Australian Government

Auditing and Assurance Standards Board

AUASB RESEARCH REPORT 8

ANCAAR – AUASB RESEARCH AND REGULATION WORKSHOP

Research informing the AUASB’s current work programme

October 2022

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Foreword

The AUASB recognises the importance of relevant and reliable evidence and academic research to inform our standard-setting activities. The AUASB's evidence informed standard setting (EISS) strategy directs our activities to ensure that standard-setting deliberations and decisions are informed by relevant and reliable evidence and research. The AUASB encourages and supports research that provides evidence on the current audit and assurance environment that informs our current and future agenda.

The ANCAAR-AUASB Research and Regulation Workshop is a critical element in how we engage with the academic community with the objective to discuss how research can inform our standard-setting activities. This objective was achieved through the AUASB presenting its strategic priorities, the academic community presenting existing research and the implications to the AUASB, and also any gaps which create opportunities for research going forward.

The AUASB thanks all attendees for their participation, and in particular those who presented their research. The AUASB also welcomes input from academics on opportunities for research in the future.

Bill Edge
Chair
Auditing and Assurance Standards Board

Research should always underpin great public policy, ensuring it is informed, evidence based and benefits our nation.

One of the greatest examples is the income contingent loan scheme, developed at The Australian National University (ANU), which provides access to higher education, regardless of an individual's financial background, ensuring all those with talent have the means to succeed. This model has also been used to underpin Medicare and the childcare rebate – public policies which most Australians will access during their lifetime.

In the tradition of bringing research and policy together, ANU hosted a symposium in September 2022 with leading scholars and industry stakeholders who specialise in research, policy and regulation. The joint efforts of the Australian National Centre for Audit & Assurance Research (ANCAAR) and the Auditing and Assurance Standards Board (AUASB) are a living demonstration of the vital role universities play in shaping and developing public policy which impacts everyday Australians.

This symposium was a valuable opportunity to collaborate across academia, government and business and I would like to thank the participants for their engagement and for their ongoing work to improve and lead in auditing and assurance best practice.

I hope these discussions continue and I look forward to seeing the outcome of this ongoing collaboration.

Professor Brian P. Schmidt AC
Vice-Chancellor and President
The Australian National University
2011 Nobel Prize (Physics)

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Preface

This Research Report summarises presentations from the Australian National Centre for Audit & Assurance Research (ANCAAR) – Australian Auditing and Assurance Standards Board (AUASB) Regulation Workshop held at The Australian National University (ANU) on 15-16 September 2022. The organising committee comprised Anne Waters (AUASB), Greg Shailer (ANCAAR, ANU), Roger Simnett (Deakin Integrated Reporting Centre, Deakin University) and Ken Trotman (UNSW Audit and Assurance Research Lab, UNSW Sydney). The workshop was designed as a roundtable forum to promote discussion on important issues that are of current interest to regulators and standard setters, particularly the AUASB.

The primary aim of the program to obtain insights into how the AUASB can better access and interpret research that might inform their standard setting activities. A broader purpose was to identify how research has and can inform evidence-based regulatory developments in auditing and assurance in Australia. The program was largely structured around the AUASB's current agenda, with sessions focused on areas of current international and Australian standard setting activity, but also involved other significant areas of regulatory interest; most notably, the interests of the Commonwealth Auditor General and ANAO as both a for-own-use standard setter and as a voluntary user of AUASB standards, and the interests of ASIC.

The emphasis on discussing research in relation to the AUASB's current agenda and other regulators or users related concerns was also intended to aid in identifying areas in which future research could have value.

Sessions included brief overview presentations from researchers and regulators that were intended to promote discussion by workshop participants, who are listed at the end of this report. To encourage the open exchange of information and ideas, much of the discussion was held under the Chatham House Rule.

Executive Summary

This roundtable was undertaken with the principle aim of identifying recent research activities that inform the AUASB's current agenda. A secondary aim was to identify gaps in knowledge where further research activities would be beneficial. Held over two days, and attended by 30 invited participants from academia, accounting professional bodies, and standard setters and regulators, the roundtable heard invitees and discussed implications for the AUASB on seven key areas. Some of the major considerations identified for the AUASB in each area were:

Implications for Consideration by AUASB	Reference
1. Informing Audit and Assurance Regulatory Reforms	
Important for AUASB to distinguish between higher and lower quality research.	1.2
Better interaction needed between academics and the profession in agreeing on the key research questions and providing the data to address those questions.	1.2
AUASB, in conjunction with professional bodies and the accounting firms, to help make available the most appropriate data to support rigorous research.	1.2, 1.3
2. Sustainability Assurance	
Government has indicated that reporting for climate change will need to be mandatory for large, listed companies and financial institutions, and that government will look at international best practice in this regard. These is support for current international initiatives relating to assurance of sustainability reporting, with main issues including determining appropriate assurance provider, the need to establish the reporting framework first, the scope of the audit and how materiality applies, and the level of assurance on the information and whether that changes over time.	2.2
With trend in Australia to integration of financial and non-financial information in the annual report, AUASB should educate the Australian market on the contribution and value of integrated reporting assurance.	2.3
AUASB should consider a market communication as to what is possible now in the context of the systemic changes being worked on by the IFRS Foundation, focusing on what can be achieved under existing assurance standards.	2.3
With broader information increasingly being included in the annual report, the AUASB should consider the relationship between Australian Standards on Auditing (ASAs) and Australian Standards on Assurance Engagements (ASAEs), and the role of ASA 720.	2.3, 2.8
The greater integration of financial and sustainability information that is occurring is increasing the likelihood of provision of sustainability assurance by accounting firm providers, especially those also undertaking the financial statement audit. This is changing the current competitive landscape.	2.4, 2.5
Various forms of credibility-enhancing mechanisms other than independent assurance, such as the disclosure of the processes underpinning the integrity of non-financial reports, are emerging. The AUASB should consider these	2.4

credibility-enhancing mechanisms in their deliberations on the reforms to the assurance standards on sustainability reporting.	
There should be clarity as where EER assurance fees are disclosed (AASB implication). As independence concerns are lower for categories of assurance and audit-related fees, compared with non-audit service (NAS)fees, fees for such assurance engagements by the incumbent auditor should not be included in NAS fees.	2.5
Use of ASAE's by non-accounting practitioners is beneficial over the use of other assurance standards (e.g., AA, ISO) in improving the transparency of the assurance report and signalling quality to the market. Nonetheless, the lack of enforcement on compliance by such practitioners with conditions of use (disclosure of ethics and quality control frameworks) is a concern and potentially impacts quality.	2.5
Mandatory sustainability assurance acts to expand the scope of the assurance engagement, promotes more reliance on the use of sustainability information and increases likelihood of incumbent financial statement auditor becoming the assurance provider. However, it may also promote a compliance driven assurance practice which may stifle assurance innovations.	2.5
Perceived credibility of sustainability reporting is nuanced, affected by the presence of assurance as well as stakeholders' perceptions of assurers' characteristics including assurers' expertise, independence, and reputation. Quality of disclosure of such characteristics in assurance reports should be reviewed.	2.6
Significant recent increase in climate-related disclosures in the Annual Report by listed companies in Australia, but most are outside the financial statements, thus covered by ASA 720. This disclosure trend increases the importance of ensuring that ASA 720 is fit for purpose in current environment. There are concerns as to whether the ASA 720 level of involvement of auditor is correct and understood.	2.7
Significant increase in climate-related information in financial statements and remuneration reports by listed companies in Australia also leads to direct impacts on financial statement audits, but there has not been a consequential change in underlying auditing standards or application material to support this. Is further guidance needed?	2.7
While most engagements assurance or climate-related information still only provide limited assurance, there is a trend occurring in the Australian market to assurance reports containing both reasonable and limited assurance. There is no clear guidance provided for such reports. Implications and need for guidance should be considered.	2.7
Considering recent initiatives such as the three lines of defence and the IAASB's trust model that include both internal and external mechanisms in ensuring the credibility and trust, AUASB should consider its mandate over this broadening view of credibility enhancing mechanisms.	2.8

With discussions around the potential assurance of ISSB reporting standards, AUASB should consider how such assurance will work in Australia alongside Corp Gov Recommendation 4.3.	2.8
3. Public Sector Auditing and Assurance Issues in Australia	
Should KAM reporting be mandated for certain entities in the public sector?	3.2
ASAE 3500 currently only refers to the three E's (Economy, Effectiveness, Efficiency). Ethics is the fourth 'E' in the PGPA Act. Should ASAE 3500 also cover Ethics?	3.2
4. Less Complex Entities	
There are multiple dimensions of complexity, which creates difficulties in establishing clear criteria or qualitative guidance for assessing complexity. Standard setters should take into account auditors' knowledge and ability (currently not mentioned in the proposed LCE standard).	4.2
Given that agency conflicts in small and less complex entities can be very different from those in large and complex entities, concern that proposed auditing standard for LCE may not be effective in meeting its intended purpose. AUASB should consider nature of agency relationships and their implications for assurance of LCEs.	4.2
For very small charities, reviews not a substitute for audit because, there is no saving on work effort as an audit level of knowledge is required for review engagements; audit firm methodologies are mainly developed for audits; client does not understand or desire limited assurance engagements; and a substantive approach consistent with audit was identified as most appropriate approach to these types of engagements.	4.3
For very small charities, concerns were identified around quality of audits. In particular, financial reporting framework not being followed (suggests AASB consider providing example of what sort of wording to include if Australian Accounting Standards not being followed (AASB)), and disclosure in audit report of responsibilities of management and Those Charged With Governance (TCWG) not clear (suggesting current standard wording of AUASB in audit report which talks about separate responsibilities of Mgt and TCWG does not work. Suggest AUASB consider alternative wording for responsibilities of management and TCWG for very small entities.	4.3
There may be benefits from exploring new types of engagements for audits of less complex charities, similar to the UK examination engagement (UK Charity Commission), which is effectively a combination of review engagement procedures and agreed upon procedures desired by the regulator.	4.4
5. Reporting and Assurance on Internal Controls frameworks	
Mandatory reporting of internal control has resulted overseas (US) in the disclosure of material internal control weaknesses, with resulting pressures resulting from such disclosures causing companies to improve their systems	5.2

Audit of internal control is more controversial. At least overseas not clear whether benefit exceeds costs, especially for small companies.	5.2
Internal control certification in Australia should remain voluntary due to the significant costs associated with mandatory and audited internal control certification.	5.3
6. Extending the auditor's obligations: Going concern assessments and disclosures	
AASB and AUASB should consider use of different terms used to clearly signal the seriousness of an issue related to GC (applies to company disclosures as well as audit reports).	6.2
AUASB should consider clearer guidelines for auditors on when to use different types of GC opinions, and AASB to consider how companies report threats to their GC status.	6.2
Tone of language of disclosures included in financial statements (audited in accordance with ASA 570) can be different to tone of disclosures of other information (covered by ASA 720). Evidence to date is consistent with auditors considering the tone of language used in financially distressed clients' qualitative disclosures to indicate future audit risk, yet there is nothing included in either auditing standard on consideration of tone, or variations in tone. AASB/AUASB should consider whether guidance related to tone is beneficial.	6.2
7. Extending the auditor's obligations: Fraud prevention and detection	
Should Australian auditing standards be updated to consider whistleblowing-related audit procedures. Little reference at the moment.	7.2
Can auditors in Australia better leverage off companies' internal whistleblowing systems and procedures to better assess fraud risks? Can auditors rely more on internal auditors who should have better knowledge, and how can this be reflected in AUASB standards?	7.2

Future Research Opportunities

The secondary aim of the roundtable was to identify gaps in knowledge where further research activities would be beneficial. Rather than summarising in the executive summary, we would recommend that prospective researchers play close attention to the section where their research interest lies, paying close attention to why the issue is on the work program of the AUASB, and giving consideration to what work has been or is being done, and future research suggestions that are outlined.

1. Informing Audit and Assurance Regulatory Reforms

The aim of this introductory session was to outline the objectives of the roundtable, hear about the AUASB's strategic priorities, and hear from two leading academics on the role of research in informing regulation and standard setting. Key questions that were explored include:

- How can academic research better inform the AUASB?
- What is the AUASB trying to achieve with regard to their evidence-informed standard setting strategy?
- Is this being achieved?
- How can the AUASB and academics work more cooperatively?
- More broadly, what are the lessons learned from the development and implementation of prior regulatory reforms (such as CLERP 9) and the processes and findings of regulatory reviews, including the Parliamentary Joint Committee's inquiry into the regulation of auditing in Australia, and from developments in other jurisdictions.

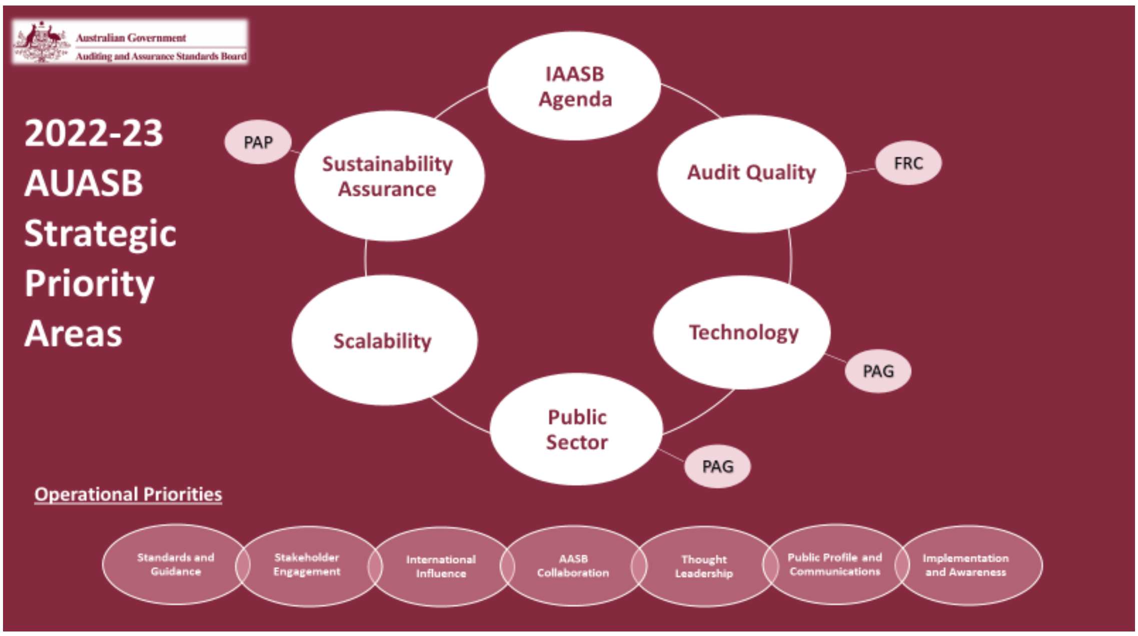
Structure of the session	
Anne Waters – AUASB	The AUASB's strategic priority areas
Professor Ken Trotman – UNSW	Enhancing the AUASB's evidence informed standard setting strategy
Professor Stephen Taylor – UTS	Audit regulation and the need for research

1.1 The AUASB's strategic priorities

Anne Waters, Deputy Technical Director, AUASB

The AUASB's (2019) [evidence informed standard setting (EISS) strategy]() directs our activities to ensure that standard-setting deliberations and decisions are informed by relevant and reliable evidence and research. The AUASB encourages and supports research that provides evidence on the current audit and assurance environment that informs our current and future agenda.

