



**ASIC**

Australian Securities & Investments Commission

CONSULTATION PAPER 265

# Communicating audit findings to directors, audit committees or senior managers

July 2016

## About this paper

The *Australian Securities and Investments Commission Act 2001* (ASIC Act) was amended in 2012 to allow ASIC to communicate specific financial reporting and audit findings identified from reviews of audit files directly to directors, audit committees or senior managers of companies, responsible entities or disclosing entities.

This consultation paper seeks your feedback on our proposed criteria for determining which findings from our reviews of audit files we would communicate to directors, audit committees or senior managers.

We are also seeking your feedback on our proposal to let an entity's board of directors know that we will be reviewing audit files relating to the entity as part of our routine audit firm inspections.

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Document history

This paper was issued on 25 July 2016 and is based on the Corporations Act as at the date of issue.

### Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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## The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on communicating specific financial reporting and audit findings to directors, audit committees or senior managers. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see Section C, 'Regulatory and financial impact'.

### Making a submission

You may choose to remain anonymous or use an alias when making a submission. However, if you do remain anonymous we will not be able to contact you to discuss your submission should we need to.

Please note we will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any personal or financial information) as confidential.

Please refer to our privacy policy at [www.asic.gov.au/privacy](http://www.asic.gov.au/privacy) for more information about how we handle personal information, your rights to seek access to and correct personal information, and your right to complain about breaches of privacy by ASIC.

Comments should be sent by 7 October 2016 to:

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## What will happen next?

|                |                      |  |
|----------------|----------------------|--|
| <b>Stage 1</b> | 25 July 2016         | ASIC consultation paper released       |
| <b>Stage 2</b> | 7 October 2016       | Comments due on the consultation paper |
| <b>Stage 3</b> | By mid-December 2016 | Regulatory guide released              |

## A Background to the proposals

### Key points

We do not currently communicate findings from our audit inspections to directors, audit committees or senior managers of the entities reviewed.

In 2012, the *Australian Securities and Investments Commission Act 2001* (ASIC Act) was amended to allow ASIC to communicate specific financial reporting and audit findings identified from reviews of audit files directly to directors, audit committees or senior managers of companies, responsible entities or disclosing entities.

This paper sets out our proposed criteria for determining which findings from our reviews of audit files we would communicate to directors, audit committees or senior managers of the entities concerned, rather than reporting all findings.

We also set out our proposal to let the board of directors of an audited entity know that we will be reviewing audit files relating to the entity as part of our routine audit firm inspections.

### Our current practice for communicating audit findings

- 1 We currently communicate the findings from our inspection of audit files by issuing confidential reports to the individual audit firms that are inspected. In addition, an omnibus public audit inspection report is released on a ‘no names’ basis at the end of each 18-month cycle of inspections.
- 2 The ASIC Act was amended in 2012 to allow ASIC to communicate specific financial reporting and audit findings identified from reviews of audit files directly to directors, audit committees or senior managers of a company, responsible entity or disclosing entity to assist the entity to properly manage its affairs. We must provide the auditor concerned with at least seven days notice before communicating the information.
- 3 The information disclosed must be about:
  - (a) how the audit of the entity was conducted by an Australian auditor; or
  - (b) the entity’s compliance with:
    - (i) the requirements in Ch 2M of the *Corporations Act 2001* (Corporations Act) to prepare financial statements and reports; or
    - (ii) the continuous disclosure requirements of s674 and 675 of the Corporations Act.
- 4 To date, we have not used the ability to communicate findings from our reviews of audit files to directors, audit committees or senior managers on a

routine basis. However, the existence of this ability has assisted us, in numerous cases, to work cooperatively with audit firms in contacting entities where we have had significant concerns about the entity's financial reports.

- 5 As a matter of general practice, the largest six audit firms inform directors where ASIC will be reviewing audit files. Through [Information Sheet 196](#) *Audit quality: The role of directors and audit committees* (INFO 196) and other means, we encourage audit committees to ask audit firms for the results of our reviews of an entity's audit files. We understand that audit firms will communicate the findings from our reviews of audit files when requested to do so by the entity audited.

## Purpose of this paper

- 6 This paper sets out our proposed criteria for determining which findings from our reviews of audit files we would communicate to directors, audit committees or senior managers of the entities concerned, rather than reporting all findings. These criteria would be explained in a new regulatory guide.
- 7 Our proposed criteria are narrow in scope on the assumption that auditors already provide directors, audit committees or senior managers with satisfactory information, in a comprehensive and timely manner, on the concerns identified by ASIC from our reviews of audit working papers.
- 8 This paper also sets out our proposal to let the board of directors of an audited entity know that we will be reviewing audit files relating to the entity as part of our routine audit firm inspections. We would encourage directors to seek information directly from their auditors about any issues or concerns arising from our review.
- 9 We welcome any feedback you may have on our proposals. We will take your comments into account when finalising our regulatory guide.

