved the quality of U.S. audits, more recent literature (see below), which uses more sophisticated research designs to address endogeneity concerns, is finding evidence that the PCAOB is indeed having a positive impact on audit quality.

1. **Lamoreaux, P.T. (2016). Does PCAOB inspection access improve audit quality? An examination of foreign firms listed in the United States, Journal of Accounting & Economics, 61, 313-337.**

To gain insight into the PCAOB's auditor inspection program, Lamoreaux examines the association between the PCAOB's access to inspect auditors of foreign SEC registrants and audit quality. Lamoreaux finds that auditors subject to PCAOB inspection access provide higher quality audits as measured by more going concern opinions, more reported material weaknesses, and less earnings management, compared to auditors who are not subject to

PCAOB inspection access. Results are consistent with PCAOB inspection access being positively associated with audit quality.

2. **Defond, M.L. and Lennox, C.S. (2017). Do PCAOB inspections improve the quality of internal control audits? Journal of Accounting Research, 55, 591-627.**

Defond and Lennox investigate whether PCAOB inspections affect the quality of internal control audits. Their research design improves on prior studies by exploiting both cross-sectional and time-series variation in the content of PCAOB inspection reports, while also controlling for audit firm and year fixed effects, effectively achieving a difference-in-differences research design. Defond and Lennox find that when PCAOB inspectors report higher rates of deficiencies in internal control audits, auditors respond by increasing the issuance of adverse internal control opinions. They also find that auditors issue more adverse internal control opinions to clients with concurrent misstatements, who thus genuinely warrant adverse opinions. Defond and Lennox further find that higher inspection deficiency rates lead to higher audit fees, consistent with PCAOB inspections prompting auditors to undertake costly remediation efforts. Taken together, Defond and Lennox's results are consistent with the PCAOB inspections improving the quality of internal control audits.

3. **Shroff, N. (2015). Real Effects of Financial Reporting Quality and Credibility: Evidence from the PCAOB Regulatory Regime. Massachusetts Institute of Technology working paper.**

Shroff examines whether financial reporting quality and credibility affect a company's financing and investing behavior. Shroff uses PCAOB inspections of non-U.S. auditors as exogenous shocks to the reporting quality of non-U.S. companies audited by PCAOB inspected auditors. He then uses the subsequent public revelation of the inspection as exogenous shocks to the reporting credibility of non-U.S. companies that employ PCAOB inspected auditors. Using a difference-in-differences research design, Shroff finds that although PCAOB inspections improve accrual quality for non-U.S. companies audited by the inspected auditors, there is no evidence that these improvements in accrual quality lead to changes in investment, investment efficiency or debt financing. However, when PCAOB inspection reports are subsequently made public, non-U.S. companies audited by inspected auditors increase their long-term debt (investment) by 11.5% (10.9%) and become more responsive to their investment opportunities. These effects are stronger for financially constrained companies and companies with non-big four auditors. Overall, the evidence in Shroff's paper suggests that regulatory oversight of the auditor helps improve reporting credibility, which in turn facilitates corporate investment by increasing companies' external financing capacity.

4. **KHURANA, I.K., LUNDSTROM, N.G., RAMAN, K. K. (2021). PCAOB Inspections and the Differential Audit Quality Effect for Big 4 and Non–Big 4 US Auditors. Contemporary Accounting Research, 38(1), 376-411.**