The AUASB's current agenda and strategic priority areas are:



All strategic priority areas (except Technology) were discussed at this workshop. The AUASB are interested in identifying what research currently exists in these areas, and what opportunities exist for research in the future.

1.2 Enhancing the AUASB's evidence-informed strategy

Ken T Trotman, Scientia Professor, UNSW Sydney

Some of the points I made in my evidence to the Parliamentary Joint Committee on Corporations and Financial Services: Regulation of Auditing in Australia inquiry (see Trotman 2019) is that, given the increasing complexities in financial statements and the increased uncertainty in professional judgments, we need to be careful not to hold auditors to a higher level of accountability than other professionals (e.g., medical, legal, directors). While an audit inspection process has many benefits, it needs to be recognised that both auditors and inspectors have difficult judgments to make. The fact that the ASIC deficiency rate has stayed high while the firms continue to invest in enhancing audit quality raises some important questions: What exactly does a deficiency mean? Why has the deficiency rate not decreased over time? What research could be carried out to answer these issues which are at present affecting the confidence in financial statements? Do these differences have implications for audit standards and, if so, what research can be done to further inform the standard setting process?

It was somewhat surprising to me to see the lack of research evidence in PJC submissions by members of the accounting profession. In particular, there were lots of suggestions for change (with no/little evidence to support the change) and lots of arguments that there was no need to change with the reasons given that there was no evidence to support the change. There was also some extremely selective use of research findings to support some views, sometimes selecting a very small part of the total evidence available. I would have expected the Inquiry to have encouraged the key stakeholders (FRC, AUASB, ASIC, professional accounting bodies, audit firms), etc. to start an evidence collection process.

One very positive step in this direction is the AUASB's adoption of an evidence-informed standard setting strategy (AUASB 2019). This document notes that the AUASB must have a robust and transparent evidence gathering process to inform and support decision making. This EISS strategy directs AUASB activities to ensure standard setting deliberations and decisions are informed by relevant and reliable evidence (para 3). This EISS strategy has three elements (para 5): knowledge and experience of informed parties, including AUASB members; research activities; and information collection through stakeholder engagement. The three elements are said to have a mutually beneficial relationship and I focus on research activities under the following headings: (a) what type of audit research can inform standard setting? (b) What is required for high quality research? (c) What is holding back high-quality research? (d) Considerations for AUASB?

What types of audit research can inform standard setting?

There are four basic types of research that can inform audit and assurance standard setting: archival, experiments, interviews and surveys. Archival research is very useful when data already exists. For example, in post-standard reviews, data can be collected on the effects of changes in standards. This data can be subdivided in different ways to examine where most of the effects occur. Archival research on data in other jurisdictions can also inform the AUASB in their considerations of revisions to standards.

Experiments are the primary research method used in many fields (e.g., introduction of new drugs/treatments are normally tested by experiments prior to introduction). In auditing, we can look at the effect of changes in the wording of standards on auditor judgments, e.g., do they lead to more or less professional scepticism. Changes in the wording of audit reports (including KAMS) can be considered and how they impact the judgments of users. The benefit of experiments is that they can test the effects of conditions before they are implemented. They can also disentangle the effects of variables that are confounded in practice. For example, many changes may be made to a standard at one time and subsequent archival research can only examine the effect of all changes together. Experiments can be used to consider the effects of changes individually or in small combinations.

Interviews with senior practitioners (e.g., partners, audit committee chairs, CFOs) can be valuable to better anticipate potential issues. While surveys are popular in practice, they are of limited value unless very carefully constructed.

What is required for high quality research?

- It may seem rather obvious but what is needed is high quality research on important research questions. Reading the submissions to the PJC it appears that all academic research is equally valid. I can assure you this is far from fact.
- Important questions capable of being addressed: For the AUASB there are numerous questions that can be asked but they need to be operationalised in such a way they can be addressed. For example, in medicine, an important question is what causes a particular disease and how can it be cured? It is highly unlikely just one study will solve this problem. The process usually starts with an understanding of the functions of the anatomy (e.g., brain) and the factors that affect those functions over time. For most complex research questions in auditing (e.g., what causes deficiencies in judgments) we want to know not only what causes a deficiency but when and why. This allows both remedial actions to be taken and the development of decision aids.
- Researchers who are independent and with the expertise to carry out the research: This involves someone with the training and experience to determine what data is needed to address the question and design a study with adequate internal validity to eliminate alternative explanations for the results.
- The important research questions can only be addressed if there is data available to examine the question. The quality of archival research often depends on the quality of the data available to be analysed. Practitioners sometimes question the results of research studies based on the measures of audit quality used. They are correct in doing this, but the next question is, do they have better data to be analysed? Again, for experiments, the results of studies may depend on the quality of the participants. For example, what level of auditor normally makes particular judgments and do the participants fit that category? The problem is that data is often confidential. In this case, the data has to be desensitised by the provider or there needs to be a trust relationship between the provider of data and the researcher. This can be supported by confidentiality agreements.
- Better interaction between academics and the profession in agreeing on the key research questions and providing the data to address those questions. Academics need to focus more on the challenges facing the accounting profession. AUASB can/does play a role in setting this agenda.

What is holding back high-quality research needed by the AUASB

- The accounting profession broadly defined does not see research as a priority which is somewhat different to other professions. There is a huge knowledge base in the profession and so discussions among a group of well-informed professionals on solutions is one form of evidence. Other professions (e.g., medicine, engineering, psychology) go beyond that and carry out extensive archival studies to learn from what has happened and develop carefully designed experiments to investigate the potential effects of new developments before they are introduced.

- Academics faced with a whole range of pressures and constraints in the publication process not giving sufficient focus to the emerging issues facing the auditing/assurance profession.
- Lack of data is the key constraint. Important questions can only be addressed if the data is made available. The better the data academics have to work with, the more valid are the findings of the studies. Data is needed to be provided to allow independent evidence for standard setters and regulators to make informed decisions.

Implications for the AUASB

In sum, practitioners are disappointed with academic research because it often does not address the important questions. Academics argue they would like to address the important questions but do not have the data. AUASB could consider their role in addressing the Catch 22 situation.

1.3 Audit regulation and the need for research

Stephen Taylor, Professor, UTS

Over the last 20 years there have been many aspects of how the market for audit services and the structure of audit firms themselves has been subject to criticism, with resulting introduction of new regulations and/or a continuing call for regulatory action. Examples include claims that the delivery of non-audit services should be severely restricted, the Big 4 accounting firms should be split up, there is insufficient competition in the market for audit services, firms should have two auditors rather than a single auditor, auditors should be appointed by a government agency rather than by the client-firm directors and so on. All of these claims reflect calls for further regulatory intervention, ranging from the mild to the dramatic.

Fundamentally, there are really only two ways that decisions can be made about the need to create (or remove) regulatory requirements such as those that would impact on the conduct of audits as well as the underlying structure of audit firms and the entire market for audit services. Policy recommendations must either reflect evidence, or alternately they reflect intuition.

Using medical science as an example, evidence serves as a basis to decide whether a given medical treatment is an effective intervention in addressing a health issue. Such evidence is viewed as critical because it enables reliable, robust conclusions about causality (i.e., does Drug A represent an effective intervention in treating Disease X). In a similar vein, arguments about the role of non-audit services or the structure of the market for audit services in influencing audit quality are ultimately questions that can either be addressed via evidence, or alternately by intuition. Surely good policy should be evidence-based?

Adopting a sceptical approach to the role of anecdotes in forming broad judgements is not to say that such examples might not be of importance. For example, an event may be extremely infrequent, but have an exceptionally high cost. While corporate failures often have high costs, what is less clear is how the audit process identifying failure at an earlier point would have eliminated, rather than merely reduced those costs. Detailed analysis of relatively infrequent events can be of use in reducing their likelihood, but that is not the same as making broad, general conclusions about the extent to which such outcomes are broadly typical, and therefore warrant regulatory intervention.

In order to assemble evidence on the drivers of variation in audit quality, we first need observable measures that capture audit quality variation. Here there is a major challenge, as the audit process itself is unobservable to researchers. There are really only two readily observable outcomes of the audit process. These are the auditor's report, and the audited financial statements themselves. Each has significant limitations as an indicator of audit quality.

The assessment of audit quality based on the audit report reduces audit quality to a binary outcome (Francis 2011). High audit quality is where the audit report is seen to "match" the true underlying situation, so that low quality is generally seen as being where an unqualified report is followed by events such as corporate failure (i.e., the type of outcomes that typically receive media and regulatory attention). However, as I have noted above, these types of events are very much the exception rather than the rule, suggesting that our ability to make reliable and generalizable inferences from such events is very limited. Nevertheless, regulators, media and politicians appear to respond to such events in a way that overstates the extent to which they represent the relevant population of audited firms. This is consistent with most regulatory innovation in securities markets being reactive to corporate scandals and of limited subsequent effectiveness.

The only other observable outcome is the audited financial statements. Financial statements are not just a reflection of audit quality, as they are a joint product of management representations and the quality of the audit process. However, the assumption in developing such evidence is that the quality of the financial statements should be positively correlated with audit quality. This approach reflects the definition of audit quality outlined above, but it is applied so that audit quality is viewed as being "greater assurance of high-quality financial reporting". Focussing on the quality of financial reporting is also consistent with most, if not all of the current criticisms aimed at audit firms, which are triggered by what appears to be instances where the financial report does not seem to have reflected underlying economic circumstances (i.e., the accounting appears to have been aggressive, as evidenced by financial distress or outright failure).

However, exactly what constitutes higher quality financial statements has been the subject of extensive debate. Some examples of approaches taken to identify quality variation include measures of abnormal accruals, accrual estimation errors, propensity to beat common benchmarks (i.e., prior year's earnings, avoiding a loss or beating analysts' forecasts), financial restatements, financial fraud and the extent of accounting conservatism. Although the diversity of ways in which accounting quality is measured may serve to confuse users of this research, it provides the potential to compare the robustness of results linking such measures to possible indicators of audit quality. But all such measures of financial reporting quality are potentially very noisy, and subject to a wide range of practical limitations.

Consequently, an evidence-based analysis of audit quality may ultimately be informed by actual audit files, as well as the assessment of audit decision making processes. Both forms of evidence likely require the support of regulators and audit firms, as such data is likely unobservable to researchers who are equipped with the skills to robustly assess and critique the extent to which there is evidence supporting the need for regulatory intervention.

Implications for AUASB

In contrast to many national securities regulators, the AUASB already has a strong commitment to evidence-based standard setting. Of course, evidence relevant to new or revised standards can take many forms. Descriptive evidence can be an important input to the identification of possible issues, but causal evidence is necessary in establishing how standards (or other forms of legislative intervention) can successfully address alleged deficiencies in audit procedures and reporting. Given the difficulties researchers face in observing audit processes, and the noisy nature of most observable proxies for audit quality, the AUASB, in conjunction with professional bodies and the accounting firms, needs to do everything possible to ensure that data is available to support rigorous research on which subsequent standards and rules are based.

2. Sustainability Assurance

With the importance of sustainability reporting and assurance in the current environment, and the range of current initiatives and research being undertaken, this topic area was spread over two sessions. The first session covered the current environment and provided context on various national and international initiatives. The second session covered specific assurance and other credibility enhancing research projects. As we consider international developments in relation to sustainability reporting and potential impacts for Australia, it is important that we have evidence about current assurance and other credibility-enhancing practices regarding corporate reporting other than the financial statements and how the integrity of this information is maintained. How are entities verifying the integrity of their reporting outside the financial statements which are subject to audit? How are listed entities complying with ASX Corporation Governance principles recommendation 4.3? What credibility enhancing techniques beyond external assurance are being used? If Australia adopts the ISSB's reporting standards, should this information be subject to external assurance, other credibility enhancing techniques?

Structure of the session	
Matthew Zappulla – AUASB	Sustainability Assurance – the state of play and key questions
Doug Niven – ASIC	Assurance over sustainability information
Michael Bray – IFRS Foundation and Deakin University	International trend: Towards a more integrated approach to assurance
Shan Zhou –University of Sydney	A review of research and practice
	Assurance of climate-related and other sustainability information: A few studies to share
Xinning Xiao – Monash University	Discussion of research findings on sustainability reporting and assurance
Jean You – UNSW	Climate-related disclosures and assurance in Australian listed companies
Eka Tan – Deakin University	Overview of ASX Corporate Governance Recommendation 4.3 White Paper

2.1 Sustainability assurance – the state of play and key questions

Matthew Zappulla, Technical Director, AUASB

As Australia prepares for the release of the ISSB standards and considers whether this reporting will be mandated for certain entities, it is critically important to consider whether this information should be subject to assurance. Currently assurance is:

- Voluntary and usually limited assurance.
- Mainly provided by the financial statement auditor but entities may choose providers outside the accounting profession.
- Usually under ISAE / ASAE 3000, but other standards (ISAE / ASAE 3100, 3410) and other frameworks (ISO) also used.

The IAASB is developing a specific sustainability assurance standard that is framework, user and practitioner neutral. The following challenges exist in developing a specific Sustainability assurance standard:

- Limited vs reasonable assurance
- Suitability of reporting criteria
- Scope of sustainability subject matter
- Evidentiary requirements
- Materiality
- Use of experts
- Reporting content
- Prospective information

The IAASB has developed a Project Plan to create an overarching sustainability assurance standard (ISSA 5000 *General Requirements for Sustainability Assurance Engagements*) that addresses the conduct of an assurance engagement in its entirety (i.e., addresses all elements of the engagement from engagement acceptance through to reporting) which will:

- Include specific requirements and application material for areas of the engagement where priority challenges have been identified
- Be principles-based and suitable for assurance engagements on all sustainability topics
- Be a standalone standard that includes defined terms, drawing upon relevant requirements and application material in ISAE 3000 and ISAE 3410, specific ISAs, the EER Guidance released in 2021, as well as 'new' material where necessary

The proposed timeline is to issue an exposure draft in September 2023 and a standard in early 2025. This is roughly 2 years after the ISSB release their standards.

In addition, there are local implementation considerations:

- What is an appropriate regulatory framework?
- How should entities required to apply new sustainability reporting requirements be defined, including thresholds for reporting and assurance?
- Where should Sustainability reporting reside – in the financial report, the OFR or separately?
- What level of assurance should be required for sustainability reporting?
- Who should provide assurance (financial statement auditor? SME / sustainability expert?) and what independence and quality management standards should apply?
- What standard-setting structure needs to support introduction of sustainability reporting? (i.e. separate ASSB or keep within AASB? Overhaul the AASB/AUASB/FRC, like the XRB in NZ?)
- What additional guidance should the AUASB be considering whilst the IAASB develop their sustainability assurance standard/s?

The AUASB is keen to identify what research exists to assist the AUASB and other policy makers on these critically important issues.

2.2 Current status of legislation for reporting and assurance of sustainability information in Australia, and challenges going forward

Doug Niven, Chief Accountant, ASIC

Background

The International Sustainability Standards Board (ISSB) is to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and markets information on sustainability-related risks on an enterprise value basis. The ISSB is aiming to issue final standards on general sustainability and climate disclosures in early 2023. There is widespread in-principle support in Australia for adopting the ISSB framework.

