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**AN ANALYSIS OF THE INCONSISTENCIES REGARDING THE CO-  
REGULATORY ENVIRONMENT FOR REGISTERED COMPANY  
AUDITORS IN AUSTRALIA**

Dr Max Bessell, Dr Lisa Powell and Grant Richardson\*

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# AN ANALYSIS OF THE INCONSISTENCIES REGARDING THE CO-REGULATORY ENVIRONMENT FOR REGISTERED COMPANY AUDITORS IN AUSTRALIA

**ABSTRACT:** This paper examines the inconsistencies regarding the co-regulatory environment for registered company auditors in Australia with particular reference to two regulator groups: (1) the Australian Securities and Investments Commission (ASIC); and (2) the professional accounting bodies. Francis framework for quality audits is used as a basis to analyse this co-regulatory environment. This paper finds that this environment is inconsistent in terms of: the selection bias of the ASIC inspection program; access to client engagement documentation; interaction between professional accounting bodies and ASIC; non-*Corporations Act* audits and legal enforceability; differences in ASIC inspections vs. quality reviews; and, auditor option choice and stakeholder protection. Hence, there are registered company auditors (RCAs) who may be negligent (either intentionally or unintentionally) and have little possibility of being detected or if detected, may not be subject to legislative sanctioning.

## I. INTRODUCTION

Auditing plays an important role in many countries, including Australia, by providing a level of confidence for users of financial information through the independent verification of financial reports prepared by entities.<sup>1</sup> This applies to entities in capital markets, local governments, not-for-profit organisations (i.e. national and regional community-based entities such as charities, sporting clubs, environmental groups, religious institutions and community interest organisations), professional associations (e.g. accounting, medical and engineering bodies), non-government schools and many others.<sup>2</sup> It is not unreasonable to expect that users of financial reports require the level of confidence surrounding those reports to be as high as possible and this occurs when audit quality is present.<sup>3</sup>

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<sup>1</sup> See Paul M Healy and Krishna G Palepu, 'Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical literature' (2001) 31 *Journal of Accounting and Economics* 405, 406 where the level of confidence is discussed. Also, Alice Belcher, 'Audit quality and the market for audits: an analysis of recent UK regulatory policies' (2006) 18(1) *Bond Law Review* 1 refers to the confidence that investors seek from auditors. Further note that the purpose of an audit is to 'enhance the degree of confidence of intended users in the financial report.' The relevant auditing standards are Auditing and Assurance Standards Board, *Forming an Opinion and Reporting on a Financial Report*, ASA 700, 1 December 2015; Auditing and Assurance Standards Board, *Communicating Key Audit Matters in the Independent Auditor's Report*, ASA 701, 1 December 2015; Auditing and Assurance Standards Board, *Modifications to the Opinion in the Independent Auditor's Report*, ASA 705, 1 December 2015; and Auditing and Assurance Standards Board, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, ASA 706, 1 December 2015.

<sup>2</sup> These are in addition to the audits conducted by the various Auditors-General throughout the Australian jurisdictions (e.g. government departments, public hospitals and in some states universities).

<sup>3</sup> Paul J. Coram, Theodore J. Mock, Jerry L. Turner and Glen L. Gray, 'The Communicative Value of the Auditor's Report' (2011) 58(2) *Australian Accounting Review* 235-252, 237.

Francis<sup>4</sup> provides a rigorous framework for understanding audit quality<sup>5</sup> from the supply side perspective.<sup>6</sup> Key factors in the framework include a country's legal system, the regulation of auditors and the institutions responsible for the oversight and administration of that regulation. But '[w]e have barely scratched the surface in our understanding of the role of institutions, and this is a very important direction for future archival research on audit quality.'<sup>7</sup> Francis argues that the incentives for auditors to produce high quality audits are affected by the design of regulations, the regulators, and the sanctions that punish misconduct and low quality audits.<sup>8</sup> Hence, critical to the Francis framework is an effective regulatory environment.

Regulation can be defined as 'a sustained and focused control exercised by a public agency over activities valued by a community'.<sup>9</sup> There are many reasons why regulation is important.<sup>10</sup> One is that capital markets can only operate properly if users of financial information<sup>11</sup> are sufficiently informed. Regulation makes 'information more extensively accessible, accurate and affordable, may protect consumers against

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<sup>4</sup> Jere R Francis, 'A Framework for Understanding and Researching Audit Quality' (2011) 30(2) *Auditing: A Journal of Practice & Theory* 125.

<sup>5</sup> Audit quality can mean different things to different stakeholders, see Steve G Sutton, 'Toward an Understanding of the Factors Affecting the Quality of the Audit Process' (1993) 24 *Decision Sciences*, 88. Audit quality is assumed to occur when there is no audit failure. Audit failure occurs where the auditor has not enforced the use of accounting standards by the client or when the audit report does not identify a material error. The result is that users of the financial information may be misled. See Jere R Francis, 'What we know about audit quality' (2004) 36 *The British Accounting Review* 345. Audit quality is also largely not observable since most of what occurs in the audit process is not available to stakeholders. See Gary Colbert and Dennis Murray, 'State Accountancy Regulations, Audit Size, and Audit Quality: An Empirical Investigation' (1999) 16 *Journal of Regulatory Economics* 267.

<sup>6</sup> Francis's n4 125 paper identifies that audit quality can be viewed as arising from a supply side (which is dealt with in this paper) and a demand side. Among other things, the demand side deals with agency and signalling theories.

<sup>7</sup> Francis, n 4, 142.

<sup>8</sup> Francis, n 4, 126.

<sup>9</sup> P Selznick, 'Focusing Organizational Research on Regulation' in R. Noll (ed), (1985) *Regulatory Policy and the Social Sciences* 363 quoted in A. I. Ogus, *Regulation Legal Form and Economic Theory* (Clarendon Press, 1994).

<sup>10</sup> See the following for discussion of the various rationales; Cass R. Sunstein (1990) *The Functions of Regulatory Statutes* in Anthony I. Ogus (ed), *Regulation, Economics and the Law* (Edward Elgar Publishing Limited, 2001) 3-34; Roger G. Noll (1989) *Economic Perspectives on the Politics of Regulation* in Anthony I Ogus, *Regulation, Economics and the Law* (Edward Elgar Publishing Limited, 2001); Robert Baldwin and Martin Cave (1999) *Understanding Regulation Theory, Strategy and Practice* Oxford University Press, 9-16.

<sup>11</sup> Users are those parties who rely on information presented in the financial reports to make decisions about providing resources to an entity and include existing and potential, lenders, and other creditors. See Australian Accounting Standards Board, *Framework for the Preparation and Presentation of Financial Statements*, Framework, 2016, para OB2.

information inadequacies and the consequences thereof and should encourage the operation of healthy, competitive markets.’<sup>12</sup>

In the context of this paper, information is provided to ‘consumers’ (i.e. users) in the form of financial reports<sup>13</sup> and the role of regulation is to add confidence to those reports through the audit regime. It follows then that if the regulatory environment is inconsistent, or if the regulators are not empowered to properly regulate or if the path to sanctions is frustrated then there is the potential for some auditors not to produce high quality audits. Our paper examines the co-regulatory environment in Australia for registered company auditors (RCAs) and its compliance with the Francis framework.

