THE UNIVERSITY OF MELBOURNE
FACULTY OF BUSINESS & ECONOMICS

20th May 2024

Director
Corporate Conduct and Analysis Unit
Market Conduct and Digital Division
Treasury
Langton Cres
Parkes ACT 2600

Dear Treasury

Submission to Regulation of accounting, auditing and consulting firms in Australia

Please find attached my submission to the Treasury's consultation paper: *Regulation of accounting, auditing and consulting firms in Australia.* One of the objectives of the submission is to provide some high-level evidence of the level of competition intensity in the audit industry based on a large sample. This may assist the Treasury in some of its deliberations. Further analysis can be provided upon request.

Sincerely,

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Professional standards, regulations and laws

Q7. How effective is the existing self-regulatory framework in ensuring the integrity and quality of services provided by professionals in the audit and accounting industries? If it is not effective, how could it be improved?

The existing framework could be substantially improved by introducing regulation to make the **audit committee** a more powerful oversight and monitoring mechanism of audit quality. This would include a requirement that members of this committee be:

- experts in **both** audit and financial reporting; and
- be **independent**, of both the company board and the audit firm and thus be selected from outside the company and not from the Board of Directors

A significant potential source of talent is recently retired **audit partners** from audit firms and retired CFOs.

There is a large number of companies to regulate. More importantly the business models of companies varies substantially and in-turn there is substantial variation in the nature and complexity of financial reporting and audit quality issues (e.g the financial reporting issues vary substantially across mining, banking, insurance, technology and manufacturing companies). Given this variation the existing external regulatory bodies have neither the resources or the **specialised** expertise to hold auditors to account.

Thus the most efficient and effective mechanism is to have **company-specific** oversight of the auditor via a high-quality audit committee with expertise tailored to the company.

Currently there is neither regulatory support or industry guidelines over the roles and membership of the audit committee.[1] The membership is typically a subset of the Board of directors. Most directors do not have the in-depth expertise in **both** *financial reporting* and *auditing* that is necessary to hold auditors to account. They also may not devote sufficient time to this sub-committee given their other Board commitments and absence of regulatory support.

There is a potential large pool of high-quality experts who could be members of an audit committee. Typically audit partners retire early from the audit firms with the mandatory retirement age in many firms being < 60 years. Therefore, if these experts were members of an audit committee they would have sufficient knowledge and intrinsic motivation to know what questions to ask and be able to challenge the auditors to ensure the integrity and quality of the audit.

[1] Australian Securities Exchange (ASX) listing rule (12.7) requires those companies that are included in the S&P All Ordinaries Index to have an audit committee.

Transparency, public information and reporting

Q9 Recognising that companies are subject to reporting requirements that focus on protecting investors, should firms providing audit services to these companies be subject to enhanced transparency reporting beyond what is already mandated? If so, what additional information should be included in transparency reports? Should the information be verified?

Disclosure in regard to the activity and performance of audit committees should be enhanced by being required to be included in the annual report.

A scorecard for the activity of audit committee could include relevant metrics that would reveal information about the performance of the auditor.

Competition / resilience of the audit sector

Q18 Is there sufficient competition to provide clients with choice in selecting accounting and audit services in the Australian market? If not, what factors prevent or impede such competition?

There have been on-going concerns raised and commentary about the audit market becoming anti-competitive due to its concentration. However, there has been no evidence provided to support this claim. In a competitive market, fees should reflect costs. Hence, if fees significantly exceed costs, it suggests anti-competitive actions.

We cannot observe the underlying costs of audit firms. However, assuming the four largest firms (PwC, Deloitee, E&Y and KPMG) and small/mid-tier firms are subject to similar shocks to costs then if audit markets are competitive the audit fee changes should be similar between large and small/mid-tier audit firms.

Analysis of audit fees for Australian listed companies shows that the median annual percentage audit fee changes of companies audited by large and small/mid-tier audit firms are very similar (see Table 1). This suggests there is no evidence of anti-competitive behavior in the Australian audit market.

Specifically, over the decade from 2013 to 2022, the median percentage annual change in company audit fees was similar for both large and small/mid-tier firms, at 3.7% and 3.1% respectively. Figure 1 illustrates this change over time showing that when costs shift, both these group of audit firms adjust their fees similarly. For instance, in 2022, a widely recognized surge in costs affected many industries. Both large and small/mid-tier audit firms increased their fees by comparable rates, 10.74% and 8.88%, respectively. This similarity in % fee changes supports the notion of a competitive market.