While many in the reporting chain have commenced and undertaken work in this area, companies, assurance providers, investors and financiers will need time to prepare for any new reporting requirements.

Government position

The mandating of any new requirements for corporate reporting of climate-related information is a matter for Government policy.

At an Investor Group on Climate Change Summit on 24 June 2022, the Minister for Climate Change and Energy, Chris Bowen, referred to the Government's high-level in-principle commitment to corporate reporting on climate information and the importance of consulting with key stakeholders. Minister Bowen also indicated that reporting would need to be mandatory for "large, listed companies and financial institutions". He indicated that the Government would "look at international best practice" in this regard.

Current reporting

In the meantime, the current requirement in the *Corporations Act 2001* for listed entities to prepare an Operating and Financial Review (OFR) that accompanies and complements the financial report remains unchanged. ASIC Regulatory Guide 247 *Effective Disclosure in an Operating and Financial Review* (RG 247) continues to apply.

The auditor of the financial report currently audits information relating to climate in the financial report (e.g. asset impairment, provisions and disclosures on uncertainties and key assumptions) and not in the OFR, but ASA 720 applies to information in the OFR.

Listed entities are already required to present important information for investors in the OFR on the underlying drivers of financial performance, as well as strategies and financial prospects for future financial years. This includes covering material environmental, social and governance risks and climate-related risks that could have a material impact on the future financial position, performance or prospects.

RG 247.66 suggests that "Directors may also consider whether it would be worthwhile to disclose additional information that would be relevant under integrated reporting, sustainability reporting or the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), where that information is not already required for the OFR."

Listed entities that voluntarily report climate-related information under the TCFD recommendations will be better placed to transition to any future ISSB standard. The ISSB proposals are based on the same four pillars of disclosures as the TFCFD recommendations – governance, strategy, risk management, and targets and metrics.

Support of IOSCO and ASIC of the development of standards by the ISSB

On 3 November 2021, the International Organisation of Securities Commissions (IOSCO) issued a press release welcoming the formation of the ISSB (see IFRS Foundation´s International Sustainability Standards Board on the Right Track, Says IOSCO). The press release stated that IOSCO will consider endorsing the final standards to encourage their adoption in member jurisdictions. Endorsement of the International Financial Reporting Standards by IOSCO in 2000 was seen as key to the widespread international adoption of those standards.

On 14 December 2021, ASIC issued a media release welcoming the establishment of the ISSB, which will develop comprehensive baseline climate and sustainability disclosure standards (see 21-349MR ASIC welcomes new International Sustainability Standards Board and updated climate-related disclosure guidance).

Challenges for adopting the proposed ISSB General Requirements and Climate Disclosure standards in Australia

It will be important to balance investor demand for information against allowing time for corporates to upskill, develop systems and processes, and source data.

While many in the reporting chain have commenced work in this area, companies, assurance providers, investors and financiers will need time to upskill and prepare for any new reporting requirements.

Entities may need to establish new systems and processes to support new reporting requirements and may need to source new data from third parties in their value chains. Climate disclosures may also require region-specific scientific analysis and scenario information.

It will also be necessary to establish a legislative framework to support the making of sustainability standards and requirements for Australian entities to apply them.

Larger listed companies and financial institutions should have implementation plans underway now. Even if there is a transitional period before requirements apply, three may be investor demand for companies to report earlier.

In a submission letter dated 27 July 2022 on the ISSB exposure drafts (see Australian Council of Financial Regulators Comment Letter to ISSB), the Council of Financial Regulators (CFR) (Treasury, RBA, ASIC and APRA) expressed support for the establishment of the ISSB to deliver a comprehensive global baseline for sustainability-related disclosure standards. While the submission also expressed in-principle support for adopting the proposed ISSB general sustainability and climate disclosure standards (subject to their final form) in Australia, the commencement, scope and mandatory nature of any new reporting regime are ultimately matters for the Australian Government to determine.

Without detracting from this broad support, the letter drew attention to the following matters which may benefit from further consideration as the ISSB progresses towards finalisation of the proposed standards:

- transitional and phasing arrangements that balance demands for information from investors and other users with giving adequate time for reporting entities to prepare for new disclosure requirements (including upskilling, developing appropriate systems and processes, and having access to necessary data).
- whether some flexibility may be required in terms of the proportionality and/or scalability of the standards if they are applied to smaller entities. This is particularly

relevant for Australia given the large number of small to medium sized listed entities in Australia relative to some other international jurisdictions.

- the need for clear and consistent definitions, guidance and support for entities adopting the proposed standards, in order to promote consistent and comparable disclosure. For example, ISSB guidance on applying the 'significance' and 'materiality' criteria in the proposed general sustainability disclosure standard, as well as a clearer definition of the value chain and its operational boundaries.
- whether the proposed industry-based climate metrics should be field tested by some issuers in different industries and jurisdictions. Experience from the field tests may assist to improve those metrics and ensure their relevance and applicability across different jurisdictions.

Future ISSB work plan

While the ISSB is focusing its efforts on finalising the general sustainability and climate disclosure standards, it intends to consult on its future work plan to develop further sustainability standards on specific topics. Although a background paper was presented to the July 2022 ISSB meeting, the ISSB has not yet considered which topics might be covered in the work plan. Possible topics could include biodiversity, nature, soil, human capital and modern slavery.

Assurance

There are differing views as to who should provide assurance over sustainability reporting. There may be synergies in the auditor of the financial report providing assurance over sustainability information and using experts as appropriate. Auditors are familiar with assurance levels and are subject to quality management and independence standards.

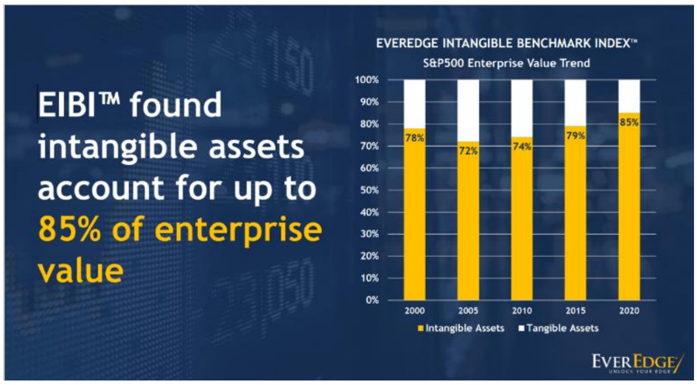
On 15 September 2022 IOSCO issued a press release supporting the work of the IAASB and IESBA in developing standards (IOSCO encourages standard-setters' work on assurance of sustainability-related corporate reporting)

Other matters to consider on assurance of sustainability information may include:

- The need for a reporting framework first;
- The scope of the audit and how materiality applies;
- The level of assurance on the information and whether that changes over time;
- Relevance vs auditability of information;
- Obtaining assurance over information from value chains/Scope 3 emissions;
- Whether assurance could stifle reporting in the initial periods of reporting;
- The approach to assurance on individual industry metrics; and
- Auditing forward-looking information, and opining on governance, risks, strategies, etc.

2.3 International trend: Towards a more integrated approach to assurance

Michael Bray, Special Adviser, IFRS Foundation Connectivity and Integrated Reporting Team and Professor of Practice (Integrated Reporting), Deakin University



Intangible asset specialist, Everedge (2022) found that 85% of the enterprise value of S&P500 companies is not recognised on balance sheets under IFRS Accounting Standards. Not only does this leave a significant information gap for investors – *a reporting gap* - it also leaves a significant gap in investors being able to have confidence that they have all the reliable information they need to assess an organisation's enterprise value – *an assurance gap*.

Integrated reporting became a core component of the corporate reporting system upon consolidation of the Value Reporting Foundation into the IFRS Foundation on 1 August 2022. An IFRS Foundation 'vitality campaign' on integrated reporting, to complement the successful market outreach campaign on the exposure drafts issued by the International Sustainability Standards Board (ISSB), is scheduled to take place in Q4 2022. The *reporting gap* has been closed to a significant extent.

With the consolidation and simplification of sustainability reporting that has been achieved through the IFRS Foundation, it is timely that the International Auditing and Assurance Standards Board (IAASB) has commenced a sustainability assurance project. That project will be broadly based – it will be framework-neutral and will cover all information in all corporate reports, including the Integrated Reporting Framework (IRF) and integrated reports (Zhou et.al., 2020). Therefore, integrated reporting assurance will become a core component of the corporate reporting system through the IAASB's sustainability assurance project. There are promising signs that the *assurance gap* is closing.

However, sustainability reporting is a very broad topic, and so naturally is sustainability reporting assurance. The IAASB's stated initial focus is on a framework-neutral standard which is likely to be more focused on the sustainability metrics contained in sustainability disclosures than on the description of *The Business* and other features of integrated reporting assurance. While the ISSB standards will require a partial description of the business in relation to climate and other ESG matters given their grounding on the TCFD Recommendations, there is a risk of the IAASB not sufficiently focusing on the comprehensive treatment of matters required by the Integrated Reporting Framework.

The integrated reporting process will always be a material business process within the business model which must be described in an integrated report in accordance with the Integrated Reporting Framework. The description of the integrated reporting process and controls within it in an integrated report will be part of the population of information for which responsibility by the board of directors must be acknowledged under paragraph 1.20 of the IRF, whether the process disclosure recommended in paragraph 1.24 of the Framework is made or not. Accordingly, internal control assurance is embedded in integrated reporting assurance. The *assurance gap* may not be closed to a sufficient extent.

The project aims to produce an overarching sustainability assurance exposure draft by early 2024 and a standard by the end of 2025 for market adoption in 2026-27. Unfortunately, such a timeline may disappoint investors and other stakeholders (including IOSCO) who want something more quickly. The *assurance gap* may not be closed quickly enough. This has significant implications for the AUASB.

Sustainability including integrated reporting assurance in practice

The annual IFAC (2022) Sustainability Assurance Benchmarking study demonstrates that the assurance of ESG metrics in practice is maturing. That benchmarking study to date has not examined integrated reporting assurance, an emerging practice. That an integrated report meeting the requirements of the IRF can be suitable criteria for assurance under International Standards of Auditing has been demonstrated by the 13 known instances of integrated reporting assurance since 2019 outside of Brazil, Spain and Italy. In Brazil, integrated reporting assurance (and integrated reporting) has been mandated by the securities regulator since 2019, and so there are hundreds of instances of integrated reporting assurance. The pioneers of integrated reporting assurance are the Dutch bank, ABN Amro, and its financial statement auditor, EY, which provided the first instance of integrated reporting assurance in 2019. All 13 instances of successful delivery of integrated reporting assurance have used ISAE 3000 or national equivalents.

The 13 instances are a small population. Brazil increases the population significantly. In the 13 instances and in Brazil the assurance was mainly provided by three of the large accounting firms (KPMG, PwC and EY); and has been provided for organisations in a variety of countries (India, Australia, Malaysia and the UK as well as the Netherlands) and industries (pension funds, life insurance, property & construction, oil & gas, pharmaceuticals, and automotive as well as banking). Australia at this stage has the most instances of integrated reporting assurance in the world.

The ISSB's General Requirements and Climate Reporting standards will provide a building block towards more widespread integrated reporting assurance as they require a partial description of *The Business* as it relates to climate and other ESG matters; and the French regulator already requires assurance by the financial statements auditor on the partial description of *The Business* required in Management Reports. The ISSB's General Requirements and Climate Reporting standards will provide the basis of suitable criteria for assurance under ISAE 3000.

Finally, ISA 720 *The Auditor's Responsibilities Relating to Other Information* requires the financial statements auditor to consider the 'other information' in reports that contain the audited financial statements (normally annual reports), such as integrated reports and integrated report equivalents (e.g., the Strategic Report in the UK, the Operating & Financial Review in Australia). This latent building block for more integrated reporting assurance is underappreciated.

IFAC Integrated Reporting Assurance Series

IFAC recognised the importance of the IAASB's 'extended external reporting assurance guidance' in 2020, with IFAC being a driver in the IAASB establishing its sustainability reporting assurance project.

Consistent with its advocacy about the importance of assurance in the context of the corporate reporting ecosystem, IFAC, in collaboration with the International Integrated Reporting

Council (now consolidated into the IFRS Foundation) and Institute of Internal Auditors, has to date produced two papers on integrated reporting assurance:

- The first instalment explains what integrated reporting assurance is and is not, and on that basis its distinctive contribution and value (IFAC and IIRC 2021).
- Instalment 2 explains the responsibility of the board of directors for the integrated report and underlying reporting process; the contribution that internal audit can make to assist the board in discharging that responsibility; and how this can underpin an effective and efficient independent external integrated report audit (IFAC and IIA 2022).
- Instalment 3 is under development. It will feature attestations from leading investors on the value to investors of integrated reporting assurance and feedback from organisations that have obtained integrated reporting assurance (a demand signal to directors and assurance practitioners).

Instalment 2 demonstrates that internal control reporting and assurance already exists in practice within the context of integrated reporting assurance.

As outlined later in this section, Tan et al. (2022) recently published a white paper on ASX 300 Corporate Governance Recommendation 4.3 Disclosures. They examined the effectiveness of communication in Recommendation 4.3 disclosures and the efficacy of integrity enhancement processes, including ESG metrics and integrated reporting assurance, and found significant room for improvement. They made recommendations to ASX300 companies, the ASX Corporate Governance Council, ASX and professional accounting bodies, to use integrated reporting and integrated reporting assurance to back and improve Recommendation 4.3 disclosures. There is a significant alignment between the director responsibility statement required by the IRF and Recommendation 4.3. Australian directors should use the director responsibility statement and their obtaining integrated reporting assurance as an important basis for establishing the credibility of their Recommendation 4.3 disclosures.

<u>The Accountancy Profession</u>

IFAC (2021) noted the key role of the accountancy profession in the development and implementation of reporting frameworks and standards that go beyond traditional financial reporting, including development of robust internal control processes, systems and controls; assurance; and identifying, measuring, and reporting relevant metrics supported by best practices or reporting standards. Integrated reporting assurance is a significant opportunity for the accountancy profession.

It may also be possible for professional accountants to develop integrated business assurance engagements on integrated reporting management systems and other elements of integrated decision making and materiality determination for reporting to executives and boards of directors.

Such integrated business assurance opportunities, as well as integrated reporting assurance, are critical to the ’audit of the future’ and indeed the future of the accountancy profession.

Implications for AUASB

- Everedge (2022) is something for the AUASB to ponder – will IAASB sustainability assurance project fill the gap on a timely basis? The AUASB should support the adoption of ISSB standards and assurance thereon, and remain abreast of the IFRS integrated reporting communications campaign Given that Australia is country with significant integrated reporting adoption, will this standard pay sufficient attention to integrated reporting?