The auditing profession<sup>14</sup> in Australia operates in a co-regulatory<sup>15</sup> environment which includes oversight functions that are driven by government regulation and the policies of professional accounting bodies. An analysis of this environment reveals inconsistent oversight of auditors, uncertainty in relation to the powers of the regulator, and insufficient powers of professional accounting bodies to properly regulate. The implications are that audit failure<sup>16</sup> may be occurring, or could occur, and that the failure may not be detected, or if detected that auditors may possibly avoid sanctions. This paper therefore suggests that the present co-regulatory environment in Australia raises serious questions as to whether it meets the requirements of the Francis framework.

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<sup>12</sup> Martin Cave and Martin Lodge (2012) *Understanding Regulation Theory, Strategy and Practice* by Robert Baldwin, Martin Cave and Martin Lodge, Oxford University Press 19.

<sup>13</sup> For consistency the term ‘financial reports’ is used in this paper. Readers might also find the term ‘financial statements’ in other circumstances. The two terms are interchangeable and generally incorporate a Statement of Profit or Loss and Other Comprehensive Income, Statement of Changes of Equity, Statement of Financial Position (often referred to as the Balance Sheet), Statement of Cash Flows and supporting Notes: Australian Accounting Standards Board, *Presentation of Financial Statements*, AASB 101, 20 June 2012, para 10.

<sup>14</sup> While auditors do not presently have a dedicated professional body in Australia and may be seen as a sub-group of the accounting profession, it is still appropriate to regard them as professionals of the auditing profession. See Sylvia R Cruess, Sharon Johnston and Richard L Cruess, ‘“Profession”: A Working Definition for Medical Educators’ (2004) 16 *Teaching and Learning in Medicine: An International Journal* 74, 75. See also Ruth D Hines, ‘Financial Accounting Knowledge, Conceptual Framework Projects and the Social Construction of the Accounting Profession’ (1989) 2(2) *Accounting, Auditing & Accountability Journal* 72 where she refers to different aspects which make up a profession.

<sup>15</sup> The Institute of Chartered Accountants, *Quality Review Report 2014* (September 2014), 5 <[http://www.charteredaccountants.com.au/~media/Files/The%20Institute/Annual%20reports/2014/0714-68%20CC%20Quality%20Review%20Report\\_WEB\\_FA.ashx](http://www.charteredaccountants.com.au/~media/Files/The%20Institute/Annual%20reports/2014/0714-68%20CC%20Quality%20Review%20Report_WEB_FA.ashx)>.

<sup>16</sup> Audit failure occurs when the audit opinion is unqualified, but there is a material misstatement in the financial reports. Kathryn Kadous, ‘The Effects of Audit Quality and Consequence Severity on Juror Evaluations of Auditor Responsibility for Plaintiff Losses’ (2000) 75 *The Accounting Review* 327.

The remainder of this paper is organised as follows. Section II provides the background for understanding audit in terms of the Francis framework. Section III considers who audits in Australia? Section IV examines the co-regulatory environment for auditor oversight. Section V reports on the inconsistencies of the co-regulatory environment. Section VI provides several potential options to address the concerns. Section VII concludes the paper.

## II. UNDERSTANDING AUDIT IN TERMS OF THE FRANCIS FRAMEWORK

The application of the Francis framework for the production of high quality audits assumes knowledge of auditing. However, the literature indicates that auditing can be misunderstood<sup>17</sup> and therefore, clarification of the purpose of auditing and the role of auditors in the Australian context may well be fruitful. Many people understand an audit to be the regular verification of an entity's financial reports. The outcome of the verification process is communicated to users through an audit report which conveys the auditor's opinion concerning whether the financial reports are true and fair<sup>18</sup> and assists users' in their decisions.<sup>19</sup> Although the vast majority of audit reports are unmodified (i.e. the financial reports are deemed to be true and fair), there is capacity for the auditor to comment on areas of concern.<sup>20</sup> The practices and procedures of auditing can be viewed from two perspectives: (1) the demand side; and (2) the supply side. The demand side is driven by users' requirements for audit quality,<sup>21</sup> but is outside the scope of this paper.

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<sup>17</sup> See, for example, Brenda Porter, 'An Empirical Study of the Audit Expectation-Performance Gap' (1993) 24(2) *Accounting and Business Research* 49-68.

<sup>18</sup> *Corporations Act* s297 and s307(a)(ii) and Stephen Kwaku Asare and Arnold M. Wright, 'Investors', Auditors', and Lenders' Understanding of the Message Conveyed by the Standard Audit Reports on the Financial Statements' (2012) 26(2) *Accounting Horizons* 193-217, 196.

<sup>19</sup> Asare and Wright, n 18 196.

<sup>20</sup> Auditing and Assurance Standards Board, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, ASA 200, 1 December 2015, para 3 ('Overall Objectives').

<sup>21</sup> The demand side incorporates agency theory, where auditors are used by investors to monitor the activities of management, (Brian T. Pentland, 'Getting Comfortable with the Numbers: Auditing and the Micro-Production of Macro-Order', (1993) 18 *Accounting, Organizations and Society*, 605, 606) reduce information asymmetry thus minimise the cost of capital, and to detect expropriations (D. Paul Newman, Evelyn R. Patterson and J. Reed Smith, 'The Role of Auditing in Investor Protection' (2005) 80 *The Accounting Review* 289, 290, 303).

The Francis framework relates to the ‘supply side’ for audit quality. He prescribes six input elements into this framework: (1) audit inputs; (2) audit processes; (3) accounting firms; (4) audit industry and audit markets; (5) economic consequences of audit outcomes; and (6) institutions (or institutional settings). Of particular interest in this paper are the institutions which:

“... Refers to the legal system in a country that determines an auditor’s legal responsibilities, as well as the broad set of institutions that regulate accounting and auditing practices and, therefore, create incentives for both individuals and accounting firms.”<sup>22</sup>

Francis’s institutional setting can be synthesised into the following three components: (1) the governance structures used by entities to strategize and oversee their operations; (2) the laws dealing with auditors; and (3) the bodies responsible for regulating auditors. Governance structures within organisations (e.g. the board of directors) are linked to audit quality through the oversight and monitoring of external auditors.<sup>23</sup> There is a further overlay for those organisations which also have audit committees.<sup>24</sup> The oversight and monitoring roles of audit committees include negotiation of the auditor engagement, facilitation of the audit process, resolution of areas of concern that are identified by the auditor and management of post-audit issues.

While the governance models and structures are important to Francis’s institutional setting, it is not the focus of this paper. However, the laws dealing with auditors and the bodies responsible for regulating auditors are of specific interest. Direct links have been made between the legal environment and the incentives and behaviours of auditors.<sup>25</sup> It has been shown that where UK companies access US markets, auditors charge a premium on their fees to hedge against the greater litigious environment there.<sup>26</sup> In particular, their behaviour changes as a result of the effect of a specific law/regulation. In the US, audit fees grew post the implementation of the *Sarbanes-*

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<sup>22</sup> Francis, n 4, 140.

<sup>23</sup> Jere R. Francis, ‘What do we know about audit quality?’ (2004) 36 *The British Accounting Review*, 357.