Furthermore, both large and small/mid-tier firms have the same significant % of clients who experienced fee decreases, 35% and 37% respectively, which is another indicator of a competitive environment.

As further evidence on competition intensity, Figure 2 plots the yearly median of the variable *audit fees/total assets* for companies audited by large and non-large audit firms across time.

The metric *audit fees/total company assets* provides a measure of the price or cost of an individual company audit per dollar of assets audited. Figure 3 shows the market share of large audit firms has increased across time.

Figure 2 shows that per unit audit fees for small/mid-tier audit firms tend to increase over the sample period, with the median increasing from 0.12% in 1970-79 to 0.42% after 2010. In contrast, per unit audit fees for the large audit firms generally displays a flat to declining pattern declining from 0.13% in 1970-79 to 0.11% after 2010. The across-time decreasing per unit fees for companies audited by large accounting firms is consistent with large accounting firms both exploiting economies of scale and the presence of competition intensity.[2] This decrease in audit fees occurs notwithstanding the increasing market share.[3]

In summary the Australian audit market, based on its fee setting, doesn't exhibit anti-competitive behavior.

Further analysis of audit fees and audit market share can be provided upon request.

Table 1

% Annual Audit Fee Changes for Australia Listed Companies 2013-2022

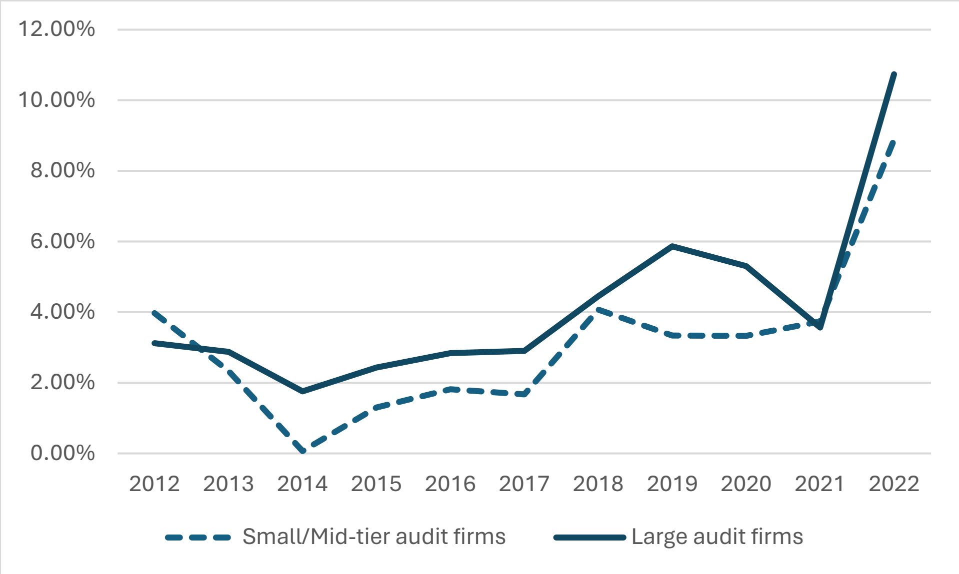
	Percentile Distribution			
Audit Firm	**25th Percentile**	**Median**	**75th Percentile**	**% Fee Decrease**
Small/mid-tier	-7.58%	3.08%	17.32%	36.74%
Four Largest	-4.94%	3.70%	18.28%	35.02%

The Table report the descriptive statistics for the annual % audit fee changes of Australian listed companies. *Four largest audit firms* are Deloitee, E&Y, KPMG and PwC. *Small/mid-tier* are all other audit firms.*%Fee Decrease* is the % of companies that had an annual audit fee decrease.

[2] The higher per unit fees for companies audited by small/mid-tier audit firms is due to the companies they audit being smaller. Thus the increasing upfront fixed costs of conducting an audit across time for all companies (e.g. due to increased regulation/ accountings standards) is an increasingly greater % of total audit fees in an small company.

[3] Some of the analysis in Figure 2 and Figure 3 is based on work by the author of this submission in the academic paper "*Why did the Big 4 firms get so large?*" (2024) by C. Ferguson, M. Pinnuck and D. Skinner

Figure 1: Median Annual % Change in Australian Company Audit Fees



The large audit firms are defined as the largest four audit firms in Australia (Deloitte, E&Y, PwC, KPMG).