- The AUASB should educate the Australian market on the distinctive contribution and value of integrated reporting assurance as components of sustainability reporting assurance. It should promote IFAC Instalments 1 and 2 in Australia and consider working with IFAC in relation to Instalment 3 with a view to ensuring that Instalment 3 is ready for issue in Australia on release by IFAC.
- The AUASB should consider a communication to the market as to what is possible under existing assurance standards (noting that ISAE 3000 was used for all 13 instances and in Brazil) while the IAASB's project continues. It may also like to consider specific guidance on the peculiar features of integrated reporting assurance, which may be useful to the IAASB. The AUASB can draw on the ABN Amro, Cbus, Bank Itau (as an example from Brazil) , Dexus and CPA Australia case studies.
- The AUASB should consider a communication, potentially in collaboration with Deakin University, on the significant alignment between the director responsibility statement required by the IRF and Recommendation 4.3 disclosures.
- Integrated reporting assurance and integrated business assurance opportunities are critical to the 'audit of the future' and indeed the future of the accountancy profession – suggesting possibilities of value to the AUASB. The AUASB should consider forming a work group on the potential market for integrated reporting and integrated business assurance in Australia; and in that context, the capacity of assurance practitioners in Australia in sustainability reporting assurance, and integrated reporting assurance in particular. The working group would probably include CAANZ and CPA Australia. Deakin University would be delighted to be involved.
- While integrated reporting assurance engagements are currently being undertaken under ISAE 3000, as broader information is increasingly being included in the annual report, the AUASB will need to consider the relationship between Australian Standards on Auditing (ASAs) and Australian Standards on Assurance Engagements (ASAEs), and the role of ASA 720.

2.4 A summary of research on sustainability assurance

Shan Zhou, University of Sydney

This summary was undertaken to inform the AUASB the main findings in academic studies regarding the impact and benefits of sustainability assurance. The summary is drawn from a literature review on the reporting and assurance of climate-related and other sustainability information (Zhou 2022).

Method

I surveyed articles (including review articles) using the archival method published between 2009 and 2021 in accounting journals ranked A*, A and B on the Australian Business Deans Council (ABDC) 2019 Journal Quality List on sustainability/Environmental, Social and Governance (ESG) assurance.

Findings

The impact of sustainability assurance documented in existing studies can generally be categorised into external impact on information users and internal impact on preparers, i.e., companies reporting sustainability information.

The external impact from having sustainability information assured includes the following:

- Improving the quality of the underlying subject matter disclosure (e.g. environmental disclosure using a GRI based index, Moroney et al. 2012);
- Increased instances of restatement of prior years' sustainability/ESG reports, reflecting positive steps forward for improving sustainability reporting quality and effectiveness (Ballou et al. 2018).
- Positive capital market outcomes including return on equity (assets); lower cost of capital; more accurate analysts' forecasts (Casey and Grenier 2015), reduced information asymmetry (bid-ask spread, Fuhrmann et al. 2017) and increased market value (Clarkson et al. 2019).
- Lower level of capital constraint and cost of debt (Carey et al. 2021).
- Greater standardization of the assurance reports as a result of the mandatory sustainability assurance in France (Gillet-Monjaret 2018).

The internal impact on companies engaging in sustainability assurance include the following:
- Enhanced environmental reputation (scores reported as part of Newsweek magazine's rankings of the 'greenest companies in America', Birkey et al. 2016); inclusion in the Dow Jones Sustainability Indices (DJSI) (Clarkson et al. 2019).
- Reducing CSR-related misconduct (daily negative CSR-related new released by major business media outlets, Du and Wu 2019).
- Higher sustainability investment efficiency (deviation from the optimal level, proxied by the mean of the environmental and social score from ASSET4, Steinmeier and Stich 2019)
- Inclusion of sustainability-related targets in CEO compensation contracts (Al-Shaer and Zaman 2019).

A few studies extended the examination of third-party assurance to a broader range of credibility-enhancing mechanisms and have documented capital market impacts of these mechanisms (Zhou et al. 2019). Another strand of studies focuses on the different types of assurance providers in this market and discusses implications on the process and outcomes of the assurance engagement (Huggins et al. 2011; O'Dwyer et al. 2011). More recent studies turn to the implications of the more integrated form of reporting on the dynamics of different types of assurance providers (Lu et al. 2022).

Implications for AUASB

- Compared to the large body of literature on sustainability reporting, studies documenting the impact and benefits of sustainability assurance are limited. One of the reasons is the lack of publicly available data on sustainability assurance which is usually restricted to the contents of published sustainability assurance reports. Additional information on sustainability assurance such as key assurance matters similar to the key audit matters in financial statement audit reports, and fees charged and/or hours to perform the assurance engagement could spur more research to enlighten areas of significance and interest. For example, how to best measure assurance quality?
- The greater integration of financial and sustainability information that is recently occurring is increasing the likelihood of provision of sustainability assurance by accounting firm providers, especially those also undertaking the financial statement audit. Recent evidence suggests there are benefits in using the same provider to provide both services (Lu et al. 2022). On the other hand, concerns for financial statement auditor independence when also providing other services (including sustainability assurance) have been raised in the recent International Ethics Standards Board for Accountants and by the Australian Parliamentary Joint Committee.

- Various forms of credibility-enhancing mechanisms other than independent assurance are emerging, such as the disclosure (or reporting of the reasons for non-disclosure) of the processes underpinning the integrity of any periodic corporate report other than the financial statements, including sustainability reports and any other non-financial information released to the market in the Recommendation (Rec) 4.3 disclosure requirement of the Corporate Governance Principles and Recommendations (ASX Corporate Governance Council 2019). Should these credibility-enhancing mechanisms be considered in the deliberations on the reforms to the assurance standards on sustainability reporting?

2.5 A few studies to share on sustainability assurance

Shan Zhou, University of Sydney

Introduction

This report contains a summary of three recent studies on sustainability assurance I conducted, with co-authors. We aim to inform the AUASB in their considerations of sustainability assurance. I discuss below the background, research questions, method, results, and implications for the AUASB for each study.

Study One: Lu, Simnett and Zhou (2022). Using the Same Provider for Financial Statement Audit and Assurance of Extended External Reports: Choices and Consequences. *Auditing: A Journal of Practice & Theory*, forthcoming.

Lu et al. (2022) is undertaken against the background of an increasing uptake of Extended External Reports (EER) assurance and the trend of integrating sustainability/non-financial information into the annual report. In this paper, we aim to provide answers to the following research questions:

- What drives companies to choose the same versus a different assurance provider on their financial and EER reports?
- What are the consequences (audit outcomes) of choosing the same versus different assurance provider?

Using 3,159 EER assurance engagements during 2012-2016 covering 50+ jurisdictions, we document the following findings:

- Providers' expertise in EER assurance and extent of integrating non-financial information into annual report increase likelihood of using same provider for both financial statements and EER. Independence concerns (i.e. prior year NAS ratio) decrease likelihood of using same provider.
- Companies with the same provider for both financial statements and EER have higher financial statement audit quality without paying significantly different audit fees.
- Being the financial statement auditor has a greater likelihood of taking over the EER assurance service and becoming the sole provider than vice versa.
- There is a lack of consistency as to whether EER assurance fees are included in audit-related service fees or NAS fees. There were 97 instances where the category of EER assurance services fees could be identified, with 36 classified as audit-related services and 61 included as NAS (or similar descriptions). None were included as part of audit fees. When EER assurance fees included as audit-related services fees, no independence concerns identified, while a high ratio of NAS fees increases independence concerns. Thus classification of EER assurance fees has a real-world impact.

Implications for AUASB

- There are benefits of improved audit quality without significant increase in audit costs when companies engage their financial statement auditor as EER assurance provider.
- The trend of integrated reporting creates a natural advantage of accounting firm providers in this market, which may have implications for competition in the assurance market.
- Whether EER assurance fees are included in audit-related services fees or NAS fees make a difference in affecting perceived financial statement auditor independence.

Study Two: Ge, Simnett and Zhou (2022). Evaluating the Use of International Assurance Standards by Non-accounting Practitioners. Second round review at *Auditing: A Journal of Practice & Theory*.

When recently revising assurance standard ISAE 3000, the IAASB determined that public interest would be best served if all competent practitioners (including non-accounting practitioners) were able to use the ISAEs. A condition of use is that the assurance report must disclose the engagement's underlying ethics and quality control frameworks. We aim to provide evidence to the following research questions:

- Is there an increase in the use of ISAE 3000 by other practitioners?
- Do practitioners (both accounting and non-accounting) comply with the condition of use?
- Implications of using ISAE 3000 for other practitioners?

Using 4,075 EER assurance during 2014-2017 covering 40+ jurisdictions, we document the following findings:

- A significant increase in ISAE 3000 application post-revision by non-accounting practitioners with those switching to ISAE 3000 gaining more market share.
- Significant increase in references to underlying ethics codes/quality control frameworks by non-accounting assurance providers post implementation period. But non-compliance rate for these providers remains high (62% ethics code, 83% quality control framework).
- Non-accounting practitioners switching to the use of ISAEs improves assurance report quality in terms of reference to ethics and quality control framework, inclusion of a statement of independence, and disclosure of additional procedures, including interviews, site inspection, review the approach to stakeholder engagement, review the outcomes of stakeholder consultation report, review of source documents.
- Non-accounting practitioners switching to ISAE 3000 attract more clients.

Implications for AUASB

The use of ISAE by non-accounting practitioners is beneficial in improving the transparency of the assurance report and signalling quality to the market. Nonetheless, the lack of enforcement on non-compliance is a concern and may be a threat to legitimacy for IAASB.

Study Three: Simnett, Thurheimer, Yang and Zhou (2022). The Impact of Mandatory Assurance on Sustainability Information, *work in progress*.

This study is motivated by the EU directive 2014/95/EU which requires large public interest entities to disclose information on environmental, social, and employee matters, among other non-financial disclosures, from 2017. EU members can impose state-specific requirements on companies regarding assurance obligations. Three EU members to-date (France, Spain and Italy) have imposed third-party assurance requirements on non-financial information. It is a still a work in progress, and we aim to provide evidence on the impact of mandatory sustainability assurance on reporting and assurance practice, and information users.

With 466 listed companies in Spain (treatment) and 475 listed companies in Netherland (control) across 2013 to 2020 with mandatory assurance in Spain effective from 2018, we document the following preliminary findings:

- An increase in full report assurance (as opposed to assurance on some sustainability indicators).
- An increase in the use of sustainability indicators in Executives' compensation plans.
- An increase in using the same assurance provider for both the financial statement audit and sustainability assurance.
- An increase in assurance efficiency as reflected in the number of days used to complete the assurance engagement.
- Assurance innovation observed in Netherland (with voluntary assurance), with key assurance matters disclosed in a combined audit and assurance report. These key assurance matters include Scope 3 emissions; reporting criteria for sustainable revenues; estimates and assumptions concerning the calculated impact of avoided Co2 as presented in the value creation model; Business conduct, integrity and transparency, and consistent and correct application of KPI definitions across the group and over time.

Implications for AUASB

Initial findings indicate that mandatory sustainability assurance expands the scope of the assurance engagement, promotes more reliance on the use of sustainability information within the company and results in greater likelihood of financial statement auditor becoming the assurance provider. On the other hand, it may promote a compliance driven assurance practice which may stifle assurance innovations.

2.6 Sustainability reporting credibility and assurance

Xinning Xiao, Monash University

Background

Despite the prevalence of sustainability reporting and assurance (KPMG 2020), there have been concerns with the credibility of sustainability reporting (e.g. Boiral, Heras-Saizarbitoria, and Brotherton 2019; Chen et al. 2016; Diouf and Boiral 2017; Sethi, Martell, and Demir 2017). The failure of managers to meet stakeholders' expectations of providing credible sustainability disclosure gives rise to a 'credibility gap' (Dando and Swift 2003; Hsueh 2018). The credibility gap is detrimental to the usefulness of sustainability reports and exacerbates stakeholders' distrust and scepticism about the authenticity of communicated sustainability information.

Research objective and method

To bridge the credibility gap, there is a need to better understand stakeholders' perceptions of the factors affecting the credibility of sustainability reporting. To this end, Xiao and Shailer (2022) investigate the perceptions of four stakeholder groups – users, preparers, assurers, and standard-setters – as to what factors affect their credibility assessment of corporate sustainability reports. Drawing on information credibility theory, we frame a review of prior studies concerned with sustainability reporting to construct a preliminary framework of factors pertaining to the source and message credibility of corporate sustainability reports. We refined these factors through semi-structured interviews with different stakeholder groups. We then assessed the relative importance of these factors across stakeholder groups by using a questionnaire survey.

Main findings

We find that management characteristics and assurance are particularly important to stakeholders' credibility assessments of sustainability reporting. Source characteristics (e.g., management trustworthiness, expertise, and track record) and assurance-related factors (e.g., presence of assurance, assurers' expertise, and assurers' reputation) generally are considered more important than message characteristics (e.g., completeness, balanced tone or comparability). Our findings further reveal a substantial credibility gap between users and preparers in the relative importance of influential credibility factors.

Implications for AUASB

Our findings contribute to a more nuanced understanding of assurance as a credibility-enhancing mechanism of sustainability reporting. We find that assurance is important to stakeholders' credibility assessments. Specifically, the perceived credibility of sustainability reporting is affected by the presence of assurance as well as stakeholders' perceptions of assurers' characteristics including assurers' expertise, independence, and reputation. Our analysis also reveals some important differences in the credibility perceptions between different groups of stakeholders. These differences are particularly prevalent between preparers and users. We find that, compared to users, preparers generally under-rate the importance of the presence of assurance, assurance level, and assurance scope.

The misalignment of preparers' and users' perceptions suggest preparers might be mis-investing effort on aspects that do not increase credibility, which may explain the credibility gap between preparers and users. Our findings thus inform standard-setters' deliberations on the impact of potential credibility-enhancing mechanisms of sustainability reporting. These results will be of interest to standard-setters and reporting entities as they contemplate how to better align the current reporting practices with users' expectations or preferences.

For the consideration of researchers and the AUASB, below are a few key researchable issues facing the profession and the standard-setters:

- To what extent should sustainability reporting and assurance be mandated and standardised?
- How to measure sustainability reporting quality?
- How to measure sustainability reporting assurance quality? Relatedly, how to assess assurer's expertise and independence?
- What are the reporting implications of sustainability reporting assurance?
- How can different types of assurance enhance users' perceptions of the credibility of sustainability information?
- What are the alternative credibility-enhancing mechanisms of sustainability reporting other than external assurance?

2.7 Climate-related disclosures in Annual Reports by Australian listed companies

Jean You, UNSW Sydney, and Roger Simnett, Deakin University

Aim of the research

The objective of this research is to inform the AUASB of the current practices of climate-related disclosures and audit/assurance in the annual reports and corporate governance statements for Australian companies. It is intended to contribute to the AUASB's consideration of appropriate credibility-enhancing techniques of such climate related information.

Method and sample

Our sample was all ASX-listed companies whose reports were available on the Connect4 database for the period from 2018 to 2021. It covered nearly all ASX listed companies in the 4-year sample period.

The scope of this study was based on the application scope of Australian Auditing Standards. We focus on required reports, the combined annual report and its associated Appendix 4G corporate governance statement (CGS), under the reporting framework of ASX Listing Rules (Paragraph 4.7, Chapter 4). Although sometimes the CGS is now presented outside the annual report, it is referenced within the annual report and is a compulsory disclosure. As such, this study does not cover voluntary standalone sustainability or climate-related report, which are outside the scope of Australian Auditing Standards, with the exception of ASA 720.