<sup>24</sup> Audit Committees are mandatory in Australia for companies included in the S & P All Ordinaries Index at the beginning of its financial year. See ASX Limited Listing Rule 12.7. Other companies do elect to have Audit Committees although not legally required to do so. Other entities also might be required to have Audit Committees. For example, *Local Government Act (SA)* s126 requires local governments to have an audit committee.

<sup>25</sup> Francis above n 23 359.

<sup>26</sup> Ananth Seetharaman, Ferdinand A. Gul and Stephen G. Lynn, ‘Litigation risk and audit fees: evidence from UK firms cross-listed on US markets’ (2002) 33 *Journal of Accounting and Economics* 91.

*Oxley Act*.<sup>27</sup> This Act increased the amount of regulation and introduced a regulator primarily as a result of the Enron collapse. The inference again being that auditors reacted (i.e. behaviour changed) due to increased regulation.<sup>28</sup> Nevertheless, not all research clearly shows that regulation and regulators do matter to auditors.<sup>29</sup> What is clear though is that interventionist regulation and regulators will continue to affect audit quality, and that more research and understanding on this issue is warranted.<sup>30</sup>

Statutory and common law both impact on auditors in Australia. The *Corporations Act*<sup>31</sup> and the *Australian Securities and Investments Commission Act*<sup>32</sup> have a direct effect on auditors. Other statutes can have an indirect impact on auditors. For instance, any deceptive and misleading conduct by auditors may be captured under the *Competition and Consumer Act*.<sup>33</sup> Common law also applies to auditors. Cases primarily dealing with professional negligence and contract law have been determined over many decades and much is available in the literature regarding this.

The regulators for auditors and the auditing process in Australia are the Australian Securities and Investments Commission (ASIC) and the professional accounting bodies. Further, the Francis framework for audit quality includes institutions or institutional settings, and incorporates a regulatory environment which is the legal system in a country. A part of that system includes the monitoring and oversight of auditors. The objective here is that the monitoring and oversight activities need to be effective to provide the incentive for auditors to behave in a manner that produces audit quality.

### III. WHO AUDITS IN AUSTRALIA?

It is evident that Francis's framework for audit quality includes the auditor. After all, it is their behaviour that is being targeted. However, in Australia, identifying the auditor

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<sup>27</sup> *Sarbanes-Oxley Act* 15 USC 7201 (2002).

<sup>28</sup> Alope Ghosh and Robert Pawlewicz, 'The Impact of Regulation on Auditor Fees: Evidence from the Sarbanes-Oxley Act' (2009) 28(2) *Auditing: A Journal of Practice & Theory* 171.

<sup>29</sup> Rafael La Porta, Florencio Lopez De Silanes and Andrei Shleifer, 'What Works in Securities Laws' (2003) Working Paper No. 03-22, Tuck School of Business at Dartmouth

<sup>30</sup> Mark DeFond and Jieying Zhang, 'A review of archival auditing research' (2014) 58 *Journal of Accounting and Economics* 275, 314.

<sup>31</sup> 2001 (Cth) ('*Corporations Act*').

<sup>32</sup> 2001 (Cth) ('*ASIC Act*').

<sup>33</sup> 2010 (Cth).



is not as straight forward as one might expect. In the context of financial report audits, the term ‘auditor’ is specifically used to denote the person who undertakes that audit and signs the audit report.<sup>34</sup> The main auditor designations in Australia in this specific context are registered company auditors (RCAs) and professional accounting body members who act as auditors.

## **Auditor designations**

### *RCAs*

The RCA is the only legislatively established auditor designation in Australia in terms of financial report audits.<sup>35</sup> An RCA is established by the *Corporations Act* and the primary role is to audit the financial reports of companies in Australia.<sup>36</sup> The approval and maintenance (including investigations) of RCAs is managed by the regulator, ASIC.<sup>37</sup> Once approved, any RCA has the legislative authority to audit the largest and most complex companies in Australia.

To be approved as an RCA<sup>38</sup> an applicant must, *inter alia*, demonstrate that they have satisfied the minimum levels of ‘competence and integrity’ to be an auditor.<sup>39</sup>

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<sup>34</sup> Another role of audit relates to assurance engagements, which are essentially non-financial report audits. The term given to a person who conducts an assurance engagement is an ‘assurance practitioner’. An example of an assurance engagement is a compliance audit where that task is to ascertain if an entity has complied with a particular law, regulation, contract or policy. It is fair to say that the term ‘assurance practitioner’ is not widely used in the business world, presumably because the term ‘auditor’ is more colloquial. While the different terminology may be confusing, it does separate out the role of an auditor with respect to financial reports and those of other engagements.

<sup>35</sup> There is another legislative auditor designation being Self-Managed Superannuation Fund (SMSF) auditors. From the 1<sup>st</sup> January 2013 SMSFs must have their accounts audited by an SMSF approved auditor: *Superannuation Industry (Supervision) Act 1993* (Cth) s 35AC (‘*SIS Act*’). SMSF auditors are registered pursuant to s 128D of the *SIS Act*. Part 9A of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) deals with the qualifications, knowledge and experience required for an SMSF auditor to be approved. ASIC is the regulator of SMSF auditors. SMSF audits are quite specific to SMSFs and the skill and knowledge of SMSF auditors relate to SMSFs and are not necessarily fully transferable to the audit of a set of financial reports of other entities. It is fair to say that an RCA has the necessary attributes to audit an SMSF, but it does not necessarily follow that an SMSF auditor has the attributes to audit non-SMSF activities. Consequently, while the SMSF auditor is a legislative auditor designation it is not one relevant to this paper.

<sup>36</sup> RCAs can also operate as audit firms and audit companies: see *Corporations Act* s 324AA for the appointment and s9 for the definitions of audit firm and audit company.

<sup>37</sup> ASIC’s role as the regulator is vital in the Australian financial and investment system. This includes dealing with fraud and incompetence matters which impinge on that system. Suzanne Le Mire, ‘It’s Not Fair!’ The Duty of Fairness and the Corporate Regulator’ (2014) 36 *Sydney Law Review* 445.

<sup>38</sup> All Auditor Generals are recognised as an RCA: *Corporations Act* s 1281.

<sup>39</sup> *Corporations Act* s 1280 and operationalised by Australian Securities and Investments Commission *Regulatory Guide 180: Auditor registration* (2016) 6.

Competence and integrity are determined by evidence of qualifications, skills and the applicant being capable, fit and proper.<sup>40</sup> During the period 1981 to the present, the requirements prescribed by the *Corporations Act* and its antecedents for assessing applicant qualifications and being a capable, fit and proper remained relatively unchanged. However, since 2004, the requirements for the demonstration of minimum skills level for prospective RCA's have become significantly more rigorous.

