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By email

Dear Terry

CONSULTATION PAPER 257: Improving disclosure of historical financial information in prospectuses: Update to RG 228

We are pleased to have the opportunity to respond to *Consultation Paper 257: Improving disclosure of historical financial information in prospectuses: Update to RG 228* (“**Consultation Paper**”).

General Comments

KPMG welcomes the regulatory intent of the proposals and is generally supportive of most proposals as drafted. In particular we believe the case studies provide a basis for understanding ASIC’s approach to interpretation of key requirements.

Our comments on the specific questions raised in the Consultation Paper are set out in Appendix 1 to this letter along with our comments which do not clearly correlate to specific questions.

We would be pleased to discuss our comments further with ASIC. If you have any questions, please contact David Willis on (02) 9346 6220 or Jonathon Gould on (02) 9335 8509.

Yours sincerely

Craig Mennie
Partner

Appendix 1 KPMG's specific comments on CONSULTATION PAPER 257: Improving disclosure of historical financial information in prospectuses: Update to RG 228

Corporate form and historical reporting requirements

B1 We propose to clarify that, subject to the circumstances described in proposals B11–B13, an issuer should disclose audited historical financial statements for two-and-a-half or three years for both the issuer and any business it acquires. This is regardless of whether the financial statements were required by law to be produced (apart from being in the prospectus) or whether the business is in a corporate form: see draft RG 228.88.

B1Q1 Do you have any comments on this proposed clarification?

KPMG is supportive of ASIC providing clarification as to its expectations regarding the disclosure of historical financial information in prospectuses. KPMG is also generally supportive of an expectation that an issuer disclose audited historical financial statements for two-and-a-half or three years for both the issuer and any business it acquires.

B1Q2 Is it unduly onerous to for an issuer to obtain audited financial information about the business being acquired?

Compliance with this requirement will have a number of practical implications. These include:

- Issuers will need to make allowance in their listing timetables for the additional time to have the historical financial information of an acquiree audited whenever the business to be listed includes businesses or entities recently acquired;
- There is likely to be an additional cost to the acquisition/sale process for the purchaser or the target if historical financial information needs to be audited prior to acquisition, or prior to listing if the acquisition and listing are being undertaken concurrently.

It is not uncommon for sale and purchase agreements to include successful IPO of the consolidated group as a condition precedent to the completion of the acquisition. This requirement may result in the acquiree being audited, and the resulting audit report being unmodified, also becoming conditions precedent.

There will be circumstances in which the requirement to have audited historical financial information may be too onerous, particularly where the acquired business is immaterial to the overall group to be listed or is a business carved out of a larger entity and has not historically been separately audited. KPMG acknowledges that ASIC has attempted to address some of these circumstances in the proposed Table 10, but anticipates that additional circumstances are likely to come to light as experience grows.

B1Q3 Are there potential impediments to issuers providing audited rather than reviewed or unaudited historical financial information? If so, under what conditions would these arise?

In certain circumstances, such as if a business is being carved out of a larger corporate group, it may be impracticable for an acquirer to have the access to the books and records necessary to enable the conduct of an audit of the business for the previous three financial years.

Alignment of accounting policies may not be practical as the necessary information may not be available to facilitate determination of the adjustment to the starting position of the 3 year historical track record.

In order to disclose 3 years of audited historical financial information, this would also typically require the performance of assurance level procedures in respect of significant balances/transactions for the year prior to the third year being disclosed (i.e. a fourth year), in order to reduce the risk of material misstatement in respect of opening balances.

Depending on the nature of the entity to be audited, there are a number of factors which can impair the auditor's ability to audit historical financial information once a significant period of time has passed since the financial year end. Those factors can include:

- Inability to attend stocktakes that occurred in the past or other real-time events where observation/testing/extraction of data requires attendance of the auditor at that time
- Difficulties accessing books and records
- Quality of books and records may not be sufficient to facilitate auditing.
- If accounting standards or policies have changed in the intervening period, the information may not be available to determine adjustments required.
- There may be unsubstantiated journal entries, for example, a reversal of deferred revenue when the auditor cannot, or has not, audited the establishment of the deferred balance.
- If the issuer was separated from a larger group in the past, it may not be possible to effectively verify separation-related assumptions that were made.