## B Our proposals

### Key points

We are proposing to:

- establish the criteria for communicating specific financial reporting and audit findings to directors, audit committees or senior managers of companies, responsible entities or disclosing entities; and
- let directors know that we will be reviewing an audit file relating to the entity as part of a routine audit firm inspection.

## Criteria for communicating financial reporting and audit findings

### Proposal

B1 We propose to:

- communicate our specific financial reporting and audit findings to directors, audit committees or senior managers of companies, responsible entities or disclosing entities, having regard to the criteria set out in Table 1; and
- release a regulatory guide setting out these criteria and explaining how they will apply.

### Your feedback

B1Q1 Do you have any comments on our proposed criteria set out in Table 1?

B1Q2 Are there any additional criteria that we should consider including?

**Table 1: Proposed criteria for communicating financial reporting and audit findings**

| Criteria  | Description   |
|---|---|
| 1 Communication of material misstatement will assist in timely resolution of a matter | We have concerns that an entity's financial report is materially misstated, and we consider that disclosing to the entity specific information from the entity's records contained on the audit files will assist in addressing the matter more efficiently and achieve a more timely resolution.   |
| 2 Finding from a previous year has not been addressed                                 | We have identified that an auditor did not obtain reasonable assurance that an entity's financial report was free of material misstatement in a previous year, and our follow-up review reveals that our concerns have not been addressed.<br><br>Note: Follow-up reviews are usually only undertaken when there are particularly significant findings. |



| Criteria   | Description  |
|--|--|
| 3 Planned enforcement action   | <p>We intend to take enforcement action in relation to an entity's auditor, but the matter cannot be effectively dealt with in the short term through the Company Auditors and Liquidators Disciplinary Board (CALDB) or through the courts.</p> <p>In these circumstances, and taking the particular facts into account, we may inform the directors of the entity so that they can consider appropriate action (e.g. seeking the resignation or removal of the auditor).</p>   |
| 4 Independence requirements not met  | The auditor of an entity does not meet the independence requirements of the Corporations Act, has not addressed the matter, and has not communicated the matter to the directors or in the auditor's required independence declaration.  |
| 5 Failure to obtain reasonable assurance that a financial report is free of material misstatement across a number of key audit areas | <p>We have formed the view that an auditor has not obtained reasonable assurance that an entity's financial report is free of material misstatement across a number of key audit areas and having regard to all or some of the following:</p> <ul style="list-style-type: none"> <li>(a) the relative severity of the matters, taking into account our assessment of the possible impact and the probability of that impact occurring (e.g. whether the financial report has been restated and, if not, the likelihood of an actual material misstatement in the financial report, and the likely market impact of such a misstatement);</li> <li>(b) whether the audit firm has already remediated our concerns by performing the necessary audit work for the year of the audit in question;</li> <li>(c) if not already remediated, whether the auditor has committed to taking adequate steps to address the issues in a timely manner, has definite plans in place, and has a history of satisfactorily addressing such issues; and whether the issues affect a number of entities;</li> <li>(d) whether the audit firm can demonstrate that it has already satisfactorily communicated the matter to the entity's audit committee or directors in a comprehensive manner; and</li> <li>(e) whether there is genuine uncertainty about the level of audit work required by the auditing standards or accounting standards.</li> </ul> |

Note: These criteria are not intended to be exhaustive and the weight given to each factor will depend on the particular circumstances.

## Rationale

### Improving audit quality

- 10 Auditors and directors are important gatekeepers in ensuring the quality of financial reports, which promotes investor and market confidence. Directors should support and promote the high quality of independent audits in the interests of investor and market confidence in an entity and its financial reporting.
- 11 Information from our reviews of audit files may assist directors to:
- (a) take action to address deficiencies in an entity's financial report;
  - (b) improve systems and processes supporting financial reporting; and
  - (c) discuss with the auditors actions to improve audit quality.

- 12 If an auditor does not address deficiencies in their audit, the directors can seek the resignation or removal of the auditor.

### **Framework supporting criteria**

- 13 Our proposed criteria are based on the objective of an audit—as set out in the auditing standards having the force of law under the Corporations Act—that is, to obtain reasonable assurance that a financial report is free of material misstatement.
- 14 This measure is supported by the auditing standards, which provide a framework to support our criteria. It is also the basis for measuring audit quality used by ASIC and adopted by the International Forum of Independent Audit Regulators and other international audit regulators.

