PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

INQUIRY INTO ETHICS AND PROFESSIONAL ACCOUNTABILITY: STRUCTURAL CHALLENGES IN THE AUDIT, ASSURANCE AND CONSULTANCY INDUSTRY

Submission by BDO Group Holdings Limited

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TABLE OF CONTENTS

INTRODUCTION

BDO is pleased to provide this public submission to the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into ethics and professional accountability, considering structural challenges in the audit, assurance and consultancy industry.

As a leading provider of audit, tax and advisory services across Australia, we are committed to proactively driving the continual enhancement of transparency, accountability and quality across the profession.

BDO is one of Australia's largest accounting firms. We have 267 partners and 2,360 people working collaboratively across 12 offices (as at 1 July 2023), who advise a wide range of clients, including individuals, small and medium businesses, large corporations, not-for-profits and the public sector. Our annual revenue for FY23 was circa $AUD 498 million.

We operate as a member of the BDO global network, which comprises 111,307 people in 1,803 offices across 164 countries. As at 30 September 2022, the combined fees of BDO's firms worldwide were $12.8 billion.

BDO International Limited is not a profit-making entity. Its purpose is to provide member firms with global policies, priorities, procedures, methodologies, and tools to guide their service delivery and quality and risk management. BDO in Australia implements these resources and undertakes further localised activity and enhancements to suit our regulatory environment. In doing so, we consider the insights gained via our relationships with international BDO peers into the global regulatory landscape. Ultimately, our firm and our people are accountable under local Australian laws and to clients, regulators and industry bodies.

As a BDO member firm, we must always meet strict membership and performance criteria, including an ongoing commitment to uphold a reputation for quality and high ethical standards, comply with domestic and international standards and requirements, and maintain a system of quality management that meets the International Standard on Quality Management (ISQM) 1.

Our submission

BDO believes opportunities exist to enhance the confidence in, and transparency of, our profession. In this submission we set out three focus areas for the Joint Committee's consideration.

1. **Separation of audit and advisory service practices is not the answer** – A forced separation puts audit quality at risk. Audit-only firms would lack access to the other experts needed to deliver a comprehensive audit, they would be unable to retain and attract talent, and market competition would decline as smaller firms exit and the pool of providers diminishes. Instead, revisiting the recommendations of the Parliamentary Inquiry into Auditing, improved non-audit independence rules and a change in regulatory oversight is required.
2. **Company structure obligations are part of the solution** – Company structures, as adopted by BDO, are regulated in accordance with the *Corporations Act 2001* (Cth) so require us to adhere to greater transparency and accountability obligations than partnership structures and provide confidence to the community because of the disclosures required. Obligations under the Act are size-dependent and address the Joint Committee's focus areas of entity reporting and transparency, executive accountability, whistle-blower policies and protections, and governance obligations.
3. **Gaps in regulatory oversight must be filled** – We have observed that the rise of consulting within our profession has created a gap in regulatory oversight. There is clarity around external regulation for 'traditional' areas – audit, tax and financial advisory services – yet, for advisers and services outside these classifications (e.g. management consultants, cyber security advisers, risk managers) it is less clear and regulation of consulting professionals and the services they provide is ambiguous. A careful balance between self-regulation and external regulatory oversight needs to be addressed.

Below we set out supporting information for each focus area and, by doing so, address key elements from the Joint Committee's terms of reference.

SEPARATING AUDIT IS NOT THE ANSWER

Recent incidents of unethical behaviour in the accounting and professional services industry have prompted calls by some commentators for a forced regulatory separation of professional services firms' consulting and auditing practices. This is despite no evidence that the reported conflicts of interests and unethical behaviours within the consulting arms of the firms in question undermined audit integrity or quality.

BDO does not support the creation of audit-only firms. Such an approach would lead to a range of negative side-effects and fail to address the underlying need for improved regulatory oversight in areas outside of audit. Auditors already have high obligations imposed on them because all auditing standards issued in Australia carry the force of law. Australian Securities and Investments Commission (ASIC) supervision and enforcement activities mean there are significant consequences if auditors do not meet these obligations. What needs attention is how to effectively oversee the entire profession and restore public trust in the important role auditors play in the market.