B1Q4 Do you have any feedback on the related examples in Case Studies 1–7 and 11 in Section C?

Case study 1 – KPMG agrees with ASIC's view.

Case study 2 – this requirement will result in roll ups taking longer to complete, and longer to list. Whilst KPMG agrees with ASIC's view, a practical impact is that either the acquirer or the vendors will have to fund the cost of the audits, which could be material to individual small business owners. This may be a cost they are not prepared to finance, particularly if it is not certain that the IPO will go ahead.

Case study 3 – KPMG understands ASIC's concern in relation to the materiality level adopted by the group auditor, however it is worth noting that a large listed business is likely to have robust accounting and information systems, financial reporting processes, accounting policies and practices, and an internal audit function. It is also unlikely to permit sufficient access to its books and records to facilitate the performance of an audit at a lower level of materiality. This

is an instance in which KPMG would encourage ASIC to consider whether a review would be sufficient, rather than an audit.

Case study 4 – Whilst it could be contended that this case study introduces an element of inconsistency into ASIC’s position, KPMG agrees with ASIC’s view. The potential inconsistency arises from the acceptance of 18 months audited historical financial information for a material business as acceptable when the core principle of the consultation paper is that audited historical information for three years should be disclosed. Nevertheless, KPMG recognises that avoiding the inconsistency would effectively mandate the preparation and disclosure of pro forma consolidated financial information for the full three years and KPMG agrees with ASIC that there is no need for that provided the potentially misleading trend in the historical financial information which may result is sufficiently explained in the text of the prospectus.

Case study 5 – KPMG agrees with ASIC’s view.

Case study 6 – KPMG agrees with ASIC’s view and notes that the entity is likely to have been audited already if it has a level of professional investors. KPMG agrees that the historical expenditure levels of the entity are likely to be of particular interest to investors.

Case study 7 – KPMG agrees with ASIC’s view in relation to the specific case study, however notes that ASIC view may not necessarily be appropriate for all industries. For example, if the scenario involved the acquisition of a portfolio of properties into a newly formed Real Estate Investment Trust, the disclosure of historical information pertaining to the performance of the properties may not be relevant if the properties have historically been held for purpose other than pure investment.

Case study 11 – KPMG agrees with ASIC’s view.

Audited financial information

B2 We propose to clarify that where an audit or review opinion (for half-year financial information) included in a prospectus has a qualification or modification that indicates that the audit opinion provides limited independent assurance for investors, we are likely to treat the financial information as effectively unaudited. In the event we treat the information as unaudited, it is likely that we will view the prospectus as not complying with the s710 test: see draft RG 228.92

B2Q1 Do you have any comments on this proposed clarification?

Concerning preparation and audit of financial information, in proposed paragraphs 228.92 and 228.93 of the Regulatory Guide the language “effectively unaudited” is used. The label “effectively unaudited” is incorrect. An audit opinion containing a modification does not render the financial information unaudited. It is preferable that ASIC’s reasoning for not considering the information appropriate for disclosure is based in terms of compliance with section 710 of the Corporations Act 2001. We recommend that ASIC revises this language to “not reliable”, “potentially misleading” or other similar terms.

KPMG is supportive of ASIC's position, but notes that ASIC refers to "qualification" and "modification" as if they are separate and mutually exclusive. A qualification to an audit opinion is one form of a modification to an audit opinion. It would be sufficient for ASIC to refer to a modification, as that would capture both. This occurs also in the list of proposals and questions on page 35 and twice in proposed paragraph 228.92 of the Regulatory Guide.

B2Q2 Do you believe that risk disclosure can remedy issues related to the disclosure of financial statements that contain, for example, disclaimer opinions where the auditor could not access appropriate accounting records for material areas of the financial statements? If so, why?

If the financial information to which the disclaimer opinion applies is material to the issuer's group financial statements, KPMG does not consider that risk disclosure can remedy the issues.

B2Q3 Do you have any feedback on the related examples in Case Studies 8–9 in Section C?

Case study 8 – KPMG agrees with ASIC's view.

Case study 9 – KPMG agrees with ASIC's view, but notes that the specific facts and circumstances of each individual scenario will need to be considered on a case by case basis.