In order to identify the climate-related disclosures, we searched a list of climate-related keywords among the annual reports and CGSs. We first referenced the keywords used in the ASIC report (2018). We then extended this list based on our pilot review of annual reports. Finally, we adopted the following key terms to identify climate-related disclosures: "CO2" "climate related" "climate-related" "climate strategy" "TCFD" "Climate Resilience" "climate active" "climate action" "climate change" "global warming" "carbon emission" "greenhouse gas" "climate risk" "carbon risk" and "GRI".

Descriptive results

1. Climate-related disclosures

The overall rate of climate-related disclosures in the ASX listed companies increased from 19% in 2018 to 36% in 2021. Further to the overall rate, we examined the disclosure rate in each industry with the GICS sector classification. Every industry sector experienced an increasing disclosure trend of between 10-35% from 2018-2021, with Utilities the highest proportion on disclosers in 2018 (56%) and 2021 (74%), and Health Care (9% in 2018 to 21% in 2021) and Information Technology (7% in 2021 to 24% in 2021) having the lowest proportion. The disclosure rate for entities in industries that were exposed to more climate-related risks (TCFD 2017; AASB-AUASB 2019) had a higher average disclosure rate than for entities in other industries.

Most climate-related disclosures were non-financial in nature and located in areas of the annual report/CGS outside the financial statements, meaning that they were covered by ASA 720. Most disclosures were likely to happen in the sections such as principle 7.4 of the CGS, or, in the annual report, sections on sustainability, risk management, environmental regulation, or a discussion of performance in the director’s report and chairman or CEO’s letter. Given that the format of annual reports is not standardised in Australia, there were a small proportion of disclosures outside of the stated sections above.

Despite being a relatively small proportion, there is an increase in climate-related disclosures in the notes to financial statements from 4% in 2018 to 10% in 2021. The likely notes with reference to climate-related content were basis of preparation, property, plant and equipment, impairment of non-financial assets, and carbon offsets in revenues and expenses. For financial companies, financial risk management was the most likely note.

An increase in disclosures in the remuneration reports contained in the Annual Report was also noted. An increasing number of companies adopted climate-related performance as one of the incentive measures. In the remuneration reports, climate-related performance was usually reflected by quantifiable indicators such as scope 1 and 2 greenhouse gas emissions. The audits of remuneration reports, which are mandatory in Australia, should enhance the credibility of the quantitative information on climate-related performance.

2. Climate-related impacts on financial statement audits

Besides assurance directly applied against the climate-related information, we noted climate-related impact on financial statement audits. We found an increase in climate-related content in key audit matters from none in 2018, 1 in 2019, and 5 in 2020 to 9 in 2021. The climate-related KAMs were often repeated by the same company over respective years. All of these KAMs were raised for companies in climate sensitive industries, and the topics of KAMs were similar within the industries. For example, financial companies have climate-related KAM on allowance for expected losses or impairment. Energy and Materials companies have climate-related KAMs on the carrying value of assets and goodwill.

Climate-related information was more likely to be involved in the discussion of audit procedures to address the KAM than key risks identified by the auditor. Four auditors' reports raised climate-related content as a key risk, while ten reports disclosed how auditors address climate-related issues and one report contained both risk and procedures.

3. Reference in Annual Reports to climate-related assurance engagements

In addition to mandatory financial statements audits, we noticed an increase in the number of companies mentioning in the Annual reports their provision of voluntary assurance over climate-related information. We understand some companies might indicate their assurance provision or attach the assurance report in the Annual report, but if not mentioned in the annual report/CGS they are outside the scope of this study.

There were 45 assurance reports contained in the Annual report in addition to the audit reports across the sample period. All but one such assurance report was issued by Big 4 auditors, with one assurance report issued by a non-accounting firm. 39 out of 45 engagements provided limited assurance, while 6 engagements provided multiple levels of assurance, such as limited assurance over sustainability information and reasonable assurance over greenhouse gas emissions. The choice of assurance standards was limited to ISAE/ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* and/or ISAE/ASAE 3410 *Assurance Engagements on Greenhouse Gas Statements*. We observe many reporting frameworks against which assurance was provided, including GRI, Greenhouse Gas Protocol, industry-specific reporting frameworks, NGERs legislation, TCFD and SASB. Assurance was applied against one or multiple reporting frameworks in the one assurance engagement.

Implications for AUASB and other standard-setters/regulators

Australian listed companies across all industry groups are rapidly increasingly recognising climate impacts directly in their Annual Report/CGS. The increasing disclosure rate across all industries adds support to the AASB and AUASB joint submission to the ISSB (2022) regarding not emphasising industry-specific reporting standards because, while climate sensitive industries have been more likely to voluntarily disclose climate-related information with extant reporting standards and/or guidelines, companies in all industries are increasingly voluntarily recognising the importance of these disclosures to their investor stakeholders.

From an assurance perspective, most climate-related disclosures in the Annual Report were outside the financial statements and are thus the credibility-enhancing techniques are covered by ASA 720. The final revised ASA 720 was one of the more contentious outcomes from the revision of the auditor reporting standards, with concerns as to whether the level of involvement of the auditor is correct, understood, and this disclosure trend increases the importance of ensuring that ASA 720 is fit for purpose in the current environment.

The significant increase in climate-related information in financial statements and remuneration reports, also leads to direct impacts on the financial statement audits. Although this was anticipated by the AASB-AUASB (2019), which subsequently drove equivalent guidance respectively by the IASB (2020) and the IAASB (2020), there has not been a consequential change in underlying auditing standards or application material to support this.

With regards audit reporting considerations, we note a rising number of KAMs are including climate-related impacts, as well as a case where the auditor reported the impact of climate change on their audit planning in their audit report. There is no guidance or examples in the current ASA 700 series for auditors as to what they should include in their report for this type of information. We are now seeing instance of better practice which could be showcased.

With the current assurance practices, although most engagements still provided limited assurance only for climate-related information, there is a trend occurring in the Australian market to assurance reports containing both reasonable and limited assurance levels. There is no clear guidance provided for such reports.

Further, of relevance to the AASB, the large variety of reporting frameworks for climate-related reporting suggests a demand for ISSB standards to deliver a global baseline of more consistent sustainability, including climate-related, disclosures.

2.8 Research on ASX Corporate Governance Council Recommendation 4.3

Eka Tan, Peter Carey, Roger Simnett and Michael Bray, Deakin Integrated Reporting Centre, Deakin University

Aim of the research

This report analyses how ASX300 entities have responded to a major initiative by the ASX Corporate Governance Council (the Council) to drive improvements in the quality and integrity of periodic corporate reporting, in particular Recommendation 4.3, which relates to additional reports published by listed entities that are not subject to audit or review.

The unpublished academic paper, which is a follow-up study from the white paper, aims to observe the determinants of Recommendation 4.3 disclosure quality and the implications of Recommendation 4.3 disclosure on reporting quality and capital market effect.

Method and descriptive results:

In this report, we examine and analyse first-time disclosures in response to Recommendation 4.3 by ASX 300 entities (by market capitalisation, at 30 June 2021). We analysed disclosures by 240 entities within the ASX 300. Sixty entities were excluded because they were either exempted from following the Principles and Recommendations as either foreign listed (33) or investment products (25), with 1 indicating they did not follow Recommendation 4.3 under the "if not, why not' provision, and 1 suspended from trading. Among the 240 entities in the sample, there were 85 entities within the ASX 100, 80 entities within the ASX 101-200, and 75 within the ASX 201-300.

Results

To measure the effectiveness of ASX 300 entities' communication in relation to their Recommendation 4.3 obligations, we rated their endeavours on a 4-point scale:

Effectiveness of communication	Number of entities
No disclosure (0 points)	29 (12%)
Boilerplate disclosure (1 point)	36 (15%)
Limited entity-specific disclosure (2 points)	115 (48%)
Clear and comprehensive entity-specific disclosure (3 points)	60 (25%)
TOTAL	240 (100%)
Mean Score	1.86

- **No disclosure (0 points).** Twelve per cent (N= 29) of entities provided no identifiable disclosure in relation to Recommendation 4.3.
- **Boilerplate disclosure (1 point).** Fifteen per cent of entities in the sample group (N= 36) did not provide entity-specific disclosures, but rather used 'boilerplate disclosures'– general statements that could apply to any entity.
- **Limited entity-specific disclosure (2 points).** Forty-eight per cent of sampled entities (N= 114) made entity-specific disclosures, but with only limited details of how their integrity enhancing processes operated in practice.
- **Clear and comprehensive entity-specific disclosure (3 points).** Just 61 entities (25%) out of the 240 in the sample were rated as providing clear and comprehensive entity-specific descriptions of all the processes they used to ensure the integrity of unaudited periodic corporate reports.

While the primary focus of Recommendation 4.3 is on the effective communication of the integrity enhancing mechanisms or processes, the ASX has also made clear its interest in ensuring investors and other users have confidence in the credibility of all periodic corporate reports. Accordingly, we developed a unique measure to rate the efficacy of integrity enhancement processes and mechanisms. Entities were rated on a 3-points scale:

Integrity enhancement mechanism	Number of entities
Internal control (1 point)	67 (38%)
Internal verification (2 points)	62 (36%)
External assurance (3 points)	46 (26%)
TOTAL	175
Mean Score	1.88

- **Internal control (1 point).** Sixty-seven entities (38%) identified a single firm-specific internal control mechanism – either internal review by subject matter experts, or internal review by the board.
- **Internal verification (2 points).** Sixty-two entities (36%) had a more effective process which we defined as 'internal verification', which included review of unaudited periodic reports by both subject matter experts and the board.
- **External assurance (3 points).** Forty-six entities (26%) reported the highest level of integrity enhancement, independent external assurance, on one or more of their unaudited periodic corporate reports.

Overall, these results suggest considerable room for improvement in the communication of integrity enhancement processes and mechanisms.

Implications for AUASB

The overarching question for the AUASB in response to our findings around Recommendation 4.3 adoption by ASX300 is *whether the AUASB should take the initiative and develop guidance on integrity enhancing techniques to support Recommendation 4.3 implementation*. This is a contentious question as to whether AUASB should broaden their remit from assurance to other approaches that improve trust and confidence in these other reports. At this stage, guidance in regard to the implementation of integrity enhancing techniques is piecemeal (such as publications by the IIA on three lines of defence, 2020; and by IFAC with the IIA on the board's responsibility for the integrity of an integrated report and underlying reporting process, and the contribution that internal audit can make to assisting the board in the discharge of that responsibility), but the suggestions to consider more broadly have been outlined by the IAASB under their trust model (2022), and AUASB may have the capacity to undertake the role of developing guidance on such matters.

Some other key takeaways include:

- The terms "assurance" and "assurance engagement" are more broadly used by entities in their Recommendation 4.3 disclosures than as defined by AUASB in their glossary. Considering recent initiatives such as the three lines of defence and the IAASB's trust model that include both internal and external mechanisms in ensuring the credibility and trust, AUASB may consider how to deal with this broadening reference to 'assurance' to including integrity enhancing techniques.
- Periodic reports not subject to audit or review are being included more commonly in annual report and therefore commonly subject to ASA 720, but the line between Australian Standards on Auditing (ASAs) and Australian Standards on Assurance Engagements (ASAEs) are becoming more blurred.
- There are considerations within the AUASB around the relevant assurance standards in response to the development of ISSB reporting standards. AUASB may need to figure out how assurance will work alongside the Australian-unique corporate governance Recommendation 4.3.

3. Public Sector Auditing and Assurance Issues in Australia

In this session we examined issues such as whether the AUASB Auditing Standards fit for purpose for audits of public sector entities? The session also examined whether the AUASB approach to dealing with auditing standards issues specific to the public sector, including the recently issued Guidance Statement 023 *Special Considerations - Public Sector Engagement* assisted with dealing with these issues? Recognising that there is little current research identified as informing the AUASB agenda in this area, possible research opportunities were canvassed, including when and why are key audit matters reported and is this reporting valuable in the public sector?

Structure of the session	
Matthew Zappulla – AUASB	Public Sector Auditing in Australia and why this is on the AUASB agenda
Johanna Foyster – AUASB	Presentation: Why is this topic on the AUASB Agenda and what the AUASB has done to date
Grant Hehir and Jane Meade – ANAO	Panel Discussion: Other issues and areas where additional research may be useful

3.1 Public sector auditing in Australia and why this is on the AUASB agenda and what has been done to date

Matthew Zappulla, Technical Director, and Johanna Foyster, Senior Project Manager, AUASB

AUASB Standards are sector neutral and therefore apply to both public and private sector audits. However, there are some key differences between public and private sector audits. AUASB Standards are based on their IAASB equivalents which include only limited guidance material to assist public sector auditors in applying Standards in the public sector context.

Some years ago the Australasian Council of Auditors-General (ACAG 2022) wrote to the AUASB identifying three key issues presenting challenges in applying AUASB Standards in the public sector, requesting further guidance be developed to address these issues. The issues were:

- Agreeing the terms of a public sector engagement (ASA 210);
- How the concept of ‘going concern’ concept applies in the public sector (ASA 570); and
- How application of the ASA 220 definition of ‘engagement partner’ is applied in the public sector.

The AUASB established a Public Sector Project Advisory Group (PAG), made up of senior representatives from all Auditors-General Offices in Australia, to assist the Board in understanding the issues identified to date and to develop appropriate responses. In consultation with the PAG, the AUASB have developed and issued a new Guidance Statement GS 023 *Special Considerations – Public Sector Engagements*, which is designed to address the key issues identified by ACAG. GS 023 is an authoritative AUASB Pronouncement that will be incrementally updated as required in future to address emerging public sector auditing issues.

3.2 Panel discussion involving representatives from the ANAO and AUASB on future research opportunities

Recognising that there was little research on public sector auditing and assurance that could inform either the AUASB or public sector auditors, a panel was constructed to identify future research opportunities, The areas identified by panellists where additional research may be useful to inform AUASB and Auditors-General going forward include:

- **Key Audit Matters (KAMs)** - When and why are KAMs reported in the public sector, and is this reporting considered valuable by the public sector stakeholders? Should KAM reporting be mandated for certain entities in the public sector?
- **Audit quality** - How do Auditors-General monitor and report on audit quality across the public sector?
- **Auditing ethics** – ASAE 3500 *Performance Engagements* currently only refers to the three E's (Economy, Effectiveness, Efficiency). Ethics is the fourth 'E' in the *Public Governance, Performance and Accountability (PGPA) Act* (2013). The ANAO is developing a methodology to audit ethics. Should an updated ASAE 3500 also be expanded to also require ethics to be a mandatory objective?
- **Expansion of scope for Public Sector Financial Audits** – should there be additional auditing requirements for public sector auditors in financial audit areas where the user, being parliament, may have higher expectations of the Auditor-General's work than users in the private sector.
- **Accounting for "concessional equity"** – this is an accounting issue but a significant area of focus in the public sector.

4. Less Complex Entities

A current IAASB/AUASB initiative is to address concerns about whether auditing standards, which have become more complex in recent years, are scalable in providing assurance for less complex entities (LCE). What is the evidence on the assurance of financial reports of LCE (including some private companies, charities, Not-for-profit Organisations, or other LCEs) was considered, as well as a discussion of research examining alternatives to reasonable assurance.