Three reasons not to create audit-only firms

BDO believes there are three primary reasons not to force a separation of audit from multidisciplinary professional services firms, all of which centre on protecting audit quality and outcomes for clients.

1. Modern audit complexity dictates the need for access to multi-disciplinary experts

Audits today are increasingly complex and require inputs in excess of traditional auditing skills. Given the specific knowledge and skill auditors require to perform their role, it is unrealistic to expect them to also be across all the legal, technical and organisational requirements of an audit without assistance from specialists. A multi-disciplinary approach is required to deliver a high-quality audit, as auditors must be able to draw on the deep expertise and skills of specialists in other areas, such as taxation, valuations, and complex financial reporting matters (such as International Financial Reporting Standards), to deliver what is required for each unique engagement. If audit-only firms were to engage the services of external experts in other disciplines to obtain the additional expertise they need to deliver an audit, this would come at an additional cost to the firm. This cost, by necessity, would be passed on to clients of audit-only firms, resulting in significant increases in audit engagement costs.

2. Career growth opportunities are needed to attract and retain specialists

Audit-only firms would not be able to offer the range of challenges needed to attract the specialist talent required to support a high-quality audit. The ability to recruit the best and brightest talent requires firms to offer a range of work experiences and development pathways. In an audit-only firm it would be difficult to offer the 'excitement and variety' people with the specialist skills are looking for in a professional career. Ultimately, audit quality will suffer as pressure mounts on an audit-only firm's ability to deliver engagements and have the right people to do the job.

3. Competition will reduce

Whilst most large, listed company audits are conducted by the country's four largest auditors, there are many public company and private company audits completed by other accounting firms. This includes firms in regional Australia who conduct audits for important organisations in their local regions, including public entities such as hospital boards, local councils and other such organisations.

Requiring the creation of audit-only firms would likely cause a large number of smaller accounting firms to exit the audit market, as it would be uneconomical for them to set up a separate audit-only firm. The most likely consequence would be a significant reduction in the number of available auditors, resulting in a severe decline in competition and choice within the market.

This reduction in available auditors would likely result in some companies being unable to find auditors willing to act for them. This type of market disruption occurred in the Netherlands when the Government increased the requirements on auditors to the degree that all but seven firms ceased to conduct audits. Such market failure should not be allowed to happen.

Three recommendations to protect audit quality and independence

Audit quality and independence must be the priority. BDO suggests three actions to ensure this.

1. Review existing Parliamentary Joint Committee recommendations

In February 2020, a Parliamentary Joint Committee on Corporations and Financial Services reported on the Regulation of Auditing in Australia, making ten recommendations to improve audit quality. Importantly, the committee did not recommend audit functions be split out of existing multi-disciplinary firms. To date, none of the recommendations have been actioned by the Government, so BDO encourages a review of them in light of the current environment.

2. Clarify and strengthen non-audit independence rules

To improve auditors' independence, non-audit independence rules must be clarified and strengthened. BDO suggests this can be achieved by continuing efforts to better define the list of prohibited non-audit services. Using the guidance set out in APES 110 Code of Ethics for Professional Accountants (including Independence Standards) we suggest that a detailed list of prohibited services be developed. This would result in a clear differentiation between assurance services that can be provided by the auditor and non-audit services that are prohibited, thereby increasing confidence in the audit's independence.

Setting a higher standard for the largest listed public companies in respect to the provision of non-assurance services should also be considered. To restore public confidence in the independence of auditors of the largest companies, BDO suggests a restriction on the provision of non-audit services to companies in the ASX 300. We believe when a firm becomes the auditor of these very large companies it should excuse itself from all non-audit work, other than work that is an extension of the audit appointment. This restriction should not apply to medium and small listed entities or to unlisted entities.

3. A Balanced Scorecard ASIC inspection program

Audits conducted under the *Corporations Act* within Australia are regulated by ASIC. ASIC conducts annual inspections of the country's six largest audit firms. Recent changes within ASIC resulted in a reduction in the sample size of the audit files reviewed as part of its inspection program, and ASIC has since determined it will no longer provide audit firms with private reports or issue a public report dealing with the outcomes of these reviews.