We recommend ASIC considers including another example of circumstances in which a modified audit opinion would be acceptable. That would be where the accounts prepared historically were special purpose accounts. This is usually the case where the entity needs to prepare accounts, perhaps for its financiers, but does not need to prepare general purpose accounts and hence seeks to avoid having to prepare all the note disclosures that are required when general purpose accounts are prepared. In these circumstances the audit opinion, whilst modified to draw attention to the special purpose basis of preparation, is not modified in a manner that brings into question the reliability of the primary financial statements.

B3 We propose to clarify that we will generally accept that audit reports including emphasis of matter paragraphs (e.g. due to uncertainty about whether the company can continue as a going concern in circumstances where a successful fundraising will enable the company to continue its operations) will not result in us regarding the financial information as unaudited: see draft RG 228.93.

B3Q1 Do you have any comments on this proposed clarification?

KPMG agrees with ASIC's view.

B3Q2 Do you have any feedback on the related examples in Case Studies 8–9 in Section C?

KPMG has no further comments on those case studies.

B4 We propose to provide guidance recognising that there may be practical audit issues where up to three years of financial statements are being audited for the first time. In these circumstances, we propose to note that it is generally acceptable for the audit or review opinion to contain opening balance qualifications and, subject to materiality, issues related to inventory inspections: see draft RG 228.94.

B4Q1 Do you have any comments on this proposed clarification?

Please refer to our response to B1Q3 above, in which we identify a number of other challenges with auditing financial information in a non-contemporaneous manner. ASIC may wish to consider acknowledging more examples of matters impacting the first audit.

B4Q2 Are there audit issues other than those relating to ‘opening balance’ qualifications and inventory inspection procedures that may arise where financial statements for prior years are audited for the first time?

We consider the following items to be relevant:

- Inventory
- Alignment of accounting policies
- Access to books and records
- Information may no longer exist
- Proving existence of property, plant & equipment
- Cut-off procedures
- Please also refer to our response to B1Q3

B4Q3 Do you have any feedback on the related examples in Case Studies 8–9 in Section C?

KPMG has no further comments in relation to those case studies.

B5 We propose to clarify that the audit or review of historical financial information included in the prospectus should be conducted, for businesses and entities in Australia, in compliance with Ch 2M and, for businesses and entities from foreign countries, in substantial equivalence to Ch 2M: see draft RG 228.91.

B5Q1 Do you have any comments on this proposed clarification?

KPMG agrees with ASIC’s view. It would generally be anticipated that businesses and entities from foreign countries, which are included in issuers’ financial information in Australia, will have been audited/reviewed in accordance with substantially equivalent auditing and assurance standards.

B5Q2 Do you have any feedback on the related examples in Case Studies 8–9 in Section C?

KPMG has no further comments on these case studies.

Asset acquisitions and development of assets

B6 We propose to clarify that if assets acquired by an issuer are in substance the acquisition of a business, the issuer should generally disclose historical income statements: see draft RG 228.95.

B6Q1 Do you have any comments on this proposed clarification?

KPMG has no substantive comments on this scenario. We note however that, in the context of asset acquisitions, it is not always the case that all assets and liabilities that were used to generate historical earnings are acquired, and in such scenarios it may not be appropriate to disclose historical income statements.

B6Q2 Do you have any feedback on the related examples in Case Studies 6–7 in Section C?

KPMG has no further comments.

B7 We will use the guidance in Appendix B of AASB 3 to assist us in determining whether an issuer has in fact acquired or is operating a business rather than an asset or a collection of assets: see draft RG 228.96.

B7Q1 Do you have any comments on our proposal to use Appendix B of AASB 3?

We agree with the use of the guidance contained in AASB 3 Appendix B on the definition of a business to determine whether there has been an acquisition of a business or assets for the purposes of RG228.95. The IASB are expected to release an exposure draft on the definition of a business which will provide further guidance to assist in the assessment. Depending on if and how this exposure draft is worked into AASB 3, these amendments once finalised should also form part of the guidance that should be referred to in the assessment contemplated in RG 228.95.

We note that the application of the AASB 3 guidance to individual situations is subject to a significant degree of judgement in practice and does not necessarily lead to a clear black or white position.

