

17 October 2016

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Dear Doug

Submission on Consultation Paper 265: *Communicating audit findings to directors, audit committees or senior managers*

Ernst & Young welcomes the opportunity to offer its views on ASIC's Consultation Paper 265: *Communicating audit findings to directors, audit committees or senior managers* ("CP265") released on 25 July 2016.

As you are aware, we are supportive of both ASIC's and the Assurance Professions objective of improving audit quality. We support ASIC's current audit firm inspection program which is an important element in facilitating market confidence in the quality of financial reports. Like ASIC, we encourage active engagement by directors in the financial reporting process and believe that there is relevant information from the inspection process which is useful to share with audit committees in the context of their oversight responsibilities.

ASIC's rationale for communicating findings from their inspection program with directors, audit committees and senior management is threefold. To assist key stakeholders:

- To take action to address deficiencies in an entity's financial report;
- To improve systems and processes that support accurate and effective financial reporting;
- and
- In discussion with auditors develop actions to improve audit quality on an ongoing basis.

We believe that the first of these objectives is already achieved by ASIC's current approach of writing to entities on specific matters if, through the inspection process, ASIC identify concerns with an entity's financial report. In our view, direct communication on specific matters, is a more effective means of addressing specific financial reporting concerns which may be identified during an audit inspection, rather than the proposed communication by CP265 around findings from ASIC's audit inspection program.

We believe there is a risk with the possible interpretation of ASIC's consultation paper, that the audit process may be relied upon by directors to determine the appropriateness or quality of the financial statements and financial reporting processes and systems (as covered in paragraphs 4 and 11 of CP265). The directors' responsibility for financial reporting is separate to and independent of the audit process.

We note that globally many regulators are looking for greater transparency of inspection findings to directors and audit committees and a number of them have adopted some form of regulator communication within their own legal and regulatory frameworks.

Notwithstanding ASIC's legislative authority to communicate with directors, audit committees or senior managers regarding audit inspection findings, we believe other mechanisms exist which better promote dialogue between audit committees and the auditor with the intent of improving audit quality and the systems and processes which underpin accurate financial reporting. Given Ernst & Young's experience of the varied regimes, we believe the mechanism used by the Canadian Public Accountability Board ("CPAB") is an appropriate example of how ASIC's might alternatively achieve the objectives of CP265. In Canada, audit firms' have to provide audit committees an engagement specific report developed by the CPAB which allows findings to be presented with the regulator's perspective whilst placing responsibility (and accountability) on the audit firm for this communication.

Ernst and Young inform clients when their audit files are selected by ASIC as part of its audit firm inspection process, and routinely share relevant inspection findings, our response to those findings, and any audit quality improvement initiatives derived therefrom.

Overall we support ASIC's proposal (proposal B2 in CP265) to advise directors, audit committees and senior management of companies, responsible entities or disclosing entities of an upcoming inspection of their audit files. However, we have a number of significant concerns with the proposals contained in B1 of CP265 in relation to ASIC's communication of specific audit inspection findings and have identified specific areas where further consultation could be beneficial. In addition we have identified a number of recommendations for ASIC's consideration.

We have detailed these matters in four broad areas below and have provided responses to the specific questions raised in ASIC CP265 in Appendix 1 hereto.

1. Form and Content of ASIC's communication

1.1 Areas that may benefit from further consultation

- Matters to be included in the proposed communication and extent of detail to be provided;
- Approach to circumstances where the views of ASIC and the audit firm differ; and
- Liaison with audit firms' and considerations of firm comments in response to the proposed communication.

1.2 Further Details

Currently, ASIC's private reports to an audit firm provide a very detailed analysis of findings, conclusions, the audit firm's response. Whilst these findings and conclusions are highlighted in the private reports executive summary, details are relatively limited. As such the reports do not a 'balanced scorecard' of the strengths and weaknesses of any given audit and, in particular, do not include areas of the audit reviewed by ASIC where they had no concerns (or in the context of ASIC's stated objective from its 4 year plan of effectively communicating "what good looks like", best practice). Consequently we do not believe that reporting to directors, audit committees or senior managers, in the format of ASIC's current private report to an audit firm, will provide a better understanding of audit quality and thereby meeting the overall objectives of CP265 as previously stated.