Khurana et al. investigate whether the increase in regulatory scrutiny epitomized by the initial PCAOB inspection impacted audit quality differentially for Big 4 and non–Big 4

auditors to better understand the consequences of PCAOB inspections for different audit firm types. Because of competing views on the effect of PCAOB inspections, the relation between PCAOB inspections and the audit quality differential between Big 4 and other auditors is an empirical issue. Empirically, Khurana et al. take the endogenous choice of auditor as a given and utilize a difference-in-differences specification that takes into account the staggered timing of the initial PCAOB inspection for different-sized auditors in the United States. Results suggest that the initial PCAOB inspection improved audit quality more for Big 4 auditors than for other annually inspected or triennially inspected non–Big 4 auditors. Khurana et al. also examine annually and triennially inspected non–Big 4 auditors separately, and find that the pre-post Big 4/non–Big 4 differential audit quality effect is more pronounced for the triennially inspected non–Big 4 firms. In the larger context of the highly concentrated US audit market, Khurana et al.'s findings that PCAOB inspections accentuate the Big 4/non–Big 4 audit quality differential are of potential interest to public company audit clients contemplating an auditor change, investors interested in learning about the consequences of PCAOB inspections, regulators concerned about the Big 4 dominance of the US audit market, and academics investigating audit quality differences.

5. **Carcello, J.V, Hollingsworth, C., Mastrolia, S.A. (2011). The effect of PCAOB inspections on Big 4 audit quality. Research in Accounting Regulation, 23, 85-96.**

Carcello et al. examine whether the PCAOB inspection process results in an improvement in the quality of audits provided by Big 4 firms. They measure audit quality by examining changes in auditee abnormal accruals following each of the first two PCAOB inspections. Carcello et al. find a significant reduction in abnormal accruals in the year following the first PCAOB inspection, and they find a further reduction in abnormal accruals in the year following the second PCAOB inspection. These results are generally stronger for auditees that reported positive abnormal accruals before the initial PCAOB inspection. Carcello et al.'s results provide preliminary evidence that the PCAOB inspection process has led to improved audit quality, at least as measured by a reduction in auditee earnings management.

6. **Ahmed, A.S., Al-Dah, B., El-Helaly, M., & Fleszar, K. (2024). Related Party Transactions and Audit Quality: Evidence on the Efficacy of Auditing Standard No. 18. Auditing: A Journal of Practice and Theory, 43(1), 1-25.**

Ahmed et al. provide evidence on the efficacy of Auditing Standard No. 18 (AS18) for auditing-related party transactions (RPTs) that was issued by the PCAOB in 2014. The authors measure audit quality using general restatements and RPT-related restatements. Using a sample of S&P 1500 firms from 2011 through 2018, Ahmed et al. find that RPT firms are significantly less likely to report a general restatement compared with non-RPT firms after AS18. The authors also classify RPTs into business RPTs and nonbusiness RPTs based on the type of transactions and the transacting party. Ahmed et al. find that business RPT firms are (1) less likely to have general restatements after AS18 relative to non-RPT firms and (2) less likely to have RPT- related restatements relative to nonbusiness RPT firms. AS18 does not have any effects on nonbusiness RPTs. The authors' results are driven by S&P MidCap

400 and S&P SmallCap 600 firms. Overall, Ahmed et al's findings suggest that AS18 has enhanced the quality of business RPT auditing.

7. **Ahlawat, S. & Fitzgerald, L. (2023). A review of the second decade of the PCAOB at work. Journal of Business and Accounting, 16(1),**

Ahlawat et al. review PCAOB inspections and enforcement actions for eight firms (Big-4 and four second-tier firms) from 2009-2020 to assess the level of regulatory oversight and whether the scrutiny seen in the early years is maintained. Since the Big-4 firms manage over 78% of all U.S. public audits, the two-tier sample is adequate. Ahlawat et al's analysis revealed a gradual decrease in the percentage of audits showing deficiencies, the severity of deficiencies, the number of firms that fail to address quality control criticisms satisfactorily, and the extent of enforcement actions. In addition, Ahlawat et al. identified common weaknesses related to the same recurring auditing standards and noticed a downward trend in the frequency of occurrence. The downward trend suggests an improvement in audit quality over time.

We look forward to discussing further our recommendations with Treasury. Please address all enquires to Professor George Tanewski. Department of Accounting, Deakin Business School, 221 Burwood Highway, Burwood 3125, Victoria. Email: g.tanewski@deakin.edu.au

Yours sincerely

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