We note that the present wording of paragraph 95 of the Draft RG suggests that there are 3 categories of transactions:

- Asset
- Business
- Entity with an operating history

Under the AASB 3 definition of a business, depending on the specific facts and circumstances, an entity with an operating history may or may not meet the definition of a business. We are uncertain if the intention of this section was to require any entity with an operating history, regardless of whether they met the definition of a business or asset to provide historical income statement information. Should this be the case, we suggest that this section be reworded to make this clear as presently there is a conflict in the requirements within this paragraph.

Further, we would suggest removing the reference to “in substance” when referring to the acquisition of a business. A collection of assets will either meet the definition or a business or not under AASB 3 and the use of the term “in substance” implies a different benchmark could be applied.

Notwithstanding the above, an important point of clarification is that the acquisition of certain assets doesn't equate to the purchase of the track record and books and records of the business

or for that matter necessarily the same business or assets used to produce the historical financial records. This will need to be considered when determining the appropriate disclosure for what has been acquired.

B7Q2 Do you have any feedback on the related examples in Case Studies 6–7 in Section C?

Case study 6 – KPMG agrees that in the limited fact pattern presented, applying the guidance in AASB 3 Appendix 3, it is likely result in Company X meeting the definition of a business. In the application of the draft RG guidance this would require historical financial information to be provided.

This assessment would be based on the fact that Company X has inputs (medical device and testing equipment) and a research and development process that is critical to the continued development and eventual commercialisation of the equipment. It is this development process when applied to the equipment that has the possibility of generating outputs or sales of the equipment in the future.

Case study 7 – KPMG agrees that in this scenario Company X is a business under the AASB 3 guidance. Whether the acquired caravan parks in themselves meet the definition of a business requires the application of judgement to the specific facts and circumstances. This example will not be relevant for all industries – refer earlier comments on case study 7.

Updating financial disclosure

B8 We propose to clarify our guidance on when financial information is considered current in a prospectus. RG 228.89 already states that issuers should include current financial information in their prospectus.

This extends to requiring the inclusion of half-year financial information. Where the existing business that is the subject of the fundraising has not changed substantially and has an acceptable audit history (as described in draft RG 228.91–RG 228.94), the financial information will generally be considered current if the prospectus includes the most recent: (a) half-year audited or reviewed financial statements (where the prospectus is lodged with ASIC less than three months after year end); or

(b) full-year audited financial statements (where the prospectus is lodged with ASIC less than 75 days after half-year end).

B8Q1 Do you have any comments on this proposed clarification?

KPMG is supportive of ASIC providing this clarification.

B8Q2 Do you have any feedback on the related examples in Case Studies 10–11 in Section C?

KPMG does not have any comments.

B9 In some instances the business that is the subject of the fundraising may have changed so substantially that any unaudited post-balance-date material event disclosure would be of similar or greater significance for investors as the disclosure in the most recent audited or

reviewed financial statements. We propose that in such cases the audited financial information included in the prospectus should have a more current balance date: see draft RG 228.90.

B9Q1 Do you have any comments on this proposed clarification?

KPMG agrees with ASIC's view, but would encourage ASIC to provide some examples of such events.

B9Q2 Do you agree that the issuer should provide audited rather than reviewed disclosure in the circumstances described above?

The question of whether an audit or review should be required will be dependent on the nature and significance of the event. Having another audit performed can be a time consuming and costly exercise for the issuer. Hence, KPMG would encourage ASIC to provide some examples of when it feels an audit would be required.

B9Q3 Where an issuer has commenced operations and seeks to raise funds using a prospectus in its first year of operation, should the issuer be required to include audited rather than reviewed accounts?

KPMG is of the view that the accounts should be audited.

B9Q4 Do you have any feedback on the related example in Case Study 11 in Section C?

KPMG has no further comments on the case study.

Inclusion of cash flow statements

B10 We propose to provide guidance that historical cash flow statements may need to be included in a prospectus where the financial history otherwise requires disclosure: see draft RG 228.87(b)(ii).

B10Q1 Do you have any comments on this proposed clarification?

KPMG agrees that cash flow statements should be disclosed, and is supportive of ASIC providing clarification in that regard. Disclosure of cash flow statements is consistent with typical market practice. KPMG would encourage ASIC to be clear that two-and-a-half or three years of cash flow information should be disclosed, consistent with the requirements for profit and loss information.