Our experience with past inspections has highlighted that differences in opinion or views sometimes arise between ASIC and the audit firm in relation to the interpretation and application of Australian Auditing Standards. As such there are instances where there is disagreement on certain inspection findings. Presently, there is a mechanism whereby the large firms and ASIC meet to discuss such differences in a collaborative and constructive manner with a goal to reaching agreement on interpretation matters. CP265 does not articulate a process prior to any direct communication with identified stakeholders, nor the nature of the communication proposed in this situation.

Additionally, there are situations where the firm and ASIC may disagree on the significance of the finding to the overall audit conclusion. We are concerned that the criteria proposed in CP265 does not identify in sufficient detail, the framework ASIC will use to determine which findings will be communicated and how the significance of findings will be determined. It appears that inconsistencies could arise due to the varying interpretation of ASIC criteria, particularly given the use of subjective language such as “particularly significant” in criteria 2 and “relative severity of the matters”, “genuine uncertainty” and “having regard to all or some of the following” in criteria 5. We note that other jurisdictions provide greater clarity on determining matters which are communicated. In the United States for example we note that findings are only shared with respect to those matters which remain un-remediated after 12 months.

Accordingly, we believe that firms and individual audit partners may become more defensive in their approach to inspection findings. In our view, the working relationship major firms currently strive to maintain (based on transparency, openness, and constructive dialogue, with a mutual objective of achieving improved audit quality), may become more confrontational, less constructive, and therefore undermined.

Time and effort may become more heavily focused on challenging findings, conclusions, recommendations and the precise wording of the findings, with less effort focused on achieving CP265’s stated objectives.

The consultation paper does not outline the process, if any, ASIC intends to apply in determining the audit firm’s views on the findings it intends to share with relevant stakeholders, or whether the proposed communication will include any comments in response from the firm. Should direct communication of audit inspection finding proceed in the manner CP265 envisages, we believe it is important there is a process to incorporate comments from the firm.

We believe that ASIC’s proposal, in B2 of CP265 (to directly communicate findings), may not be in the best interests of promoting high quality audits. The proposal may create a defensive stance between ASIC and the audit firms with a consequential negative impact on the timely agreement of findings, remedial actions and recommendations for improvement. As audit inspection findings are already discussed with our clients it is not clear to us how ASIC’s proposed communication (which as it currently stands may not include the perspectives of the firm) will enable, directly or indirectly, ongoing improvement in audit quality.

Other comments with respect to the proposed criteria set out in Table 1 have been included in Appendix 1.

1.3 Recommendations

We believe that communication of inspection findings by audit firms in collaboration with ASIC, similar to the CPAB model outlined earlier, will be beneficial to an audit committee's oversight role and better promote audit quality. CPAB's protocol includes the audit firm's response to ensure a fair and balanced communication is made to audit committees and the audit firm is able to provide an appropriate context on the significant findings.

If ASIC does proceed with its current proposal to perform direct communication themselves, we encourage ASIC establish protocols for communication (following further consultation) that could include:

- A more detailed framework of how ASIC will determine the significance of findings;
- Clear criteria to be applied in the communication of findings;
- The extent of detail that is to be communicated by ASIC;
- Whether the audit firm's response to the findings will be included in the communication;
- Whether any remediation activity was agreed and whether it has been undertaken by the audit firm;
- Areas which were reviewed by ASIC where no findings were made (and potential recognition of best practice so as to articulate "what good looks like"); and
- ASIC's proposed approach to address disagreements on inspection findings between ASIC and the audit firms.

2. Timing of ASIC's communication

2.1 Areas that may benefit from further consultation

- Details of the expected timing of communication related to the financial reporting cycle; and
- Details of the linkage between the proposed timing of audit firm communication and comment forms relating to the inspection, and the proposed communication with identified stakeholders.