Structure of the session	
Peter Carey – Deakin University and Noel Harding – AUASB, UNSW	Why is this on the AUASB agenda and research questions
Dale Fu – Deakin University	Review of research Literature on audits of LCEs
Yitang (Jenny) Yang – UNSW	Research on assurance of small charities

4.1 Why this is on the AUASB agenda and research questions

The ISAs are designed to be applied to a wide variety of entities with differing circumstances and sizes, ranging from those whose nature and circumstances are simpler and more straightforward (i.e. LCEs), to those entities whose nature and circumstances are more complex. As operating and reporting environments are becoming more complex and continually evolving, auditing standards are also becoming longer to address complexity.

In April 2019, the IAASB issued *Discussion Paper, Audits of Less Complex Entities* to understand the many issues and challenges being faced relating to audits of LCEs. As well as exploring the identified issues and challenges in auditing LCEs, the DP proposed various actions the IAASB could undertake and sought stakeholder views on preferred actions. Based on this the IAASB developed *Proposed International Standard on Auditing for Audits of Financial Statements of Less Complex Entities* which is a stand-alone standard for LCEs.

The AUASB issued a Consultation Paper seeking public comment on the IAASB's proposed stand-alone standard, as well as consideration of possible alternative options for Australian LCE audits. In its submission to the IAASB the AUASB concluded that the proposed standard would not, in its current form, be widely supported in Australia. The AUASB's view is that the proposed standard does not adequately address the challenges in applying the ISAs on LCE engagements, and is more likely to increase, rather than decrease, the audit expectation gap.

The IAASB is still considering feedback on the proposal standard.

The AUASB received very little feedback on possible alternative options for Australian LCE audits and the options it included in its consultation paper. The AUASB is interested in research which may assist, including the following that were included as part of the AUASB consultation paper:

- Standard-Setting Activities - AUASB
    - Adopt the ISA – LCE when issued by the IAASB, subject to modifications under the compelling reason test.
    - Limited targeted revisions to the ASAs subject to the compelling reason test. For example, where practitioners experience significant challenges in applying a requirement in an ASA to an entity's less-complex elements, the ASA could possibly be revised to deal with the challenge by including additional application

and other explanatory material focused on describing considerations specific to LCEs.

- Revision of the Review Standard to increase the level of robustness of procedures.
- Education regarding review and multi-scope type engagements, so the product of such engagements is better understood to meet user needs.

- Other Activities with a linkage to AUASB standards
    - Developing (or supporting other groups in developing) targeted non-authoritative guidance to assist practitioners in applying the ASAs to LCE audits. Such non-authoritative guidance could include specific industry guides / practice aids, work programs, templates, software solutions.
    - Education and training of complex standards.
    - Investigation of a new / different level of assurance product, something more than limited assurance but not as high as reasonable assurance.
- Activities outside of standard setting
    - Engage with those responsible for drafting legislation, at Commonwealth and State levels to consider the needs of users in specific market segments with appropriate regulators e.g. SMSFs with ASIC and ATO, small NFPs/charities with ACNC. Investigation whether there may be a need in some scenarios for a multi-scope engagement for example, reasonable assurance over cash balances and the related internal controls, but limited assurance over the remainder of the financial report.
    - Consider introducing a level of audit practitioner other than a Registered Company Auditor. For example, SMSF auditors are approved SMSF auditors as approved by ASIC. This may alleviate the pressure on the diminishing pool of registered company auditors.
    - Consider further revision or introduction of new auditing or assurance reporting thresholds / consideration of alignment with some accounting framework thresholds, thereby reducing the number of entities that require an audit.

4.2 Review of the research literature on audits of LCEs

Presented by Noel Harding, AUASB member and UNSW Sydney, and prepared by Dale Fu, Deakin University, on the basis of a publication by Coram et al. (2022).

Aim of the research

The purpose of this research is to synthesise and discuss prior academic literature regarding auditing small to medium-sized entities (many of which would be less complex entities) to inform the AUASB in their considerations of adopting the newly developed auditing standard for Less Complex Entities (LCEs). Prior academic research adopts a wide range of methodological approaches to explore the auditing process of LCEs because the extant findings based on public companies can hardly provide insight to standard setters and regulators. With reference to this research, we comment on the following three questions:

- Who shall use the auditing standard for LCE
- Are there different agency costs when auditing LCEs
- How do auditors conduct audits for LCEs

Literature review and discussion

There are no universally accepted definitions of LCE yet. Different parties may have different views on what could be perceived as "less complex". The proposed auditing standard for LCE sets out its scope by prohibiting certain classes of entities (e.g., listed entities or public interest entities) and entities with certain qualitative characteristics indicating complexity (e.g., use of component auditors or use of internal auditors). However, research presents different views on this. For example, Coram et al. (2022) analyze audit market structure of Australian listed firms and find that the bottom 10% firms (with lowest audit fees) have audit fees of $A14,000 on average. Given the relatively low audit fees, these audits are likely to be small and be considered as less complex. Similarly, the use of component auditors may not be indicative of complexity because research finds that group audit complexity majorly arises from coordination and communication challenges, cross cultural differences and language barriers, but there are still less complex group audit structure cases (Sunderland and Trompeter 2017; Downey and Bedard 2019; Downey et al. 2020; Downey and Westermann 2021). When it comes to the use of internal auditors, Carey et al. (2000) report that Australian family businesses are more likely to use internal audit rather than external audit when the external audit is not compulsory. Therefore, the involvement of internal auditors may suggest that business owners are seeking reliable financial information, rather than being an indicator of complexity.

We also highlight the importance of understanding the agency relationships in the LCE auditing setting because agency conflicts are the primary source of the client's incentives to demand for auditing (DeFond and Zhang 2014). The nature of agency conflict is different in LCEs compared with that in complex entities. Agency conflicts in large and complex entities are mainly between owners and management, while agency conflicts in LCEs are more likely to be between majority and minority shareholders and between ownership interests and debtholders (e.g., Chen et al. 2011; Langli and Svanström 2014; Carey et al. 2000; Niskanen et al. 2010; Schierstedt and Corten 2021). For other types of LCEs, such as charities and non-for-profit organizations, agency conflicts may come from their membership structure (i.e., the existence of many members) (Johansson et al. 2022). In addition, prior literature also documents that private firms do not have strong incentives to report high quality earnings (Ball and Shivakumar 2005). The cost of switching auditors for small business, compared to large business, is relatively low (Abbott et al. 2013). Private companies may use audited financial information for different purposes (Dedman et al. 2014). As the agency costs for LCEs differ from that for complex entities, the specific demand for auditing may also vary (i.e., LCEs are less likely to purchase a financial statement audit).

Finally, we want to point out that we still have insufficient understanding of the auditing process for LCEs. LCEs usually have informal internal control structures (e.g., management by walking around) and informal internal reporting system. An audit methodology focused on collecting evidence regarding the effectiveness of internal controls and corporate governance procedures is likely to be ineffective (Van Buuren et al. 2014, 2018). Extant literature on auditing small or medium-sized entities also shows that they are more likely to be audited by smaller and local accounting practices (Ghosh and Lustgarten 2006). And these small and local practices usually have smaller audit teams (Langli and Svanström 2014). Meanwhile, threats arising from economic bonding is less likely to be a concern for smaller accounting practices (Hope and Langli 2010; Langli and Svanström 2014). Also, reputation and litigation costs may not be salient in small accounting practices (Johnstone and Bedard 2003; Bell et al. 2015). We call for more research to open up the black box of the process of auditing LCEs.

Implications for AUASB

Consistent with the comments from Coram et al. (2022), we believe that there are multiple dimensions of complexity, which creates difficulties in establishing clear criteria or qualitative guidance for assessing complexity. We recommend standard setters to take into account auditors' knowledge and ability (which is currently not mentioned in the proposed standard) that may impact perceptions of complexity. Also, we recommend that group audits shall not be universally excluded from the scope of the standard. Even though many group structures are complex, there are some groups that will exhibit characteristics that are consistent with them being classified as a less complex entity.

The IAASB developed the draft auditing standard for LCE based on the material contained in the extant full suite of standards. Given prior literature shows that agency conflicts in small and less complex entities can be very different from that in large and complex entities, we are concerned that the proposed auditing standard for LCE may not be effective in meeting the purposes for which it was being drafted because the extant full suite of standards were written for auditing entities with different levels of complexity.

For example, there is a need to reinforce the principles of firm and engagement level quality management in an audit of an LCE. This is because auditors in small and medium practices do not have many opportunities to seek advice from and discuss difficult judgments with colleagues. They also have less access to training and policy manuals and cannot easily access quality reviews (Langli and Svanstrom 2014; Sundgren and Svanstrom 2013). Also, the strong relationship between the auditor and client management in audits of less complex entities cause threats to the exercise of an appropriate level of scepticism (Langli and Svanstrom 2014). Furthermore, auditors in small and medium size audit practices may not apply business risk audit perspectives, instead choose to follow a substantive approach, suggesting potential audit risk (Van Buuren et al. 2018).

In this regard, research highlights that the proposed auditing standard for LCE may be deficient in the areas of:

- Audit firm quality management
- Professional scepticism
- Risk identification and assessment

Finally, we call for more research on how auditors conduct audits for LCEs, considering the idiosyncratic nature of the less complex entity market (i.e., there are various types of LCEs). From the review of the literature regarding auditing small and medium-sized entities, we cannot draw a conclusion on what would be the most appropriate and effective way of auditing LCEs.

4.3 Research on assurance of small charities

Yitang (Jenny) Yang, UNSW Sydney, and Roger Simnett, Deakin University

Aim of the research

This research was undertaken to inform the AUASB in their considerations of the audit of Less Complex Entities. We identified small charities in Australia, registered with ACNC, is most appropriate population to explore current audit initiatives. The characteristics of these entities are:

- less than $250,000 annual revenue;

- are not required to prepare financial statements (can submit key financial information as part of annual information statement); and
- encouraged to submit annual report to ACNC.

Method and descriptive results:

We first undertook a random sample of 500 charities in first year of registration (2014) in order to extrapolate findings across the population of small charities registered with ACNC. 110 submitted annual reports to ACNC, with 56 assurance reports identified (53 audit, 3 review reports). Of the 53 audit reports, 35 were unqualified, 2 contained EOM, and 16 were qualified, mainly on the basis of concerns of the completeness of revenue.

In order to identify trends in lodging, audit and assurance we traced the 110 submitting charities to 2018. 65 remained as small charities, and 49 continued to lodge. Of these 49, 38 were same last time (21 including assurance report, 17 not). Eight switched to including, 3 switched to not. 20 of 21 assurance levels remained unchanged, (19 audit, 1 review), one switched from audit to review. We also traced the 390 non-submitting to 2018. 283 remained as small charities, and 121 switched to lodging annual report. Of these 121, 48 included assurance report (42 audits, 6 reviews).

Additionally, we traced the 100 largest small charities (based on total assets in 2014), registered in both 2014 to 2018, in order to identify trends in lodging annual reports, assurance, and assurance level. In 2014, 45 lodged an annual report, increasing to 74 in 2018. There was a decrease in associated assurance reports from 29 to 23. Of the 19 charities with assurance report in both 2014-2018, all were audit in 2014, with 18 audit and one review in 2018. We also undertook discussions with assurance practitioners of charities to better understand results and trends.

Result

Our descriptive results involved compliance with ASA 700, the only audit standard we can observe (all audit and review engagements are subject to audit/review standards).

ASA 700 auditor report requirement	Included		Not included	
Title	50	94.34%	3	5.66%
Addressee	46	86.79%	7	13.21%
Responsibilities of management	40	75.47%	13	24.53%
Auditor's responsibilities	48	90.57%	5	9.43%
Auditing standards	49	92.45%	4	7.55%
Financial reporting framework	38	67.86%	18	32.14%
Audit opinion	53	100%	0	0%
Auditor's name	51	96.23%	2	3.77%
Auditor's signature	43	81.13%	10	18.87%
Location	43	81.13%	10	18.87%
Auditor report date	44	83.02%	9	16.98%
Auditor's report contains all of the above	**18**	**33.96%**	**35**	**66.04%**

Implications for AUASB

There is demand for voluntary audits from the small charities sector. These services are provided by a wide range of assurance practitioners, very little representation by Big 4, only 2 across all of our samples, and also very small representation by Top 20 assurance firms.

There are very few review engagements, and the number of such engagements are not increasing, suggesting this engagement not an effective alternative to audits of LCEs. Discussions with practitioners provided the following reasons:

- as an audit level of knowledge is required for review engagements there is no saving on work effort;
- methodologies are mainly developed for audits;
- client did not understand or desire limited assurance engagement; and
- a substantive approach consistent with audit was the most appropriate approach to these types of engagements.

Concerns were identified around quality of audits in accordance with auditing standards (700 series). In particular,

- financial reporting framework being followed. Suggest providing example of what sort of wording to include if Australian Accounting Standards not being followed (AASB); and
- responsibilities of management and Those Charged With Governance (TCWG). Suggests current standard wording of AUASB for responsibilities of management and TCWG does not work. The current suggested wording talks about separate responsibilities.

There were a number of instances where Australian Accounting Standards are deemed to be followed, but there are departures from the accounting framework adopted, and no mention by auditor of such departures (e.g., audit fee disclosures). Of the 53 charities that disclose audit reports, only 20 (38%) disclose audit fees in financial reports. For information audit fees are on average 6.5% of revenue (average audit fee $3,858, average revenue $59,776).

Concerns about audit quality and cost suggest that separate LCE standard *may* be beneficial, along with further education. Also suggest that there may be benefits from exploring new types of engagements, such as UK examination engagement (UK Charity Commission 2021), which are effectively a combination of review engagement procedures and agreed upon procedures desired by the regulator.

5. Reporting and Assurance on Internal Controls frameworks

Structure of the session	
Anne Waters – AUASB	Why this is on the AUASB's agenda and research questions
Shan Zhou –University of Sydney	Internal Controls Reporting and Assurance - Evidence from SOX in the US
Mukesh Garg – Monash University	Assurance of internal controls and ASX Corporate Governance Recommendations

5.1 Why this is on the AUASB's agenda and research questions

Anne Waters, Deputy Technical Director, AUASB

The FRC PJC Inquiry Working Group and AUASB have continued to conduct preparatory work as we await a government response to the final report. Recommendation number 9 is as follows:

> The committee recommends that the *Corporations Act 2001* be amended such that entities required to have their financial reports audited under the Act must establish and maintain an internal controls framework for financial reporting. In addition, such amendments should require that:
> a) management evaluate and annually report on the effectiveness of the entity's internal control framework; and
> b) the external auditor report on management's assessment of the entity's internal control framework.

It is worth noting that whilst the PJC still support this recommendation they acknowledged in their final report that this may be costly, and it may not be appropriate to implement this now.

It is widely acknowledged that an effective system of internal controls is critically important to support high quality financial reporting and auditing. Many submissions to the inquiry raised concerns with entity's corporate governance and internal controls over financial reporting and recommended that consideration is given to implementing an internal controls framework similar to that in the US as this is widely recognised as being successful in improving the quality of financial reporting. Further to that the AUASB have received feedback that there is a need to consider initiatives to increase accountability of management and directors for implementing an effective system for internal controls over financial reporting in Australia.

