



Mr Doug Niven  
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Audit  
Australian Securities & Investments Commission  
GPO Box 9827  
Sydney NSW 2001

**By email**

7 October 2016

Dear Doug,

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

Thank you for the opportunity to comment on ASIC’s proposals for communicating audit findings to directors, audit committees or senior managers (**CP265**). We consider that setting a clear and robust framework for ASIC communicating audit findings to an audited body is important to providing transparency to auditors and the entities they audit, and in facilitating investor and market confidence in ASIC’s oversight of financial reporting and audit.

We support the need for a Regulatory Guide setting out clear criteria for determining which findings will be communicated. As ASIC has not used its ability to communicate findings since the ASIC Act was amended in 2012, we believe ASIC’s need to use its power should be restricted to very limited circumstances.

We are concerned that communication by ASIC with audited bodies about ASIC’s observations during its audit inspection program may have a negative effect on confidence in the market and the regulatory regime. It may also create a level of uncertainty and undermine the relationship between the audited body and the auditor. It is our view that the many and extensive discussions that auditors have with those charged with governance should be taken into account and should minimise the extent to which ASIC would see the need to use this power.

We note that paragraph (c) of subsection 127(2D) of the ASIC Act provides that “the information should be disclosed to the company, to the responsible entity of the registered scheme, or to the disclosing entity, in order to assist the company, scheme or entity to properly manage its affairs”. As a matter of course, KPMG communicates directly with audit committees in relation to audit-related matters that ASIC brings to our attention. We consider this to be the best approach to promote investor and market confidence in the quality and reliability of financial statements and audits.

It is our view that for any circumstance where ASIC considers whether to communicate directly with an audited body about audit quality concerns, any decision to communicate should be

taken only where it is evident the audit firm has not already communicated or will not satisfactorily communicate the matter to the audited body's audit committee or directors.

We note the objective set out in paragraph 19 of CP265 of assisting in the timely resolution of a matter and helping to ensure that investors and the market are properly informed. However, it is unclear how the recipients of ASIC's communications will deal practically with the information which will be communicated. Considerations of directors' liability may lead Board members to interpret the information as requiring disclosure to the market, or to take other actions which may have unintended consequences in terms of impact on share price and/or unwarranted public concerns about the quality and dependability of financial reports and audits.

### **Specific comments**

Appendix 1 of our submission responds in detail to the questions set out in CP265 and provides comments and recommendations in relation to our general observations about the proposals.

We would be pleased to discuss our comments with ASIC. If you have any questions, please contact Martin McGrath on (02) 9335 7630 or me on (02) 9335 7182.

Yours sincerely



Duncan M McLennan  
NMP - Audit & Assurance



Appendix 1: CP 265 KPMG response

| Proposal   | Question  | KPMG comments   |
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| <p><b>B1</b> We propose to:</p> <p>(a) 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</p> <p>(b) release a regulatory guide setting out these criteria and explaining how they will apply.</p> | <p>B1Q1 Do you have any comments on our proposed criteria set out in Table 1?</p> | <p><b>Criterion 1</b></p> <ul style="list-style-type: none"> <li>We note that ASIC already communicates with an entity where it has concerns that the entity’s financial report is materially misstated. It is appropriate for such communication to rely on and reference as its source information the entity’s records rather than information on the audit files. Audit documentation should not serve as evidence for a point in this regard and ASIC should refer only to records of the audited body as the source documentation.</li> <li>Relying on powers to communicate information on the audit files to resolve a matter “more efficiently / quickly” leaves ASIC exposed to allegations that it is both “short cutting” established processes in order to save time and costs, and passing the burden of resolving its concerns onto the entity itself.</li> </ul> <p><u>Recommendation 1</u>: KPMG recommends that ASIC should not communicate information from the audit files, or quote from an auditor’s workpapers, when communicating concerns that a financial report is materially misstated.</p> <ul style="list-style-type: none"> <li>We note also that the phrase, “We have concerns” establishes a low threshold for ASIC to make a decision to communicate.</li> </ul> <p><u>Recommendation 2</u>: KPMG recommends in relation to the description of criterion 1 that the phrase, “We have concerns” is replaced by the phrase, “There is clear evidence indicating that”.</p> <p><b>Criterion 2</b></p> <ul style="list-style-type: none"> <li>KPMG makes no comment.</li> </ul> <p><b>Criterion 3</b></p> <ul style="list-style-type: none"> <li>We note that in some circumstances ASIC has issued media releases or made public statements about its intention to take enforcement action. We also note that ASIC has stated that normally, it will only make a public statement about regulatory actions:           <ul style="list-style-type: none"> <li>— in criminal proceedings – no earlier than at the time of the first court appearance by the accused</li> </ul> </li> </ul> |