2.2 Further Details

ASIC's findings are currently communicated via the issuance of confidential reports to the individual audit firm inspected as well as the release of an aggregated public audit inspection report, on a 'no names' basis. This occurs at the end of each 18-month cycle of ASIC's audit inspection program. The firms sometimes do not receive all the final individual engagement comment forms prior to the aggregated public audit inspection report being released. There are many factors resulting in these delays and we have been working constructively and cooperatively with ASIC to improve the efficiency of the inspection process, since moving to a continuous inspection cycle process.

In our view, proposals under CP265 may add additional complexity to this process and may further increase timing challenges (given current lack of clarity around the form and content of ASIC's proposed communication) and uncertainty as to how differences in opinion (between ASIC and audit firms on inspection findings) are intended to be dealt with.

We are concerned CP265 does not address the expected timing of communications. This timing could be problematic if significant findings are communicated to clients before an audit firm is given the opportunity to appropriately consider and respond on those findings intended to be communicated. We are also concerned that there may be a significant time lag between the company's reporting cycle, inspection date, findings being identified and the finalisation of the inspection comment forms.

2.3 Recommendations

We recommend that ASIC give due consideration and obtain further feedback in respect on:

- The timeliness of communications for the process as a whole;
- In particular how this will be achieved given the objective of criteria 1 under proposal B1 is to assist in timely resolution of inspection findings including:
 - A proposed timeframe for communicating findings to companies;
 - The relevance and benefit of communicating inspection findings where significant time has elapsed since the company's reporting cycle and inspection date; and
- An appropriate process for discussing and agreeing findings with the audit firm prior to the proposed communication with directors, audit committees or senior managers.

3. Director's responsibilities on receipt of communication from ASIC

3.1 Areas that may benefit from further consultation

- Clarity of ASIC's expectations of directors, audit committees and senior management on receipt of direct communication; and
- Clarity around the prospective interaction with other regulators, such as Australian Prudential Regulation Authority (APRA) and the Australian Taxation Office (ATO).

3.2 Further Details

We support ASIC's objective to promote active engagement by directors and audit committees in understanding the audit firm's audit quality processes and performance, particularly through monitoring of the firm's inspection results arising from ASIC's inspection program. The proposals contained in CP265 reinforce expectations for directors and audit committees to take greater responsibility for audit outcomes. We strongly support this initiative.

However, we do not support suggestions for taking (potentially pre-emptive) action, such as removing an audit firm as a direct consequence of ASIC's communication of significant audit inspection findings. ASIC already has the requisite authority to initiate and effect this type of outcome, should it see fit to do so, and the perceived "delegation" of responsibility to the directors and an audit committee (that CP265 seems to suggest), is not, in our view, appropriate.

Communication of ASIC's findings to members of the board or audit committee who may not have an audit background may also provide additional challenges for them to appropriately understand and interpret inspection findings. This would seem particularly likely in situations where differences in opinion may exist between the audit firm and ASIC on the interpretation of auditing standards or on the significance of the findings communicated.

We understand that ASIC is considering whether findings from its review of audit files should be communicated to other regulators, such as the Australian Prudential Regulation Authority (APRA) or the Australian Taxation Office (ATO). In our view, such communication may be construed by other regulatory authorities as “adverse findings” and therefore potentially impinge, for example, on an individual audit partner’s “fitness and propriety” test (see paragraph 50 of APRA’s Prudential Standard CPS 520 “Fit and Proper”).

In this situation, the provisions of CPS 520 state that “where a responsible person has been assessed as fit and proper, but the APRA-regulated institution subsequently becomes aware of information that may result in the person being assessed as not fit and proper, the institution must take all reasonable steps, to ensure that it can prudently conclude that no material fitness and propriety concern exists. Where a concern exists, a full fit and proper assessment must be conducted.”