To further inform the FRC PJC Inquiry Working Group and the AUASB the following research questions have been identified:

- Is the US SOX reporting effective in improving the quality of financial reporting? What is the cost?
- How effective is the current ASX Corporate Governance Principles recommendation 4.2 on CFO and CEO declarations? Should these be further enhanced?
- What is being proposed in the UK reforms, and should this be considered in Australia?

A summary of the presentations follows.

5.2 Internal controls reporting and assurance: Evidence from SOX in the US

Shan Zhou, University of Sydney

Sections 302 and 404 are the two key sections on internal controls in US SOX. Section 302 of SOX requires the CEO and CFO of the corporation to include a quarterly certification of their responsibility for establishing, maintaining and regularly evaluating the effectiveness of the issuer's internal controls. Section 302 is effective since 29 August 2002 for all issuers.

Section 404(a) requires each annual report to contain an internal control report which contain an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Section 404(a) is effective since 15 November 2004 for accelerated filers (public float ≥ 75 million) and 15 December 2007 for non-accelerated filers.

Section 404(b) requires an independent auditor to attest to and report on management's assessment of the internal control structure and procedures in the firms' annual report. It is effective from 15 November 2004 for accelerate filers. Non-accelerated filers were permanently exempted in 2010 and accelerated filers with annual revenue less than $100 million were exempted in 2020.

Section 302 addresses "disclosure controls and procedures" and includes both financial and non-financial information. Section 404 specifically deals with internal control over financial reporting and requires auditor attestation. The European Union has adopted similar rules to Section 302 while Japan and China have adopted similar rules to Section 404.

Research comparing Sections 302 and 404 finds that only 27% of accelerated filer firms with an adverse Section 404 report had disclosed such material weaknesses in internal control in their Section 302 certifications in previous quarters of the same fiscal year. (Hermanson and Ye 2009), suggesting Section 404 is a more stringent provision.

Survey evidence on the cost and benefit of complying with Section 404

While the cost of complying with SOX, in particular with Section 404, has been the focus of debate on the benefit of SOX, survey evidence suggests that most parties affected by SOX appreciate the benefits of SOX such as improved internal control systems, increased investor confidence and reduced fraud. As summarized in Coates and Srinivasan (2014), "Contrary to vehement criticism of SOX in some media reports and analyses by political entrepreneurs (and politically active academics), the reception of SOX among the constituencies most affected by SOX has been far more nuanced, even receptive".

Survey evidence also show that while the cost of complying with SOX is not trivial, for example, it costs $91,000 per filer for 404(a) compliance, it is declining (19% decline in the total compliance cost) after the 2007 reforms to reduce duplicative efforts in conducting the evaluation of internal control over financial reporting (SEC 2009).

Impact of mandated internal control reporting

The large body of literature on SOX has documented various benefits of SOX. These benefits include less earnings management behaviour such as manipulating results to meet or beat analysts' forecast (Koh et al. 2008), increased instances of detecting and reporting fraud (Dyck et al. 2010), less egregious restatements as being less material, more likely to occur due to unintentional errors and more likely to occur in noncore accounts (Burks 2010). Firms reporting internal control weaknesses have poor financial reporting (and remediation of internal control deficiencies is associated with an increase in financial reporting quality (Ashbaugh-Skaife et al. 2008) and lead to changes to hiring of better-qualified CFOs (Li et al. 2010).

There is also evidence that small audit firms exited the public company audit market post-SOX, suggesting that PCAOB inspections under SOX improve audit quality by incentivizing low quality auditors to exit the market, where quality is gauged by (1) avoidance of AICPA peer reviews and failure to comply with PCABO rules, (2) severity of the peer review and inspection reports and (3) clients of exiting auditors receive higher quality auditing from successor auditors, as captured by a greater likelihood of receiving going concern opinions (DeFond and Lennox 2011).

The reporting of internal control weaknesses provides useful information to the capital market. Internal control weaknesses disclosures are associated with negative market returns and increased cost of equity and debt capital (Ashbaugh-Skaife et al. 2009).
As SOX improves information quality, another strand of studies focusses on the impact of SOX on internal decision making. This line of literature documents that firms reporting ineffective internal controls have less accurate management guidance (Feng et al. 2019); and firms with inventory-related material weaknesses have lower inventory turnover ratios and more impairments (Feng et al. 2015). The remediation of material weaknesses leads to an improvement in firms' operational efficiency (Cheng et al. 2018).
Overall, the evidence suggests that mandated internal control reporting helps improve financial reporting quality and audit quality, provides useful information to the capital markets and improves the internal information used by management for better internal decision making.

Impact of mandated audit of internal controls

The mandated audit of internal control (section 404(b)) is the most controversial part of SOX. The key benefit of auditors' involvement is more accurate and reliable disclosure of internal control deficiencies which has flow-on effects in the form of higher reporting quality. It is found that auditors detect about three-quarters of unremediated internal control deficiencies through control testing (Bedard and Graham 2011). Nonetheless, the cost of complying with section 404(b) is argued to be particularly burdensome for small companies. Academic studies produce mixed results on the costs and benefits of complying with 404(b) among small firms. Some document negative impacts on small companies in terms of market value (Iliev 2010) and financial reporting quality (Bhasker et al. 2018). Further, management internal control reports under 404(a) could be a cost-effective alternative to 404(b) (Kinney and Shepardson 2009). On the other hand, other studies document benefits of complying with 404(b) even among small companies. These benefits include improved financial reporting quality and enhanced operational efficiency (Ge et al. 2017).

In recognition of the costs, in 2010 the SEC has permanently exempted non-accelerated filers from complying with 404(b), and in 2020 further exempted accelerated filers with annual revenue less than $100 million from 404(b).

Implications for AUASB

- Mandatory reporting of internal control has resulted in the disclosure of material internal control weaknesses, with resulting pressures flowing from such disclosures causing companies to improve their systems. This has been shown to be beneficial in the forms of improved internal control quality, financial reporting quality, company operations and resource allocation decisions.

- Easier to evaluate benefits when there are reliable indicators/measures of improved internal control system outcomes, such as the incidences of restatement and fraud.
- Audit of internal control is more controversial. The major benefit is to identify more internal control weaknesses which may otherwise go undetected and thus having flow-on effects on information quality and decision making. But whether benefit exceeds costs is unclear, especially for small companies.

5.3 Assurance of internal controls and ASX Corporate Governance Recommendations in Australia

Mukesh Garg, Monash University

Introduction

Corporate fraud and failures have increased the attention on internal controls over financial reports (ICFR) and demands for CEOs and CFOs to take more responsibility and be accountable for preparing the financial reports. Countries have adopted various approaches to enhancing information flows to users about ICFR. While considerable literature exists in relation to the costs and benefits of mandatory ICFR disclosure regimes, the literature is sparser on the costs and benefits of voluntary ICFR disclosure. Effective ICFR provides reasonable assurance regarding the reliability of financial reporting and preparing financial statements for external purposes (Public Company Accounting Oversight Board [PCAOB] 2007). The *Sarbanes Oxley Act* (SOX) was enacted on 30 July 2002, as a United States (US) federal law in response to the major corporate scandals and collapses subsequent to the enactment of SEC Exchange Act Rule 2002 (Garg et al. 2012). The legislators considered SOX an important tool for restoring public confidence in the capital market and strengthening corporate accounting controls. Section 302 of SOX (effective 29 August 2002) legally requires CEO and CFO to certify and disclose in the SEC filings that they have evaluated all significant deficiencies in the design or operation of internal controls and have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation (SOX 302 (a)).

Australian institutional setting and voluntary internal control certification

In order to promote and restore investor confidence, the Australian Securities Exchange (ASX) convened the Australian Securities Exchange Corporate Governance Council (ASXCGC) in August 2002 to develop recommendations for improving financial reporting. In March 2003, the ASXCGC issued its *Principles of Good Corporate Governance and Best Practice Recommendations*. CEO and CFO sign-off to the board (BPR 7.2) is a key feature of the ASXCGC Best Practice Recommendations (BPR). Principles 7, Recognise and Manage Risk, states that a company should establish a sound system of risk oversight and management, and internal control. This is to identify, assess, monitor, and manage risk, and to inform investors of material changes to the company's risk profile. The integrity of the company's financial reporting depends on the existence of a sound system of risk oversight and management, and internal control (ASX 2003). ASXCGC BPR7.2 formalises and extends management certification of financial reports under Recommendation 4.1 to assist boards to better recognise and manage risk by voluntarily certifying and disclosing the soundness, effectiveness, and efficiency of internal control and risk management system. The recommendation encouraged disclosure in the annual report about the certification process and recommended the CEOs' and CFOs' written statement to the board that:

a) The statement given in accordance with best practice recommendation 4.1 (the integrity of financial statements) is founded on a sound system of risk management and internal compliance and control, which implements the policies adopted by the board; and

b) The company's risk management and internal compliance and control system is operating efficiently and effectively in all material respects.

In the Australian setting, companies were recommended to provide certification on the quality of ICFR voluntarily. The Australian environment is unique as the certification requirements changed from voluntary in 2004–2007 to quasi-mandatory in 2008–2014 with the introduction of Best Practice Recommendation 7.2 (2nd edition – 2007). As per the second edition of BPR, the board should require management to design and implement the risk management and internal control system to manage the company's material business risks and report to it on whether those risks are being managed effectively. The board should disclose that management has reported to it the effectiveness of the company's management of its material business risks. Best Practice Recommendation (3rd edition) was introduced in 2014. The focus of the revised BPR7 was only on recognise and manage risk, with Recommendation 7.1 on the committee to oversee risk, Recommendation 7.2 on review and disclosure of risk management, Recommendation 7.3 on disclosure of internal audit, followed by Recommendation 7.4 on disclosure of whether there is material risk. Recommendation 4.2 of the 3rd Edition requires certification, but disclosing the information is no longer a recommendation.

Value relevance of Australia's voluntary internal control certification

Studies in a mandatory disclosure setting (U.S.) find that internal control deficiency is negatively associated with earnings quality (Doyle et al. 2007b, 2008; Chan et al. 2008) and positively associated with cost of equity (Beneish et al. 2008; Ashbaugh-Skaife et al. 2009). The inferences drawn from studies in a mandatory setting may not be applicable in a voluntary environment where disclosures are affirmative and not assured. A study by Garg (2017) finds that voluntary certification in the Australian setting is value relevant. Analysis of the impact of the information environment suggests that the value relevance of financial information of ICFR certification is greater for companies with higher share price volatility, bid-ask spread, and analysts' forecast dispersion. The financial information of companies operating in a weak information environment becomes more value relevant due to voluntary ICFR certification disclosure. Garg (2017) suggests that ICFR certification has an incremental effect on the value relevance of financial information for companies operating within a weak information environment (proxied by share price volatility, higher bid-ask spread, and greater analysts' forecast dispersion). The main contribution of this study to the internal control reporting literature is that it provides comprehensive new evidence on the effect of a unique Australian voluntary ICFR certification on the value relevance of financial information.

Evaluation of credibility of Australian voluntary internal controls certification

Economic incentives for ICFR reporting exist in an environment with lower monitoring and risk of litigation. In a mandatory audited regime, there can be direct consequences for providing false or misleading information on internal control coming from regulators. In the US, for example, certification of financial statements without meeting the requirements results in fines. In a voluntary setting, a company providing false information is expected to be disciplined by the market (e.g., litigation action, increase in cost of equity). The expected litigation costs in Australia are lower than in the US (Ball et al. 2000). Due to the relatively lower risk of litigation in Australia, management may be forthcoming with the disclosure of good news (i.e., certifying that the ICFR is sound, effective, and efficient). In Australia, companies may provide ICFR certification with (without) sound, effective, and efficient internal control, therefore, questioning the credibility of such certifications.

A study by Garg et al. (2017) investigated whether CEOs' and CFOs' voluntary certification and disclosure on internal controls of Australian financial reports are associated with higher quality accruals to assess whether the disclosures made in the Australian setting are credible. Results suggest that CEOs' and CFOs' voluntary certification of ICFR in Australia are associated with higher quality earnings, implying that disclosures are credible. Garg et al. (2017) also find that auditors charge lower fees for companies with good ICFR. Such companies are also associated with better corporate governance. In a third study, Garg (2018) find that companies place greater reliance on real earnings management than on accrual-based earnings management when having to comply with certification requirements. Voluntary certifiers have lower real earnings management and accrual-based earnings management relative to first-time certifiers in the mandatory period between 2008 and 2014. Besides, there is an increase in real earnings management activities among first-time mandatory period certifiers. Overall, the results of the three studies in the Australian institutional environment for listed companies suggest that voluntary certification of ICFR is credible and has positive market implications.

Implications for AUASB

The SOX-based ICFR reporting (Section 302 and Section 404), when introduced in 2002 in the US, was unique and generated much interest among researchers and analysts alike, who explored the costs and benefits of the regulation. In Australia, the ASX adopted a voluntary approach as opposed to the mandatory reporting requirement and assurance as in the US. Since the two regimes (mandatory regime in the US and voluntary certification requirement in Australia) are different, the costs and benefits are expected to differ. For example, the cost of SOX compliance is very high, with the mean (median) total compliance costs for Section 404 alone being $2.2 ($1.2) million (Krishnan et al., 2008). While in Australia, there is no direct cost of ASXCGC BPR7.2-based ICFR certification. The study of the Australian institutional environment has implications for investors, regulators, auditors, and management of listed companies as it informs them about the Australian voluntary ICFR reporting regime as an alternative to the SOX Section 404 in the US.

In Australia, out of 2,241 ASX-listed companies in 2021, 1,203 (53.68%) made a loss and 1,233 (55.02%) did not report operating revenue. It is not economically feasible to introduce costly audited internal control certification for loss-making companies and those without any revenue. The SOX does not allow flexibility to the companies on their ICFR reporting choices. Internal control certification should remain voluntary due to the significant costs associated with mandatory and audited internal control certification. There is significant flexibility in Australia as CEOs, and CFOs can choose to certify (not certify), which depends on the underlying condition of ICFR. Therefore, the cost and benefit of one system, as opposed to the other, require consideration to identify the most appropriate approach. ASX Corporate Governance Council should continue the current internal control certification recommendation based on the 2nd Edition of ASXCGC BPR provisions. Therefore, companies willing to disclose certification could choose to do so. If internal control certification recommendation is restricted to ASX-listed companies, it will benefit investors as it will not impose additional costs for reporting entities that do not have outside shareholders who could directly benefit from such certification disclosures but have the flexibility if they choose to do so. The AUASB could encourage auditors to report on concerns related to the quality of internal controls as part of the key audit matters (KAM). A combination of voluntary ICFR certification by the CEOs (and CFOs) combined with auditor's reporting on ICFR using KAM could be a good alternative for Australian reporting entities.

6. Extending the auditor's obligations: Going concern assessments and disclosures

Economic shocks, such as the Global Financial Crisis and COVID-19, have created challenges for auditors when assessing whether an entity is a going concern. In this session, participants will discuss key considerations when evaluating management's going concern assessment, and how audit reporting and scope can be expanded to enhance going concern disclosure. Will further reporting by the entity and / or the auditor assist?