The passing of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosures) Act* (CLERP9)<sup>41</sup> resulted in changes to the demonstration of practical experience<sup>42</sup> and the introduction of competency standards approved by the ASIC.<sup>43</sup> The impact of these changes means that an individual must now show a more detailed and varied work experience than was previously required by ASIC to determine whether he or she has sufficient skills necessary to meet the requirements of s1280 of the *Corporations Act*. In particular, it is now more onerous than in previous times to become an RCA. Finally, RCAs are required to follow the auditing standards<sup>44</sup> in the conduct of audits and these are promulgated by the Auditing and Assurance Standards Board (AUASB). The AUASB was established under s 277A of the ASIC Act and is permitted to make auditing standards.<sup>45</sup>

#### *Members of professional accounting bodies who act as auditors*

There are three main professional accounting bodies in Australia: (1) Chartered Accountants Australia and New Zealand (CA ANZ); (2) CPA Australia (CPA) and; (3) the Institute of Public Accountants (IPA). The professional accounting bodies principally regulate the accounting profession. There is no specific legislation which controls the profession of accounting and there is nothing inhibiting anyone calling themselves an accountant regardless of whether they have the skill set to do so.<sup>46</sup> This

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<sup>40</sup> See ASIC, n 39, for more detail.

<sup>41</sup> 2004 (Cth).

<sup>42</sup> Prior to 2004, practical experience gained working under the direction of an RCA or as a supervisor was measured in years whereas in 2004 this experience must be specified in hours.

<sup>43</sup> The current arrangements began on 1<sup>st</sup> July 2004.

<sup>44</sup> *Corporations Act* s 307A.

<sup>45</sup> *Corporations Act* s 336.

<sup>46</sup> This has not always been the case. For example in New South Wales the *Public Accountants Registration Act* was passed in 1945 and in Queensland the *Registration of Public Accountants Act* was passed in 1946. These Acts were repealed in 1989 and 1990 respectively.

also applies to the auditing profession and the use of the word ‘auditor’ (except for RCAs)<sup>47</sup> and the legislation which applies thereto.

These professional bodies all have similar structures in their membership provisions, ethical guidelines and disciplinary actions, and they also maintain quality review processes. However, the entry criteria for these bodies are not the same.<sup>48</sup> In particular, to become a chartered accountant, CA ANZ requires auditing as a mandatory course in both the academic entry requirements and their postgraduate program. To become a CPA, CPA Australia requires audit to be undertaken in either the academic entry requirements or their postgraduate program. Finally, IPA do not require auditing in either of their academic entry requirements or their postgraduate programs to become a full member.

Members of the professional accounting bodies can be divided into two main groups: (1) those who are in public practice; and (2) those who are not. To work in public practice a member must hold a public practice certificate issued by the respective professional accounting bodies. In addition, the membership designations of the professional accounting bodies do not recognise a member operating in a specific discipline area (e.g. audit, tax or insolvency). For instance, a chartered accountant who is an RCA is not recognised as an auditor in their relevant membership post-nominals or membership category. Finally, members of all three professional accounting bodies

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<sup>47</sup> It should be noted that the vast majority of RCAs are also members of a professional accounting body.

<sup>48</sup> These are: CAANZ: to become a chartered accountant the most common path is for a person to have completed an accredited accounting undergraduate or master’s degree which must include auditing, completed the Chartered Accountants program operated by CAANZ which includes a module on auditing and assurance and undertaken at least three years full time experience in a relevant accounting role: Chartered Accountants Australia, *Chartered Accountants Program* (1 April 2015) <<http://www.charteredaccountants.com.au/Candidates/The-Chartered-Accountants-Program>>.

CPA Australia: to become a CPA the most common path is for a person to hold a qualification that is at least comparable to an Australian bachelor’s degree, demonstrate completion of foundation exams studies evidence certain accounting knowledge (normally included into the degree), completed the CPA program and undertaken minimum of 36 months fulltime relevant experience. If auditing is not included in the included in the bachelor’s degree then a module on auditing must be completed as a part of the CPA program: CPA Australia, *Types of Membership* <<http://www.cpaustralia.com.au/become-a-cpa/types-of-membership>>.

IPA: to become a member a person normally needs to have an accounting qualification (minimum Diploma of Accounting) and there is no mandatory requirement to do auditing, completed the relevant IPA program (the number of courses depends on the level of accounting qualification above) and there is no mandatory requirement to do auditing, undertaken three years of workplace experience under a mentor who is a senior accountant: Institute of Public Accountants, *Membership Pathways* <<https://www.publicaccountants.org.au/become-a-member/membership-pathways>>.

who undertake an audit are required to follow the auditing standards promulgated by the AUASB,<sup>49</sup> regardless of whether they are auditing a corporate or non-corporate entity.

#### *Requirements for an audit to be conducted*

An audit of an entity is conducted because there is a legislative requirement, a legal requirement (e.g. an agreement), a governance requirement or some voluntary decision to do so. The focus of this paper is on those audits driven by legislation<sup>50</sup> and those undertaken by RCAs. However, some legislation specifies only an RCA, while other legislation specifies either an RCA or a member of a professional accounting body. These two categories are now briefly considered.

#### *RCA only*

RCAs are the designated auditor for *Corporations Act* audits, but there are many other statutes throughout Australia which require an RCA to undertake the audit of an entity. Two examples are provided as follows:

- (1) The *Local Government Act 1999* (SA), the *Local Government Act 1993* (NSW) and the *Local Government Act 2008* (NT) all require their respective local governments to have an annual audit undertaken by an RCA. There are a total of 236 local governments in these jurisdictions. A number of other jurisdictions also have similar provisions for their local governments; and
- (2) The *Australian Charities and Not-for-Profits Commission Act 2012* (Cth) ('*ACNC Act*') requires large charities registered with the Australian Charities and Not-for-Profits Commission to have their annual financial reports audited by an RCA.<sup>51</sup> There were 6,679 large charities registered in the 2013 financial year.<sup>52</sup>

#### *RCA or a member of a professional accounting body*

There are many occasions where legislation provides an option for either an RCA or a member of a professional accounting body to carry out an audit. For example, the *Associations Incorporation Act 1985* (SA) requires 'prescribed associations' to have

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<sup>49</sup> Accounting Professional and Ethical Standards Board, *Conformity with Auditing and Assurance Standards*, APES 210, 2008, para 1.4.

<sup>50</sup> Primarily because that is visible through an examination of legislation. Information on the drivers of other audits is not readily available.

<sup>51</sup> Section 60.30.

<sup>52</sup> Penny Knight and David Gilchrist, *Australian Charities 2013: The First Report on Charities Registered with the Australian Charities and Not-for-profits Commission* (2014) 7.

their financial reports audited by an RCA or a member of CPA Australia or ICAA (now CA ANZ) or<sup>53</sup> another person approved by the Commissioner.<sup>54</sup>

It is also the case that some legislation places other conditions<sup>55</sup> on members of professional accounting bodies, such as certification or demonstration of experience, over and above just being a member. For instance, the *Land Agents Act 1994* (SA) requires members to hold a practising certificate issued by their professional accounting body. If an audit of a community title scheme is undertaken in accordance with the *Body Corporate and Community Management Act 1997* (Qld) the auditor is to be: an RCA or a member of CPA Australia or ICAA (now CA ANZ) or IPA and have a total of two years auditing experience, whether continuous or not.<sup>56</sup>

In addition to the two categories mentioned above, there are many other statutes that require an audit to be conducted, but do not mention an RCA. In some cases, although not exclusively, they refer to a member of a professional accounting body. Whilst these laws do not refer to an RCA, it does not necessarily preclude them, and if they meet the specific criteria then they are able to be the auditor. To understand the variations of demands on RCAs and other auditor designations, a study was undertaken in 2014-15.<sup>57</sup> This entailed an investigation into all statutes (and where necessary regulations) of the Commonwealth and every State and Territory where an audit was stipulated, to understand who the auditors are and their scope. Overall, 137 Acts required an RCA (of which the *Corporations Act* was just one), 81 Acts required an RCA or some other person (which includes a member of a professional accounting body), 222 Acts where no specific qualification was required and 101 unique terms were used to describe who the nominated auditor should or could be. By any measure, the variation in legislative requirements for auditors is significant. Explanations for the variations are speculative, but it is likely that there is confusion with legislators and legislative drafters about auditor designations and what qualifications an auditor needs.