Should ASIC decide to communicate inspection findings in the manner proposed, directors will need to be cognisant of these consequences as part of their obligations. Furthermore we are concerned that there may be (potentially unintended) consequences on any APRA assessment to appoint a firm and/or an impacted audit partner to perform “special purpose audits” under APRA Prudential Standards.

3.3 Recommendations

We recommend that ASIC consult with key stakeholders including directors and APRA to determine the likely impact of their proposals on the “fit and proper” test performed by companies of the individual partner’s audit of APRA-regulated entities and potentially other non-related APRA-regulated entities.

Additionally, consideration should be given the mechanism of sharing findings such that they are provided with sufficient context and technical background for identified stakeholders with limited or no audit background to effectively and appropriately assess the relevant importance and implications of inspection findings communicated by ASIC.

Regulatory and financial impact

In our view, the likelihood of additional legal resources (being required to review inspection reports and any direct communication of inspection findings to Audit Committees, Board and Senior Management (proposed under CP265)) is high. This will add to the anticipated cost of compliance.

Australia’s regulatory requirements for the signing of audit reports require the identification of the individual audit partner name as well as the name of the audit firm. We believe that ASIC’s proposals need to be equitable and fair, and accommodate due process being given to both individual audit partners and the audit firm. Any such process must be expected to come at an additional cost (as more rigorous challenge is anticipated on the significance of findings assessed by ASIC which will form the basis of their communication).

There may also be other commercial consequences of ASIC’s proposals such as increased audit firm tendering (and the significant cost associated with this), with market expectation potentially extending to the disclosure of whether ASIC has reported any findings on other clients on the conduct of the audit firm and/ or audit partners previous audit inspection findings.

We would be pleased to discuss our comments with ASIC and its staff and welcome an opportunity to engage further with ASIC in roundtables. Should you wish to do so, please contact Kathy Parsons (Kathy.Parsons@au.ey.com) or on 0439 474 885.

Yours sincerely



Ernst & Young



Mike Wright

Oceania Assurance Managing Partner

Appendix 1: Responses to ASIC Proposals

Ref	ASIC Proposal	Response
Criteria for communicating financial reporting and audit findings		
B1Q1	Do you have any comments on our proposed criteria set out in Table 1?	<p>Additional comments on the proposed criteria are as follows:</p> <ol style="list-style-type: none"> 1. We understand that the financial reporting surveillance activities undertaken by ASIC are a separate process to the routine audit firm inspection process. The reference to “financial reporting surveillance” activities in paragraph 16 of CP265 is unclear as ASIC’s proposals relate to routine audit firm inspection findings and it is unclear why this reference has been included. 2. Criteria 1 implies that information in the audit files may be used to contact the company to resolve financial reporting issues. We do not believe that evidence in the form of quoted documentation obtained from the company which is included in our audit files, which currently forms part of the inspection finding communication, are appropriate for use by ASIC in communicating directly with the company. 3. For criteria 3, we note that ASIC will need to be mindful of information subject to privilege that may not be appropriate to share with the company. 4. Paragraph (d) of criteria 5 refers to the level of audit work required by “auditing standards or accounting standards” should, in our view, be amended to refer to auditing standards only. The level of audit work and required evidence and documentation on the audit file is not determined by accounting standards.
B1Q2	Are there any additional criteria that we should consider including?	No, we are not aware of any other criteria that should be included.

Ref	ASIC Proposal	Response
Advising directors of routine audit file reviews		
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?	Yes, we have no concerns with this proposal. It is our current practice to inform clients when our audit files with respect to their financial statements are selected by ASIC as part of its routine audit firm inspections.
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?	<p>As mentioned above, we understand that the financial reporting surveillance activities undertaken by ASIC are a separate process to the routine audit firm inspection process. The reference to “financial reporting surveillance” activities in paragraph 16 of CP265 is unclear as ASIC’s proposals have been designed to deal with routine audit firm inspection findings and it is not clear why this reference has been included.</p> <p>The intended benefits of this proposal are unclear if the intention is an inspection that relates to the matter of financial concern, however if this inspection will form part of the routine inspection program then our comments above apply.</p>