Figure 2: Yearly median of *audit fees/total assets* for companies audited by large and non-large audit firms across time

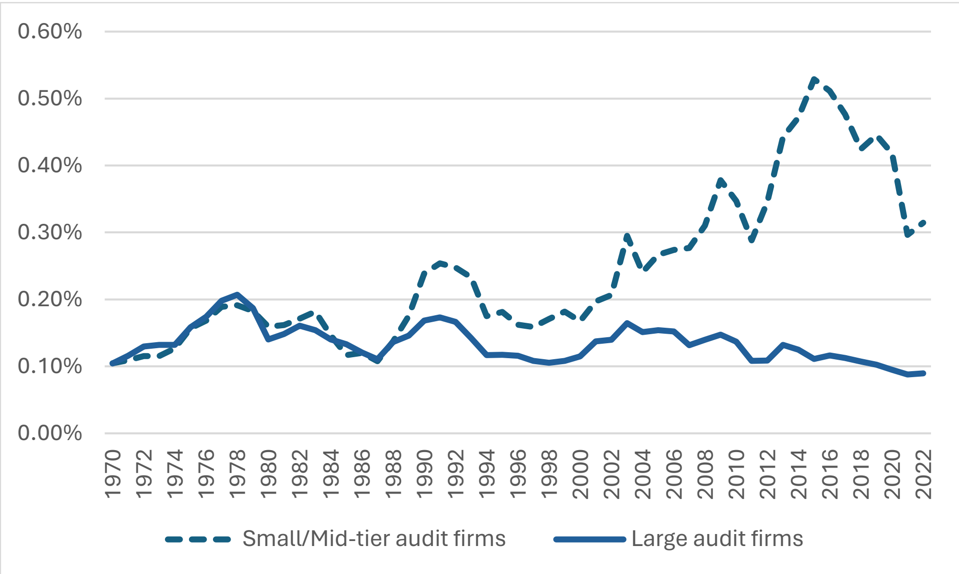
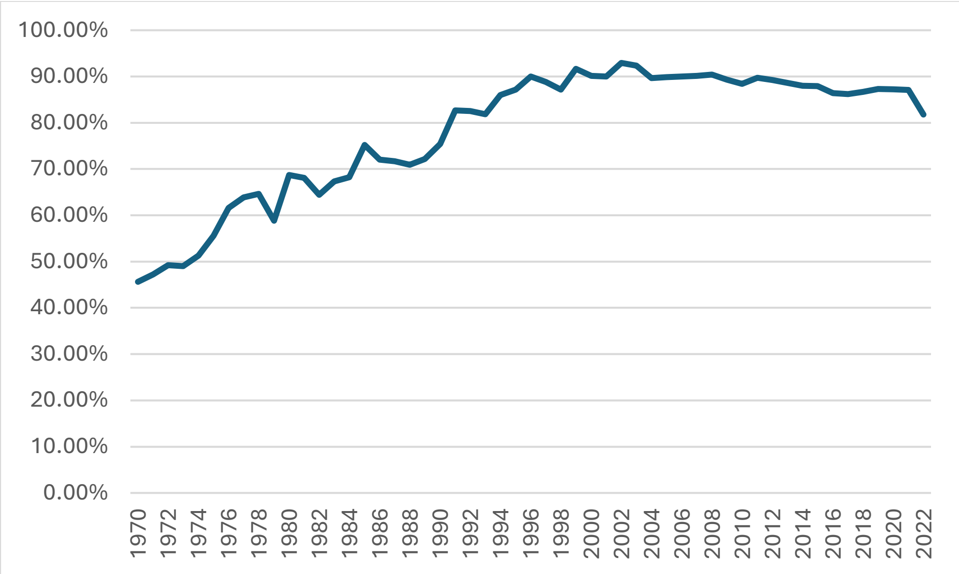


Figure reports the annual median ratio of audit fees to total assets for Australian companies audited by large audit firms. The large audit firms are defined as the largest four audit firms in Australia in 2022 (Deloitee, E&Y, PwC, KPMG) and their 8 predecessor firms pre-mergers (Arthur Andersen, Arthur Young, Coopers & Lybrand, Deloitte, Haskins & Sells, Ernst & Whinney, Peat Marwick Mitchell & Co., Price Waterhouse, Touche Ross & Co).

Figure 3: Audit Market Share of Large Audit Firms across time (in %)



Market share is measured as the large audit firms market share of audit fees. See definition of large audit firms under Figure 2.