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<sup>53</sup> While this example refers only to members of ICAA (CA ANZ) or CPA members, there are many other Acts which also include members of the IPA.

<sup>54</sup> *Associations Incorporation Act 1985* (SA) s 35(2)(b).

<sup>55</sup> For example the stipulation of a requirement for a practising certificate and/or certain levels of experience.

<sup>56</sup> *Body Corporate and Community Management Act 1997* (Qld) s 150, sch 6 (definition of 'registered company auditor').

<sup>57</sup> Registered Company Auditors Summary of Chartered Accountants ANZ Research, Chartered Accountants Australia and New Zealand, May 2015.

Overall, who audits Australia is not as well-structured and integrated as one might expect. Although RCA services are demanded by the *Corporations Act*, there are many other pieces of legislation which make similar demands. This is further complicated because some legislation also provides choices between an RCA, a member of a professional accounting body or some other alternative.

Francis's framework calls for regulatory monitoring and oversight of auditors as a part of audit quality. Given that the focus of this paper is on RCAs then, again, one might think that it is straight forward. However, it is not. The monitoring and oversight of auditors in Australia (including RCAs) is co-regulatory, between ASIC and the professional accounting bodies, and this is discussed in the next section.

#### **IV. CO-REGULATORY ENVIRONMENT FOR AUDITOR OVERSIGHT**

In Australia, there are two regulators<sup>58</sup> for auditor oversight. First, is ASIC who is responsible for the oversight of RCAs for audits they conduct primarily pursuant to the *Corporations Act*. Second, are the professional accounting bodies<sup>59</sup> who are responsible for audits carried out by their members.<sup>60</sup> These two regulators are now briefly discussed.

##### **ASIC**

ASIC manages the regulatory and disciplinary functions as the regulator for RCAs who conduct audits under the *Corporations Act*. It can also refer disciplinary actions to the Companies Auditors Disciplinary Board (CADB).<sup>61</sup> Part 11 of the *ASIC Act* establishes the CADB and s1292 of the *Corporations Act* provides for its powers with respect to auditors and liquidators. The powers include a range of sanctions from reprimand to

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<sup>58</sup> The term regulator is used in its broadest sense. ASIC is a regulator pursuant to statute, while professional accounting bodies are regulators of their members according to their respective constitutions.

<sup>59</sup> Unless there are specific provisions in legislation which we have not detected.

<sup>60</sup> This can also include RCAs as they are generally a member of one of the professional accounting bodies.

<sup>61</sup> Prior to 1<sup>st</sup> March 2017 this was known as the Companies Auditors and Liquidators Disciplinary Board. ASIC can also impose conditions on registrations or enforceable undertakings.

cancellation of registration, and these have been applied to RCAs from both large and small firms.<sup>62</sup>

The inspection program of RCAs by ASIC began in 2005 as a result of the introduction of CLERP9. The first report for the program concentrated on a series of findings from the inspections, but lacked any advice regarding the purpose of the inspection regime. A media release by ASIC regarding the report was also silent as to the purpose of the regime. While the backdrop for a regulator or ASIC inspection program is apparent (i.e. CLERP9 and preceding corporate collapses), it does not appear that there was a clear purpose for what the inspection program was to cover or intended to achieve. Given this fact, one might wonder how well the program was first strategized and whether it was a case of just doing something in the time after economic turmoil. However, subsequent ASIC communications do provide the objective of the audit inspection program as follows:

*The objective of [the] audit inspection program is to promote high quality external audits of financial reports under Chapter 2M of the Corporations Act and raise the standard of conduct in the auditing profession. This helps to ensure that users can have a greater confidence in financial reports. A strong audit profession helps maintain and promote confidence and integrity in Australia's capital markets.*<sup>63</sup>

The inspections carried out by ASIC primarily cover those RCAs who audit public interest entities which includes public companies (and incorporates listed companies) under the *Corporations Act*.<sup>64</sup> ASIC has legislative access to all files and its inspectors investigate judgments, decisions and opinions that form a part of or lead to the audit opinion. Section 13 of the *ASIC Act* provides ASIC with general powers of investigation which allows it to undertake investigations of RCAs who conduct audits pursuant to the *Corporations Act*.<sup>65</sup> ASIC can also seek from RCAs any 'information or books' that relate to ASIC's functions and powers with respect to the *Corporations*

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<sup>62</sup> See the CADB website for announcements of cases and various sanctions: Companies Auditors Disciplinary Board, Australian Government *CADB Decisions*, <<http://www.cadb.gov.au/decisions/cadb-decisions/>>.

<sup>63</sup> See the ASIC website on Audit inspection and surveillance programs, (11 July 2016), <http://asic.gov.au/regulatory-resources/financial-reporting-and-audit/auditors/audit-inspection-and-surveillance-programs/>.

<sup>64</sup> Australian Securities and Investment Commission, *Audit inspection program report for 2012-13*, Rep 397, 27 June 2014, para 1

<sup>65</sup> *ASIC Act* s 13(a).

*Act*.<sup>66</sup> ASIC conducts regular inspections of a selection of RCAs. Its report for the 18 months ending 31 December 2013 reveals that it inspected all Big 4 firms,<sup>67</sup> four mid-tier firms and nine smaller firms.<sup>68</sup>

There may be a legislative intent under s 13 of the *ASIC Act* for ASIC to have investigative powers for audits conducted by RCAs beyond the *Corporations Act*. Section 13(1)(b)(i) of the *ASIC Act* deals with laws of Australian jurisdictions which concern the management or affairs of a ‘*body corporate*.’ The s 9 definitions of the *Corporations Act* leads to this being a ‘*registrable Australian body*.’ This includes many entities which are required to have an audit under non-*Corporations Act* legislation (e.g. local governments). Given that RCAs also carry out non-*Corporations Act* audits, then one of the effects of s 13(1)(b)(i) may be to provide ASIC with the power to deal with *all* audit activities of RCAs, not only those relating to *Corporations Act* audits. The investigation of a non-*Corporations Act* audits by ASIC though may also implicate non RCA’s. Section 19 of the *Corporations Act* provides ASIC with powers to examine any person when carrying out an investigation.

### **Professional accounting bodies’ quality reviews**

Professional accounting bodies monitor their members in public practice through a quality review process. These reviews are carried out under the auspices of each professional accounting body’s policies and have no legislative support. Every member in public practice is subject to a regular review of their whole practice, at least every five years. While each of the professional accounting bodies have their own objectives for quality reviews the general theme is that they are designed to maintain high standards, protect the reputation and brand of their members, and be in the public interest.<sup>69</sup>

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<sup>66</sup> *ASIC Act* s 30A(2). This also includes the *ACNC Act* and overseas audit requirements. The term used is ‘*Australian auditor*’ and the *ASIC Act* s 5 implies that this relates to RCAs.