Structure of the session	
Anne Waters – AUASB	Why it is on the AUASB's agenda and research questions
Robyn Moroney – RMIT University	Evidence from existing research
Rebecca Mattocks – Monash University	Does the type of going concern disclosure contained in unqualified auditor reports impact investors?
Menghe (David) Zhao – ANU	The tone of Management Discussion and Analysis and audit fees

6.1 Why it is on the AUASB's agenda and research questions

Anne Waters, Deputy Technical Director, AUASB

Going concern is on the AUASB's agenda for two reasons.

1. The IAASB are revising ISA 570 *Going Concern*
2. To respond to the PJC Inquiry

Recommendation number 8
The committee recommends that the Financial Reporting Council oversee a formal review, to report by the end of the 2020–21 financial year, of the sufficiency and effectiveness of reporting requirements under the Australian standards in relation to:
- the prevention and detection of fraud; and
- management's assessment of going concern.

In response to a number of international regulatory inquiries the IAASB issued the discussion paper *Fraud and Going Concern in an Audit of Financial Statements* in 2020 to gather feedback on whether ISA 570 was fit for purpose, and whether other initiatives were required to improve financial reporting on going concern risks. To inform the AUASB's submission we conducted outreach including engaging with representatives from the academic community. In response to the feedback received the IAASB have commenced a project to revise ISA 570 and expect to issue an exposure draft in early 2023.
One of the revisions to ISA 570 being considered by the IAASB is to enhance the transparency in the auditor's report with respect to going concern. This would result in a going concern paragraph in all audit reports with different wording depending on the going concern risk (i.e., no going concern issues, going concern issues but no material uncertainty, or a material uncertainty exists).

As the IAASB's project will provide evidence to support the response to the PJC inquiry the FRC PJC Inquiry Working Group and the AUASB have agreed not to go ahead of the IAASB.

To further inform the AUASB the following research questions have been identified:

- Is the current reporting of going concern interpreted by users correctly (i.e. do users understand a material uncertainty verses a key audit matter?)
- Will a going concern paragraph increase user confidence in the quality of the audit and the financial report?
- Is the user perspective different depending on the level of risk due to going concern? (i.e. No going concern issues, a "close call", or a material uncertainty exists?)
- Is there evidence from other jurisdictions with more extensive reporting by the auditor on going concern i.e. UK, Netherlands?

6.2 Going Concern – Evidence from existing research

Robyn Moroney, Professor, RMIT University

Many research papers have considered issues surrounding auditor's going concern (GC) opinions (see Carson et al. (2013) and Geiger et al. (2019) for syntheses of that literature). These papers consider various issues including type 1 error rates (GC opinion and company survives), type 2 error rates (company fails but no GC opinion), determinants of GC opinions and consequences GC opinions. Carey et al. (2012) report that 90% of companies receiving a first time GC opinion do not fail dispelling the myth that a GC opinion becomes a self-fulfilling prophecy.

Research has frequently focused on first time reporting of a GC issue by auditors as it is common for companies to receive ongoing GC opinions. When reported for the first time, a GC opinion is news, and it is noticed. Ongoing GC opinions are discounted by the market. When the International Auditing and Assurance Standards Board first considered the inclusion of information relating to consideration of the appropriateness of the GC assumption in the audit report, I conducted an experiment with colleagues at Monash University. We found that this strategy will likely lead to investor confusion about the future viability of a company.

The language surrounding GC is fraught. Financial statements are prepared under the assumption that the company will remain a GC – positive connotation. When an auditor reports on GC, it tends to be a warning to investors that the company may not remain a GC – negative connotation. If an auditor discusses GC in every audit report (the procedures used to assess a company's GC status) or if a company receives a GC audit opinion year on year, investors likely dismiss such disclosures as the company does not fail. In this case the salience of the GC opinion is compromised.

Auditors report on GC issues in different ways. They can qualify their opinion, modify their opinion, or include a Key Audit Matter related to GC. In each case the headings differ and some of the language differs, but the term GC remains. Unless an investor is familiar with auditing standards, it can be difficult for them to gauge the relative severity of each type of opinion.

The advent of Key Audit Matters has brought a challenge for auditors as it is not always clear to them when they should include a GC modification versus a Key Audit Matter. Whilst most modify their opinion using a Material Uncertainty Going Concern paragraph, some still use an Emphasis of Matter paragraph. As part of her PhD, research is being undertaken by Mattocks (2022) to understand how these GC reporting options are affecting investor decision making.

Implications for the AUASB

The AUASB should consider:

- Language – should there be different terms used to clearly signal the seriousness of an issue related to GC? This applies to company disclosures as well as audit reports
- Do we need clearer guidelines for auditors on when to use different types of GC opinions?
- Do we need clearer guidelines for companies on how to report threats to their GC status?
- Do we need to provide investors better guidelines on how to read and interpret GC disclosures by companies and auditors?
- Weigh up the positives of informing investors that the auditor has assessed whether a company can remain a GC with the negatives that investors may then become desensitised to the appearance of the term GC and are not appropriately alerted when a serious GC matter arises
  - If a company fails and the previous year's financial report includes a GC modification (not a qualification), is that considered a fair warning? What if it was the fifth year in a row that the audit report included the same GC modification?
  - If companies continuously receive GC modified opinions and don't fail, what is a GC modification for? How are they helping investors?

6.3 The tone of Management Discussion and Analysis (MD&A) and audit outcomes

By Menghe (David) Zhao and Mark Wilson, The Australian National University,

Aims of the Research

This research was undertaken by Zhao and Wilson (2022) to obtain preliminary evidence regarding whether the content of management discussion and analysis (MD&A) in firms' annual reports in relation to financial distress is associated with audit outcomes. The outcomes examined are comparing the tone of the outcomes in the MD&A with the tone of the related discussion in the notes to the financial statements, and whether these reflect economic fundamentals, and looking to see if consistency/inconsistency in tone related to economic fundamentals is associated with systematic changes in auditor behaviour, including the type of audit opinion and audit fees, If management's discussion of a current and expected future performance appears inconsistent with their firm's economic fundamentals, auditors may perceive greater risk attaching to the client, and increase the amount of audit work performed.

Method and results

We examine the association between audit outcomes and the tone of management discussion for a sample of financially distressed US firms. The tone of management discussion is measured using the ratio of optimistic to pessimistic words in the MD&A section of firms' annual report. We focus on distressed firms because auditors are more likely to be concerned with excessively optimistic management discussion when the risk of business failure is high, and we expect that any effect of excessively optimistic discussion will concentrate in firms that the auditor has assessed as being subject to material uncertainties regarding their ability to continue operating as a going concern. To date we have concentrated on audit fees and find preliminary evidence that audit fees in the year following the issuance of a going concern opinion are higher where client firms' MD&A presents an excessively optimistic picture of the firm's performance and prospects. This is consistent with the MD&A section of firms' annual reports providing a signal of future audit risk.

Implications for AUASB

While no major standard setting bodies require that information outside the financial statements be audited, ASA 720 and its US equivalent, SAS No. 137, each require an auditor to read the other information presented in firms' annual reports and to report on whether there exist any material inconsistencies between this other information and that presented in the financial statements. Our research links decisions made under ASA 570 with disclosures of other information (ASA 720), and the evidence to date is consistent with auditors considering the tone of language used in financially distressed clients' qualitative disclosures to indicate future audit risk.

Standard setters have been active in considering potential changes to audit requirements for other information presented in the annual report. The US PCAOB (PCAOB Release 2013-005) has discussed whether to mandate a full audit of information presented in the MD&A section of firm's annual reports. Recent IASB (IFRS ED/2019/7) and AASB (AASB ED 298) exposure drafts have proposed moving some of the typical quantitative content of the MD&A section of the annual report to the notes accompanying the financial statements which, if implemented, would subject management-defined performance measures and the accompanying discussion to audit. While the quality of quantitative content in management-prepared disclosures outside the financial statements has attracted attention from regulators and standard setters in different jurisdictions, our evidence is consistent with the qualitative content in other information presented in the annual report also having an impact on auditors' assessment of their clients' future audit risk under the current accounting and auditing standards.

7. Extending the auditor’s obligations: Fraud prevention and detection

Participants will discuss auditors’ responsibility relating to fraud in an audit of a financial report. The discussion will encompass emergent issues (e.g., cyber security) and auditors' use of specialist technological tools and techniques (e.g., data analytics and other data mining tools) in an audit to prevent and detect fraud. Will further reporting by the entity and / or auditor assist

Structure of the session	
Anne Waters – AUASB	Why it is on the AUASB’s agenda and research questions
Gladys Lee – Monash University	Extending the auditor’s obligations: Fraud prevention and detection

7.1 Why it is on the AUASB agenda and research questions

Anne Waters, Deputy Technical Director, AUASB

Fraud is on the AUASB’s agenda for two reasons.

- The IAASB are revising ISA 240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of a Financial Report*
- To respond to the PJC Inquiry:

Recommendation number 8
The committee recommends that the Financial Reporting Council oversee a formal review, to report by the end of the 2020–21 financial year, of the sufficiency and effectiveness of reporting requirements under the Australian standards in relation to:
- the prevention and detection of fraud; and
- management's assessment of going concern.

In response to a number of international regulatory inquiries the IAASB issued the discussion paper *Fraud and Going Concern in an Audit of Financial Statements* in 2020 to gather feedback on whether ISA 240 was fit for purpose, and whether other initiatives were required to improve the prevention and detection of fraud. To inform the AUASB’s submission we conducted outreach including engaging with representatives from the academic community. In response to the feedback received the IAASB have commenced a project to revise ISA 240 and expect to issue an exposure draft in mid-2023.

The IAASB are considering enhancements to ISA 240 to:

- clarify the role and responsibilities of the auditor
- include more robust requirements and to reinforce the importance of professional scepticism in fraud-related audit procedures
- include enhanced transparency by communications with TCWG and in the auditor’s report.

As the IAASB’s project will provide evidence to support the response to the PJC inquiry the FRC PJC Inquiry Working Group and the AUASB have agreed not to go ahead of the IAASB.

To further inform the AUASB the following research questions have been identified:

- What enhancements to auditing standards could improve identification of fraud risks, incidences?
- Will more reporting by the auditor reduce the expectation gap? Or increase it….
- Would reporting by management / TCWG on fraud controls be more effective?
- How effective are other jurisdictions models (i.e., UK have enhanced reporting by management / TCWG, US SOX reducing fraud?)

7.2 Extending the auditor's obligations: Fraud prevention and detection

Gladys Lee, Monash University

Background

Whistleblowing is an effective mechanism to detect fraud and can be a useful source to consider when assessing and evaluating fraud risks. Most listed or large Australian companies should have implemented a whistleblowing policy and related practices as required under *Corporations Act 2001* (s1317AI) or as recommended by the ASX *Corporate Governance Principles and Recommendations* (4th edition) Recommendation 3.3. However, there is little explicit consideration of whistleblowing-related audit procedures under current Australian auditing standards.

At present, ASA 240 mentions the need to maintain confidentiality of information, such as information from whistle-blowers, while in describing the control environment, ASA 315 states that responsibility of those charged with governance include oversight of the design and effective operation of whistle blower procedures. This stands in contrast to auditing standards elsewhere where standards require auditors to perform procedures specific relating to whistleblowing allegations. As an example, in the US, AS 2110: Identifying and Assessing Risks of Material Misstatement, require that inquiries about fraud risks should include inquiries of whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistle-blower program, if such program exists) and, if so, management's responses to such tips and complaints [AS 2110.56 (a) (6)]. AS 2110 .56 (b)(3) also states that auditors' inquiries about fraud risks should include whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistle-blower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints.

Related research

A question that arises is whether auditors incorporate risks related to whistleblowing allegations into their risk assessment, and whether they can distinguish between substantiated versus frivolous whistleblowing allegations. A research study (Kuang, Lee and Qin 2021) I was involved in providing some insights. We empirically examined archival external whistleblowing data in the US (i.e., whistleblowing reports filed to US regulators or courts) and the effect on audit fees and auditors' opinion on internal controls. We found that when a client firm is subject to an external whistleblowing allegation in the year, audit fees are higher, and auditors are more likely to issue an adverse opinion on internal control. We interpret this as evidence that auditors incorporate risks relating to whistleblowing allegations in their risk assessment, thereby increasing audit fees (as a proxy for audit effort or risk) or issuing an adverse opinion on internal control.

We also found that audit fees are especially higher for substantiated compared to frivolous whistleblowing cases, and that auditors were more likely to issue an adverse opinion on internal control only in substantiated but not frivolous whistleblowing cases. We interpret this as evidence that auditors are able to separate out the noise in frivolous versus substantiated whistleblowing reports.

Implications for the AUASB

The following requires further consideration by the AUASB

- Based on US data, the findings in Kuang, Lee and Qin (2021) find evidence of auditors responding to risks in whistleblowing allegations, and that they were able to separate the noise in frivolous versus substantiated whistleblowing reports. Should our Australian auditing standards be updated to consider whistleblowing-related audit procedures?
- Preventing and detecting fraud involves more than just the auditor. Given listed, large companies have whistleblowing policies and systems, how can auditors better leverage off companies' internal whistleblowing systems and procedures to better assess fraud risks? Can auditors rely more on internal auditors who should have better knowledge?

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A separate reference list is provided for each session.

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7. Extending the auditor's obligations: Fraud prevention and detection

Kuang, YF., Lee, G., and Qin, B. (2021). Whistleblowing allegations, audit fees, and internal control deficiencies. *Contemporary Accounting Research*, *38*(1): 32–62.

Participants

To encourage discussion, participation in the roundtable was limited to 30 invited attendees, who are listed below and who were identified as being able to contribute meaningfully to aspects of the AUASB work agenda and could attend. It is recognised that other researchers are able to meaningfully contribute to the AUASB work agenda, and they are encouraged to bring their work to the attention of the AUASB – and other regulatory agencies.

Participant	*Affiliations*
Bray, Michael	IFRS Foundation & Deakin University
Carey, Peter	Deakin University
Foyster, Johanna	AUASB
Garg, Mukesh	Monash University
Ghandar, Amir	Chartered Accountants Australian and New Zealand
Harding, Noel	AUASB & UNSW Sydney
Hehir, Grant	Auditor General, Australian National Audit Office
Khoo, Eunice	ANCAAR, The Australian National University
Knechel, Robert	UNSW & University Florida
Lee, Gladys	Monash University
Mattocks, Rebecca	Monash University
Meade, Jane	Australian National Audit Office
Mehmood, Masood	Chartered Accountants Australian and New Zealand
Mills, Andrew	Financial Reporting Council
Monroe, Gary	UNSW Sydney
Naiker, Vic	University of Melbourne
Niven, Doug	ASIC
Shailer, Greg	ANCAAR, The Australian National University
Simnett, Roger	Deakin University
Subramanian, Ram	CPA Australia
Tan, Eka	Deakin University
Tan, Tiffany	CPA Australia
Taylor, Stephen	Australian Accounting Standards Board / UTS
Trotman, Ken	UNSW Sydney
Waters, Anne	AUASB
Wilson, Mark	ANCAAR, The Australian National University
Xiao, Xinning	Monash University
You, Jean	UNSW Sydney
Zappulla, Matthew	AUASB
Zhou, Shan	University of Sydney

The following made significant contributions by developing presentations but were unable to attend:

Fu, Dale	Deakin University
Moroney, Robyn	RMIT University
Yang, Yitang (Jenny)	UNSW Sydney
Zhao, David Menghe	ANCAAR, The Australian National University