Since 2019, BDO has published our private report to provide transparency about our audit quality to the market. In our view, the ASIC inspection report was never intended to be the sole measure of audit quality and we continue to publish our annual Transparency Report that sets out a more balanced picture of how we maintain and improve audit quality at BDO.

We understand the recent change to ASICs approach to audit inspection reflected a change in its priorities. The role ASIC plays in the supervision of auditors is adequately funded via the Industry Funding levy paid by auditors. ASIC has decided to redirect these funds from supervision into enforcement. BDO would support a review of this decision to ensure adequate funding is provided for supervision.

The implementation of ASQM 1 and ASQM 2 requires firms to implement a System of Quality Management (SOQM) that details how the firm supports, maintains, and improves quality. BDO would support a change in ASIC's supervision approach to move to a position where it evaluates a firm's SOQM, supplemented with some file inspection to provide a more balanced view of audit quality.

In addition, BDO would support a return to ASIC publishing an audit quality inspection report and individual audit firm reports, based on a number of measures reflected in a balanced scorecard, including but not limited to an appropriate sample size of individual audit files.

COMPANY STRUCTURE OBLIGATIONS CAN IMPROVE CONFIDENCE

A firm's structure plays an important role in determining its governance obligations. In our view and experience, professional services firms and their clients benefit when firms adopt a company structure.

Learnings from our structure

BDO operates in Australia as a network of independent member firms. The largest firm in Australia is BDO Group Holdings Limited (BDOGH) and this group operates in most of the major capital cities in Australia.

BDOGH is an unlisted public company limited by shares, formed and regulated under the *Corporations Act*. The shares in BDOGH are held by entities associated with the 'partners' of BDOGH. 'Partners' is a term used within BDOGH to designate persons of a certain level of seniority and trust within the company, albeit that those persons are not partners in the legal sense. 'Equity partners' are entitled to have related entities hold shares in the company.

BDOGH has several controlled subsidiary companies through which it carries on business. BDOGH lodges audited financial statements with ASIC that consolidate all its controlled subsidiary companies.

BDOGH is governed by a board of directors, made up of seven elected partners and an independent chair. The board has various committees and subcommittees that report to it and to which certain matters are delegated. Day-to-day management of the company is delegated to the Chief Executive Partner who, in turn, has an executive leadership team to assist them in managing the company's operations.

While all BDO entities in Australia are members of the global BDO network, BDO International Limited has no ownership interest in the firm and does not otherwise share in the Australian firm's profits. The global network is funded by member firms on a cost recovery basis.

In our view, the structure of BDOGH as an Australian incorporated company, regulated in accordance with, and complying with its obligations under, the *Corporations Act*, provides confidence to the community. BDOGH's audited financial statements, shareholdings, and details of those charged with governance are matters of public record and must be kept current in accordance with the Commonwealth's laws.

Additionally, as a large company, BDOGH pays corporate income tax at a rate of 30 per cent of its taxable income and the group pays payroll tax (along with other costs such as workers' compensation premiums and mental health levies) on salaries paid to our partners and staff in all the states we operate in.

Benefits of company structure obligations

For these reasons, BDO sees significant benefits to community confidence from the imposition of the obligations relevant to companies under the *Corporations Act* to entities engaged in the audit, assurance and consulting market. Such obligations are already size-dependent and address important areas of the Joint Committee's focus, including entity reporting and transparency; executive accountability, particularly Directors' duties; whistle-blower policies and protections; and governance obligations. It is clear these obligations can provide information of utility to the public and help enhance ethical and professional accountability on the part of firms. The benefit of such an approach is evidenced by examples in other markets, particularly the larger professional services firms in the United Kingdom.

As a profession, there is much to be gained from looking to the company regime to guide our structural and operational approach. Not only is it the practice standard for increased transparency and disclosures, but it also sets the bar for what our clients, the market, regulators, and the community expect of modern advisers.

REGULATORY OVERSIGHT NEEDS ATTENTION

Today's professional services advisers are diverse and they are not all accountants. The rise of consulting within the profession has created a regulatory oversight gap that requires attention.