<sup>67</sup> The Big 4 is a common term to collectively describe the four large accounting firms. These firms are Deloitte Australia, Ernst & Young, KPMG and Pricewaterhouse Coopers (PwC).

<sup>68</sup> Australian Securities and Investment Commission, n 63, para 162. While ASIC selects firms the underlying principle is that it is the RCAs, be they natural persons, audit firms or audit companies, which are subject to the inspection.

<sup>69</sup> For example, see The Institute of Chartered Accountants in Australia, ‘*Quality Review: past, present and future Getting the balance right*’, (August 2010), 7.



A quality review will frequently include a review of audit activities where a member acts as an auditor. From an audit perspective, it is fair to say that the dominant professional accounting body is CA ANZ. Its quality review program separates members who undertake audits into two main groups. One group contains those who conduct audits requiring an RCA and these members are subject to a quality review every three years. Other members who conduct audits are reviewed every five years.

For those members of the first group who are also subject to ASIC inspections, their quality review tries to avoid duplicating the work done by ASIC. As a result, those reviews often rely on online quantitative surveys to firms' audit staff at all levels. Data gathered are reported back to firms to aid them in improving their systems and dealing with the areas of concern identified. For RCAs not inspected by ASIC and the other group members, they are subject to a visit by a quality reviewer. The reviewer uses information acquired through a questionnaire and the on-site examination to assess compliance with relevant pronouncements.

Quality reviewers though are faced with an impediment regarding access to client files when undertaking a review. An auditor must maintain confidentiality<sup>70</sup> of client engagement documentation<sup>71</sup> and audit files can only be disclosed to other parties when there is a legal obligation to do so or client consent has been given.<sup>72</sup> Hence, when a review of a member's audit files is carried out, consent needs to be obtained from the audit client so that the reviewer can access the files. It follows that if no such consent is received then no review of that audit file can be carried out. When accessing client files the reviewer is seeking evidence that the member is, *inter-alia*, complying with relevant auditing standards. The reviewer does not investigate any judgments, decisions or opinions that form a part of or lead to the audit opinion. If a professional accounting body's quality review detects activities by a member that contravene policies or standards (e.g. if a member performs an audit which does not fully comply with the auditing standards) then that member can be referred to a disciplinary process where

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<sup>70</sup> Accounting Professional and Ethical Standards Board, *Code of Ethics for Professional Accountants*, APES110, 2013, para 140.

<sup>71</sup> Accounting Professional and Ethical Standards Board, *Quality Control for Firms*, APES320, 2009 paras 2(b) and 96.

<sup>72</sup> Accounting Professional and Ethical Standards Board, n 70, para 97.

sanctioning powers range from reprimand to expulsion from membership. This process also includes any RCAs who are members of the professional accounting bodies.<sup>73</sup>

### **A comparison of the oversight roles**

The specific oversight functions of ASIC and the professional accounting bodies are presented in Tables 1 and 2 below.

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<sup>73</sup> The Annual Statement by an Auditor for ASIC re-registration as an RCA requires the RCA to advise if they have ceased membership of a professional accounting body or been subject to any disciplinary or similar procedures from a professional accounting body.

**Table 1. ASIC Oversight Roles**

<b>Auditor type</b>	<b>Corporations Act audits</b>	<b>Non-Corporations Act audits</b>
RCA	Yes	Unknown <sup>74</sup>
Member of professional accounting body who undertakes audit, other than RCAs	Not applicable	No

**Table 2. Professional Accounting Bodies Oversight Roles**

<b>Auditor type</b>	<b>Corporations Act audits</b>	<b>Non-Corporations Act audits</b>
RCA	Yes	Yes
Member of professional accounting body who undertakes audit, other than RCAs	Not applicable	Yes

The co-regulatory environment for the oversight of RCAs by ASIC and the professional accounting bodies appears to consist of two different oversight regimes that lack a dedicated, coordinated and cohesive strategy. This approach raises questions about auditor oversight and by association, compliance with the Francis framework. A more detailed critique of the co-regulatory environment is undertaken in the next section of this paper and several inconsistencies are identified.

## **V. INCONSISTENCIES OF THE CO-REGULATORY ENVIRONMENT**

A closer examination of the co-regulatory environment for the oversight of RCAs reveals that this environment could be inconsistent in several areas including: (1) the selection bias of the ASIC inspection program; (2) accessing client engagement documentation; (3) interaction between professional accounting bodies and ASIC; (4) legal enforceability of non-*Corporations Act* audits; (5) differences in ASIC inspections vs. quality reviews; and (6) auditor option choice and stakeholder protection.

### **Selection bias of the ASIC inspection programs**

The selection bias of RCA inspections by ASIC can lead to negligent RCA's going undetected. There can be inconsistent treatment of RCAs based on whether they are selected for an ASIC inspection. The ASIC inspection program uses a risk-based (non-random) sampling approach in selecting RCAs for inspection.<sup>75</sup> The ASIC report for the 18 months ending the 31<sup>st</sup> December 2013 indicated that it inspected 17 firms which

<sup>74</sup> Refer to discussion above re ASIC's potential powers under the *ASIC Act* section s13(1)(b)(i).

<sup>75</sup> ASIC, n 63, para 12. The term RCA is used to describe a registered company auditors regardless of whether they be a natural person, an audit firm or an audit company.

undertook audits requiring RCAs. However, there are many other firms and RCAs not selected for inspection by ASIC.<sup>76</sup> The regular monitoring of these non-inspected RCAs is left to the mandatory annual statement (effectively self-reporting) which the RCAs provide to ASIC.<sup>77</sup> Moreover, those RCA's that are not selected for inspection by ASIC are subject to the quality review processes of the professional accounting bodies. If the annual statement does not provide any triggers for ASIC to investigate an RCA, then it remains for the professional accounting bodies' quality review process to provide the regulatory function. Consequently, those RCAs who are selected for an ASIC inspection receive a different level of scrutiny than those who are not. This selection bias results in inconsistent treatment of RCA's.

### **Accessing client engagement documentation**

Access to client engagement documentation differs between ASIC inspections and professional accounting body quality reviews. Lack of access to client files can hide evidence that might reveal auditor negligence which by implication, means that RCAs are treated unequally. Under ASIC inspections, the inspectors have unrestricted access to any or all client engagement documentation and RCAs must accede to ASIC's request. They can therefore discover audit non-compliance which can lead to statutory based disciplinary actions and sanctions being imposed against RCAs. This is not necessarily the case for those RCAs that are only captured by the quality review processes of the professional accounting bodies.