### **Basis of communication**

- 15 We propose to apply the criteria outlined in Table 1 in determining which findings from our reviews of audit files we would communicate to directors, audit committees or senior managers of the entities concerned, rather than reporting all findings.
- 16 Our audit inspections and financial reporting surveillances:
- (a) predominantly focus on recognition and measurement issues involving potential material misstatements of profits and net assets—arising from accounting policy choices and estimates (e.g. asset values)—rather than disclosure issues;
  - (b) exclude matters that are within a range of reasonable judgement; and
  - (c) exclude genuine issues relating to the interpretation of the accounting and auditing standards, which may be matters for the relevant international standards-setting body.
- 17 Each case will be assessed on its merits, taking into account all relevant facts and circumstances.

### **Other matters**

- 18 Matters may be communicated:
- (a) with the cooperation of the auditor; or
  - (b) using our statutory ability to disclose information.
- 19 As outlined in Table 1, in the context of resolving a concern about an entity's financial report, we would generally communicate findings from the audit files with directors, audit committees or senior managers if doing so would assist in the timely resolution of the matter and help to ensure that

investors and the market are properly informed. This may include instances where, for example:

- (a) the entity does not produce, under notice, information that we have seen on the audit files;
- (b) information available to the auditor and to the directors is inconsistent; or
- (c) the directors are unaware of relevant information concerning an offshore subsidiary.

20 We will continue to consider whether findings from our reviews of audit files should be communicated to other regulators, such as the Australian Prudential Regulation Authority (APRA) or the Australian Taxation Office (ATO).

## Advising directors of routine audit file reviews

### Proposal

B2 We propose to let an entity's board of directors know that we will be reviewing audit files relating to the entity as part of our routine audit firm inspections.

#### *Your feedback*

- B2Q1 Do you agree that we should let directors know that we will be reviewing audit files relating to the entity as part of a routine audit firm inspection?
- B2Q2 Should we also let directors of an audited entity know that we will be reviewing audit files relating to the entity as part of a surveillance activity where we already have reason for concern about the adequacy of the audit?

### Rationale

21 Our proposal to let the directors of an audited entity know that we will be reviewing audit files relating to the entity would enable the directors to seek information directly from their auditors about any issues and concerns arising from our review.

22 In particular, the directors may wish to seek information on all the issues and concerns arising. This would enable directors to ask auditors about the steps that auditors are taking to:

- (a) address any issues and concerns;
- (b) improve audit quality; and
- (c) support investor and market confidence in the quality of financial reports.

## C Regulatory and financial impact

- 23 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think that the proposed criteria will result in useful and meaningful information for directors, audit committees and senior managers, and will facilitate consistency in our assessment of when our findings should be directly communicated to directors, audit committees or senior managers.
- 24 Before settling on the final criteria, we will comply with the Australian Government's regulatory impact analysis (RIA) requirements by:
- (a) considering all feasible options, including examining the likely impacts of the range of alternative options which could meet our policy objectives;
  - (b) if regulatory options are under consideration, notifying the Office of Best Practice Regulation (OBPR); and
  - (c) if our proposed option has more than minor or machinery impact on business or the not-for-profit sector, preparing a Regulation Impact Statement (RIS).
- 25 All RISs are submitted to OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 26 To ensure that we are in a position to properly complete any required RIS, please give us as much information as you can about our proposals or any alternative approaches, including:
- (a) the likely compliance costs;
  - (b) the likely effect on competition; and
  - (c) other impacts, costs and benefits.

See 'The consultation process', p. 4.

## Key terms

| Term                   | Meaning in this document   |
|------------------------|--|
| accounting standards   | Standards issued by the Australian Accounting Standards Board under s334 of the Corporations Act   |
| ASIC                   | Australian Securities and Investments Commission   |
| ASIC Act               | <i>Australian Securities and Investments Commission Act 2001</i>   |
| audit firm             | A firm that consents to be appointed, or is appointed, as auditor of a company or registered managed investment scheme, and a firm that audits a disclosing entity |
| auditing standards     | Standards issued by the Auditing and Assurance Standards Board under s336 of the Corporations Act  |
| Corporations Act       | <i>Corporations Act 2001</i> , including regulations made for the purposes of the Act  |
| financial report       | A full-year or half-year financial report required under Pt 2M.3 of the Corporations Act   |
| INFO 196 (for example) | An ASIC information sheet (in this example numbered 196)   |
| s674 (for example)     | A section of the Corporations Act (in this example numbered 674), unless otherwise specified   |