It is BDO's view that changes to regulatory oversight must be carefully considered to avoid unintended consequences. Balance is needed between the important role of self-regulation and a properly funded regulator, to achieve an appropriate level of oversight and confidence in the market and consistency with global trends. We believe the Accounting Professional & Ethical Standards (APES) Board has an important role to play in achieving this balance, given its focus on developing and issuing high quality professional and ethical standards that are in the public interest.

Self-regulation alone cannot solve the challenges at play, as many firms already take a proactive view to self-regulation. At BDO, all our people, regardless of their practice area, must comply with stringent quality, independence and ethical standards and maintain them through regular mandatory education. What is currently ambiguous is external oversight of consulting professionals and the services they provide.

Two priority areas for regulatory action

BDO recommends the Joint Committee consider two key areas for action – standards for all professionals and the creation of an independent oversight body.

Addressing these two areas would enhance the mechanisms available to a wide range of stakeholders, including clients, statutory authorities, professional standards bodies and regulators, when it comes to holding firms and their people to account for their actions.

1. Standards to govern conduct of professionals

BDO supports a move to have an ethics standard setter governed under the oversight of the Financial Reporting Council (FRC), an approach consistent with the other Australian accounting and auditing standard setters. This would elevate the ethical standards governing the conduct of professionals, by providing legislative authority over the application of ethical standards across the audit, assurance and consulting industry.

APES 110 Code of Ethics for Professional Accountants (including Independence Standards) sets out fundamental principles of ethics for Members. Members are defined as a member or a professional body that has adopted the code as applicable to the membership, as defined by that professional body.

BDO believes a set of ethical standards that govern the conduct of individuals who are not professional accountants is needed. The standards must address the shortcomings of the current code by extending beyond the professional accountant to include all professionals who provide consulting services.

Standards should include clear guidance and minimum standards of continuing professional development, with training requirements embedded in the standards to address the principles of integrity, objectivity, confidentiality, and competency.

2. Establish an independent oversight body

BDO suggests the establishment of an independent oversight body. Professional industry bodies for consulting service advisers (e.g. Institute of Management Consultants, Engineers Australia, Risk Management Institute of Australia, etc) would be required to be registered with this body so that, in turn, so are their members. Professionals who provide consulting services in the public sector would be required to register with this body, either indirectly via their membership of a registered industry body, or directly as an individual if they are not a member of a registered industry body. A condition of registration would be the requirement for all registered professionals to adhere to standards that govern their conduct.

The body would be responsible for monitoring the conduct of registered professionals and taking enforcement action when appropriate. In addition, it would be required to produce annual reporting that contains detail on its monitoring and enforcement activities.

Creating an independent oversight body with this remit will promote transparency and accountability across the profession and increase client and market confidence.

CONCLUSION

It is clear there are opportunities available to boost confidence in the audit, assurance and consulting profession and provide greater transparency to all stakeholders. In BDO's view, the most meaningful enhancements can come by:

1. Revisiting the ten recommendations of the February 2020 Parliamentary Inquiry into the Regulation of Auditing in Australia
2. Clarifying and strengthening non-audit independence rules by continuing efforts to better define the list of prohibited non-audit services using the guidance set out in APES 110 and prohibiting the provision of non-audit services to ASX 300 companies that a firm is the auditor for
3. Introducing a balanced scorecard ASIC inspection program that would see ASIC evaluate a firm's SOQM, supplemented with some file inspection, and a return to ASIC publishing an audit quality inspection report and individual audit firm reports based on an appropriate sample size of individual audit files
4. Requiring entities engaged in the audit, assurance and consulting market to adopt the obligations that would be applicable if they were a company of the same size
5. Filling gaps in regulatory oversight by setting clear standards for all professionals who provide audit, assurance and consulting advice and establishing an independent oversight body.

We believe these enhancements would proactively address key elements from the Joint Committee's terms of reference, particularly the concepts of entity reporting and transparency, executive accountability, governance obligations, and ethics and professional accountability.

Should the Joint Committee wish to discuss this submission BDO would welcome the opportunity to do so and provide further details on the topics covered.

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