Access to clients' engagement documentation by a quality reviewer must be negotiated with the RCA and the client's authorisation received. Such access relies on RCA cooperation and client consent. Hence, a quality reviewer may not be in a position to discover audit non-compliance. This different level of access to client engagement documentation creates unequal treatments. Hypothetically, a situation could arise where one RCA undertakes the audit of a company and another RCA undertakes the audit of, say, a local government and they both fail to conduct the audit properly. It may be that the RCA who conducted the audit of the company might suffer sanctions

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<sup>76</sup> In 2013/14 there were 4,792 RCAs in Australia. Above n 63. As reported only 17 firms were inspected and the number of RCAs captured therein is not known. However, it is reasonable to assume that the vast majority of RCAs were not inspected.

<sup>77</sup> ASIC can also receive complaints about RCAs which they then might investigate but this is not a monitoring exercise.

pursuant to the *ASIC Act* and the *Corporations Act*. However, the RCA who audited a non-company might escape sanctions because the professional accounting body quality reviewers failed to discover negligence through an inability to access client engagement documentation.

### **Interaction between ASIC and professional accounting bodies**

ASIC may not become aware of negligent conduct of an RCA even though it has been detected by professional accounting bodies. In 2010, the ICAA (now CA ANZ) published a report on the quality review process entitled: “past present and future.”<sup>78</sup> This specific document outlines that the interaction of the ICAA and ASIC is limited to a consideration of the timing and findings of each other’s oversight processes.<sup>79</sup> There is no indication in this report or in ASIC’s audit inspection reports or the ICAA’s annual quality review reports that RCA breaches discovered in the quality reviews are disclosed to ASIC. Negligent conduct which is detected by an ASIC inspection of an RCA may result in disciplinary action. However, since ASIC does not inspect all RCAs and the professional accounting bodies do not appear to report audit breaches to ASIC, then it could occur that negligent activities of an RCA in an audit (even of a *Corporations Act* audit), could result in no ASIC action being taken, despite being detected by the professional accounting bodies in their quality review. Thus, the lack of disclosure required of professional accounting bodies to ASIC could lead to inconsistent treatments of separate RCAs for what might be the same negligent conduct.

### **Non-*Corporations Act* audits and legislative enforceability**

The extent of enforceability of powers of ASIC under s 13 of the *ASIC Act* with respect to non-*Corporations Act* audits by RCAs is unclear. If ASIC uses s 13 to investigate an RCA for an audit conducted under non-*Corporations Act* legislation, then it must ensure that it has legal capacity to do so and that it does not impinge on the laws of other jurisdictions. This question of enforceability has not been tested in the Courts. For instance, if ASIC wanted to undertake such an investigation of an RCA who was a partner in a Big 4 firm and who might face the prospect of losing registration, it is

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<sup>78</sup> The Institute of Chartered Accountants in Australia, n 68.

<sup>79</sup> The Institute of Chartered Accountants in Australia, n 68, 11.

difficult to imagine that the firm would not challenge the ability of ASIC to act in such a way. The outcome of that action is uncertain.

If ASIC does not have the powers to investigate RCAs for audits conducted under non-*Corporations Act* legislation under s 13 or if such powers are unenforceable, then all RCAs are not treated consistently by ASIC. In either case, it could be that audits carried out by RCAs outside of the *Corporations Act* are not subject to ASIC disciplinary action. The effect is that little may be done from a legislative enforcement perspective if an RCA conducts a non-*Corporations Act* audit improperly. This will be compounded if that RCA *only* carries out non-*Corporations Act* audits. Hypothetically, a situation could arise where one RCA undertakes the audit of a company and another RCA undertakes the audit of a non-corporate entity (e.g. a local government), and they both fail to conduct the audit properly for the same reason. It might be that the RCA who conducted the audit of the company could suffer sanctions pursuant to the *ASIC Act* and the *Corporations Act*. Yet, the RCA who audited a non-company might escape sanctions due to the inability of ASIC to investigate, notwithstanding the fact that ASIC is the regulator of RCAs. Finally, the statutory regulation of RCA's may be restricted to the *Corporations Act* audits, whereas RCAs conduct audits under many other auspices which might escape such regulation.

### **Difference in ASIC inspections vs. quality reviews**

There are differences in the oversight practices employed by ASIC and the professional accounting bodies with respect to RCAs. ASIC investigates the judgments, decisions and opinions that form a part of or lead to the audit opinion of RCAs, while the professional accounting bodies quality reviewers do not. Quality reviewers take a compliance approach when reviewing members audit activities and do not necessarily consider other aspects of the audits. The difference between the two oversight functions leads to some RCAs having a level of investigation which is more probing than other RCAs. The inability of the professional accounting body reviewers to consider the judgments, decisions and opinions of an audit is a serious limitation of scope in the review. For instance, questions regarding the sufficiency and effectiveness of audit evidence gathered are not considered by the reviewer, but these are important issues in an ASIC inspection in determining the quality of the audit and the appropriateness of

the subsequent RCA audit opinion. This represents yet another example of inconsistent treatment of RCAs.

### **Auditor choice and stakeholder protection**

Some legislation offers the option between an RCA and a member of a professional accounting body to be the auditor. This option suggests that these are equal designations and it would be reasonable to expect that the level of protection for stakeholders is the same regardless of which auditor designation is selected, which is not the case. The audit expertise of RCAs is verified through a demonstration to the effect that they possess appropriate levels of competency and integrity to obtain registration.<sup>80</sup> However, there is no such process for a member of a professional accounting body who is not an RCA and who undertakes an audit. In addition, where legislation permits a member of one of the professional accounting bodies to be the auditor it would be reasonable to expect that the level of protection for stakeholders is the same regardless of which member is selected. However, this expectation is simply not met. Chartered accountants are mandatorily required to undertake audit studies as a part of their entry qualifications and also their post graduate studies. Members of CPA Australia are required only to undertake one auditing course to obtain CPA status and IPA members do not have to do any courses in audit. For instance, a member of IPA who just received their membership and who may have never been involved in audit (either in their studies or workplace) are equally permitted to undertake an audit regardless of whether they have obtained relevant knowledge and experience.<sup>81</sup>

In summary, this section of the paper has identified several inconsistencies with the co-regulatory environment for RCA oversight in Australia. The Francis framework for high audit quality requires effective regulatory monitoring and oversight. It therefore can be concluded that the oversight of RCAs in Australia is some distance away from Francis's requirements.

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<sup>80</sup> *Corporations Act* s 1280 and 1280A.

<sup>81</sup> It is acknowledged that the ethical requirements of professional accounting bodies require members to undertake work exercising '*professional competence and due care*' (i.e. do not undertake work for which you do not have expertise). Accounting Professional and Ethical Standards Board, *Code of Ethics for Professional Accountants*, APES 110, (December 2010), ss. 100.5(c), 130.

## **VI. POTENTIAL OPTIONS TO ADDRESS THE CONCERNS**

There are several options to develop an RCA oversight strategy to resolve the aforementioned concerns raised, which would provide an environment that would be closer to the framework recommended by Francis. The following section of this paper offers two propositions based around the present oversight processes. The first proposition utilises the current roles of ASIC and the professional accounting bodies, but recommends a change to the ambit of the RCA designation. The second proposition recommends a change to the regulatory environment to cover all RCAs.