There is potential inconsistency between the requirement position in the consultation paper and the proposed drafting of the Regulatory Guide. The drafting of 228.87(b) cites cash flows as an example of other information that may need to be included if material, but paragraph 50 of the consultation paper is stronger. We support the consultation paper proposal. Therefore, we recommend cash flow statements should be required by inserting a standalone point before 228.87(b)(ii) in the same way that the requirement for an income statement is a standalone point in 228.87(b)(i).

We recommend ASIC to be clear in the drafting that 2.5 or 3 years of cash flow information is required to be disclosed, consistent with the requirement for income statement information.

Circumstances where historical financial information disclosure may not be necessary

B11 We propose to provide guidance describing the circumstances where audited financial information for the past two-and-a-half or three years would include information not relevant to an informed assessment of the issuer's financial position, performance or prospects, or which would not be reasonable for investors and their professional advisers to expect. In such circumstances, the provision of either unaudited information, audited information with a modified audit opinion, or financial information of less than two-and-a-half or three years duration may be consistent with investors receiving sufficient information for the purposes of the s710 test. Issuers may therefore justify departure from the two-and-a-half or three year audited guideline in two broad sets of circumstances, outlined in proposals B12–B13: see draft RG 228.97

B11Q1 Do you have any comments on this proposed clarification?

KPMG is supportive of ASIC providing this guidance. Please also refer to our earlier comments in respect of properties being acquired by Real Estate Investment Trusts where the inclusion of the information of the entity which is to be listed, or in relation to the properties to be acquired, may not be relevant due to the properties not previously having been held for pure investment purposes.

B11Q2 Do you have any feedback on the related examples in Case Studies 2–3 and 9 in Section C?

KPMG has no further comments on the case studies.

B12 We propose to provide guidance that historical financial information disclosure may not be necessary where two-and-a-half or three years of audited financial information, or some part of it, is not relevant: see Table 10 in draft RG 228 and Table 1 below for some examples where this may apply.

B12Q1 Does the list of examples provide sufficient clarification as to the exceptional cases in which we may accept departure from the two-and-a-half or three year guideline on the grounds of relevance? If not, what are other examples or scenarios that should be included?

Refer comments above in respect of Real Estate Investment Trusts.

B12Q2 Is there a need to define relevance? We would generally consider that an operating history is relevant if it relates to the same sphere of economic activity as those the issuer intends to engage in after the issuance.

KPMG considers that a definition would add clarity and is therefore desirable.

B12Q3 Do you have any feedback on the related examples in Case Studies 2–5 and 9 in Section C?

KPMG has no further comments on the case studies.

B13 We propose to clarify that historical financial information disclosure may not be necessary if it is not reasonable for investors and their advisers to expect two-and-a-half or three years of audited financial information: see Table 10 at draft RG 228 and Table 2 below for some examples where this may apply.

B13Q1 Does the list of examples provide sufficient clarification as to the exceptional cases where it is not reasonable to expect compliance with the two-and-a-half or three year guideline? If not, what are other examples or scenarios that should be included?

KPMG considers the examples provided to be a good basis for discussion of individual facts and circumstances, and anticipates other examples will become apparent as experience grows.

B13Q2 Do you have any feedback on the related examples in Case Studies 2–3 and 9 in Section C?

KPMG has no further comments on the case studies.

Other considerations

- 1 A strong message coming through the consultation paper is that audited historical financial information should be disclosed for an acquiree if the acquiree is material to the issuer. We recommend that ASIC provides guidance on how materiality is to be determined in this context.
- 2 We recommend that the first sentence of paragraph 228.94 in the Regulatory Guide should be reworded to “In some cases, you may need to have up to three years of financial statements audited for the first time”. This better reflects that the issuer does not audit itself.
- 3 We recommend that the first sentence of Example 1 in Table 10 at paragraph 228.97 should be reworded to “The main business undertaking you operate has changed significantly in the historical period and historical financial information for what was previously the main business undertaking has no relevance to the current business activities.” This better reflects that, whilst the main business undertaking may change, elements of the financial information may still be relevant, for example, overhead costs.