### **Maintain the current Co-Regulatory environment**

Given that ASIC basically inspects those RCAs that affect the capital markets then one potential approach would be to limit the RCA designation to those entities. Hence, this proposition restricts the requirement for the RCA designation in the *Corporations Act* to public companies only. Therefore, any entity not being a public company (including other companies) will be able to use professional accounting body members as their auditor. Of course, it will not stop RCAs being used for audits other than public companies. An additional restriction is that an RCA must audit public companies<sup>82</sup> annually to maintain registration. This will ensure that once RCAs have registration that they do not move-out of the inspection program of ASIC as many have done under the current system.

Activation of this proposition would require amendment to the *Corporations Act*. This would reduce that number of RCAs in Australia and the flow-on effects would need to be carefully considered. For instance, non-*Corporations Act* legalisation that prescribes only an RCA would be well advised to amend that need. The reason being is that if numbers are reduced due to the recommended changes, there may not be enough RCAs to meet demand. Clearly, this would require the co-operation of other jurisdictions.

A further streamlining could also occur where the professional accounting bodies accept ASIC's inspection of RCAs and forgo their quality reviews. This would also extend to those RCAs who carry out audits of non-public companies. These particular

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<sup>82</sup> While the plural of companies is used here there is no consideration of the number of public companies which need to be audited by an RCA.



RCA's would be undertaking audits of public companies and the assumption is that the ASIC inspection would be sufficient. Resourcing such an approach may not be overly different to that which presently occurs. The ASIC inspection program may already cover the vast majority of these RCA's and an extension to all may not be burdensome to it. The professional accounting bodies' quality review programs would cover the remainder, as they already do.

Under this proposition, the inconsistencies of the present co-regulatory approach discussed in this paper would essentially be overcome. The selection bias vanishes as the entire population of RCA's would be inspected by ASIC. Accessing client engagement documentation of RCA's by professional accounting bodies would not arise because all RCA's would be inspected by the regulator who has the legislative authority. There are no issues with the lack of interaction between ASIC and professional accounting bodies or differences between the ASIC inspections and quality reviews as their oversight regimes are separated and not reliant on each other. Given that all RCA's are involved in *Corporations Act* audits, ASIC would be able to monitor their audit processes and address any concerns through legislative enforceability. Auditor choice where there is presently an option for an RCA and someone else would be resolved if Australian jurisdictions were prepared to accept that the RCA designation be for public companies only and remove their title from applicable legislation. Certainly, this would not stop RCA's undertaking audits of non-public company entities, but it would resolve the issue of auditor choice in legislation where there are different levels of auditor expertise available.

A potential gap which emerges from this proposition is that there would be auditors of some *Corporations Act* entities (e.g. large proprietary limited companies) who would not come under the auspices of ASIC. However, these audits would still be captured by the professional accounting bodies quality review programs, as they presently are. This might be challenging for ASIC though as whilst they would still be the regulator of all companies, they would not have a mandate over all the auditors of all companies. Yet, the difference here is that there would be no apparent legislative sanction for auditors of non-public companies who are negligent, but it appears that this sanctioning is questionable at present anyway. It could, however, be argued that whilst they presently

have legislative coverage, they are not properly fulfilling that role at least with respect to their auditor oversight.

### **Change the regulatory environment**

The second proposition is more far-reaching than the first, but is somewhat simpler in nature. It proposes that ASIC extend its inspection program to cover all RCAs regardless of the type of audits conducted by them. Specifically, the *Corporations Act* and non-*Corporations Act* legislation audits. Therefore, professional accounting bodies would not undertake their quality reviews of any RCAs with respect to audit. Whilst this would clearly provide ASIC with resourcing and operational concerns compared to what it presently does, there would also be a level of realignment of resources due to a reduction in the extent of reviews undertaken by the professional accounting bodies. Any operational concerns are probably overstated in any event because the professional accounting bodies already have an organisational structure in place that deals with this. The key advantage of this proposition is that all RCAs would be subject to the legislative regulator and not just those from ‘the big end of town’ as is presently the case. In addition, the concerns about s 13 of the *ASIC Act* raised in this paper would need to be addressed, so that it is clear that ASIC has the powers to deal with audits conducted by RCAs in non-*Corporations Act* entities.

Many of the inconsistencies of the present co-regulatory approach detailed in this paper would essentially be overcome by this proposition. The selection bias would vanish since the entire population of RCAs would be inspected. Accessing client engagement documentation of RCAs by professional accounting bodies would not arise because all RCAs would be inspected by the regulator who has the legislative authority. There would also be no issues with the lack of interaction between ASIC and professional accounting bodies or differences between the ASIC inspections and quality reviews as all RCAs would be inspected by ASIC. Legislative enforceability issues of non-*Corporations Act* audits would be addressed as identified above. However, the issue of auditor choice where there is presently an option for an RCA and someone else would need to be addressed. This would require cooperation of Australian jurisdictions to amend applicable legislation.

In summary, the advantage of these two propositions is that they utilise the existing oversight programs of ASIC and the professional accounting bodies. The changes in the propositions essentially deal with the extent of those regimes. A common thread between these propositions is that they both provide ASIC with greater legislative reach across all RCAs regardless of how they are defined. It is difficult to accept that ASIC has coverage of the behaviours of all RCAs, but chooses to deal with them in an inconsistent way. Finally, it is appreciated that ASIC applies a risk-based approach to its inspection program, but in terms of the Francis framework it can be concluded that this inconsistent treatment does not bode well for the production of high quality audits.

## VII. CONCLUSION

The Francis framework for high audit quality requires an effective regulatory environment. The aim is to motivate auditor behaviour to produce high quality audits and punish those who do not. Such a regulatory environment needs to contain a regulator that is properly empowered and provide a clear path for effective sanctioning. This paper has argued that the co-regulatory environment for auditor oversight in Australia is inconsistent, that ASIC's powers are unclear in certain scenarios and that delinquent auditors may not be subject to effective legislative sanctioning. It establishes that there are substantive questions in terms of whether the co-regulatory environment in Australia for auditor oversight meets the Francis framework.

The co-regulatory environment in Australia appears to be some distance away from one which treats *all* RCAs equally and with the same level of consistent scrutiny. While those RCAs who audit the 'big end of town' appear to have considerable oversight from ASIC, there are many others where the level of scrutiny has been left to the professional accounting bodies in a non-legislative setting. The overall implications of the inconsistencies are that there are RCAs who may be negligent (either intentionally or unintentionally) but have little possibility of being detected or if detected may not be subject to legislative sanctioning.

This paper outlines two different propositions which address the concerns raised and fit into the Francis framework. However, these propositions do provide some challenges to the current auditor monitoring and oversight provisions in Australia. One proposition is to limit the requirements of the *Corporations Act* to restrict an RCA to be the auditor

of public companies only. The second proposition is to have ASIC extend its inspection program to cover all RCAs. It could be argued that this second proposition is only seeking what ASIC should already be doing.

ASIC's objective of its audit inspection program is to facilitate the production of high quality audits. This is intended to provide greater confidence for financial report users. Given that presently many RCAs are not inspected by ASIC one might wonder to what extent this objective is actually being achieved in practice. In any event, it is easy to imagine that there are many financial report users who feel that an audit oversight program should extend to all RCAs. If there is to be an oversight function then it should be one that is applied universally, comprehensively and consistently, and results from a strategic outlook. Employing a framework like the one envisaged by Francis seems to be a good place to start.