| Proposal | Question | KPMG comments  |
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|          |          | <p>— in civil proceedings – when the originating documents have been filed and served</p> <p>— in administrative proceedings – when the decision has been made and any relevant requirement for the decision to be gazetted and/or to update a register has been met</p> <p>— when ASIC refers a case to the Takeovers Panel, or</p> <p>— when ASIC secures a regulatory outcome.</p> <p>ASIC has also stated it will generally not publicise matters that are the subject of private hearings, such as banning and licensing hearings before ASIC’s Hearings Delegates and Companies Auditors and Liquidators Disciplinary Board (CALDB) references, when they commence.</p> <p>ASIC has adequate processes for publication of its enforcement actions, which are well established. In departing from established process, ASIC would place the obligation for action on the audited body instead. It is not clear what actions directors should take in such circumstances.</p> <p>In light of the above, ASIC’s proposal to communicate to an audited body about planned enforcement action on its auditor appears to provide scope for inconsistency and raises significant questions of procedural fairness.</p> <p><u>Recommendation 3:</u> KPMG recommends the removal of criterion 3.</p> <p><b>Criterion 4</b></p> <ul style="list-style-type: none"> <li>• KPMG notes that ASIC already has established powers to act where an auditor is not independent, and the need for this criterion to be included is not clear.</li> </ul> <p><u>Recommendation 4:</u> KPMG recommends the removal of criterion 4.</p> <p><b>Criterion 5</b></p> <ul style="list-style-type: none"> <li>• Aspects of the description of criterion 5 provide opportunity for interpretational differences. In particular paragraphs (a) and (e) do not provide the basis for consistent and objective assessment. KPMG is aware of examples of protracted negotiation between ASIC and audit firms about the threshold for reasonable assurance in particular circumstances.</li> </ul> |

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|  |  | <ul style="list-style-type: none"> <li>In our view, “genuine uncertainty” has been established in situations where more than one firm holds a view that conflicts with ASIC’s.</li> <li>Refer also to comments on judgement and interpretation under “General observations” below.</li> </ul> <p>Recommendation 5: KPMG recommends refining the description of criterion 5 to establish the basis for consistent and objective assessment.</p>   |
|  | <p>B1Q2 Are there any additional criteria that we should consider including?</p>   | <ul style="list-style-type: none"> <li>KPMG has identified no additional criteria it considers would justify ASIC communicating directly with audited bodies about audit quality matters.</li> </ul>   |
| <p><b>B2</b> 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.</p> | <p>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?</p> <p>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> | <ul style="list-style-type: none"> <li>KPMG informs an audit committee as a matter of course when its audit file is selected for inspection by ASIC.</li> </ul>  |
|  |  | <ul style="list-style-type: none"> <li>KPMG informs an entity when its audit file is selected for surveillance by ASIC.</li> <li>We consider the term “reason for concern” provides a very wide scope to the proposal. The concept of ASIC informing directors of a forthcoming surveillance where it has “reason for concern” about the adequacy of an audit appears to be contrary to the concept of natural justice and introduces the risk that where ultimately ASIC’s concerns are not borne out, significant damage will have been done to the auditor’s reputation in very unfair circumstances. Further, confidence in the quality of ASIC’s surveillance process may be impaired.</li> </ul> <p>Recommendation 6: KPMG recommends that ASIC’s approach to informing directors of a forthcoming surveillance of an auditor should not advise directors of an audited entity that ASIC will be reviewing audit files because ASIC has concern about the adequacy of the audit.</p> |

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| <p><b>General observations</b></p> |          | <p><b>Recommendation 7:</b> KPMG recommends that ASIC should communicate with the auditor in the first instance, in respect of any review of audit files regardless of the reason (i.e. whether there are concerns or it is part of the routine audit inspection process).</p> <ul style="list-style-type: none"> <li>• We note that paragraph (c) of subsection 127(2D) of the ASIC Act provides that “the information should be disclosed to the company, to the responsible entity of the registered scheme, or to the disclosing entity, in order to assist the company, scheme or entity to properly manage its affairs”. On that basis, we expect ASIC’s need to use its power to be restricted to exceptional circumstances. As a matter of course, we communicate directly with audit committees in relation to audit-related matters that ASIC brings to our attention. We consider this to be the best approach to promote investor and market confidence in the quality and reliability of financial statements and audits. We believe a default position of direct communication of these matters by ASIC with an audited body may result in undermining investor and market confidence.</li> <li>• We note that subsection 127(2F) of the ASIC Act provides that ASIC must provide the auditor concerned with at least seven days’ notice before communicating 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.</li> <li>• We also note that paragraph 18 of CP265 indicates matters may be communicated with the cooperation of the auditor; or using ASIC’s statutory ability to disclose information.</li> <li>• Allowing auditors to raise the issues themselves with the audited body is in line with the purpose in paragraph 8 of CP265, i.e., encouraging directors to seek information directly from their auditors about any issues or concerns. It also gives the auditor the opportunity to update the Audit Committee/Board of Directors first hand on steps to mitigate any issues.</li> </ul> <p><b>Recommendation 8:</b> KPMG recommends as a matter of procedural fairness the framework should provide that before entering into direct communication with an audited body, in all cases the auditor will be provided with the opportunity to raise the issue themselves with the audited body, as well as receive copies of any material proposed to be presented to or discussed with the audited body by ASIC.</p> |

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|          |          | <ul style="list-style-type: none"> <li>In our view, in the interests of promoting investor and market confidence in audit quality, the value of ASIC’s communication with the audited body would be enhanced through dialogue with the auditor in advance of the communication.</li> </ul> <p><u>Recommendation 9</u>: KPMG recommends that ASIC’s framework should provide for written notification by ASIC to the auditor of its concerns, and the opportunity to make submissions, prior to discussions taking place between ASIC and the audited body.</p> <ul style="list-style-type: none"> <li>We note the objective set out in paragraph 19 of CP265 of assisting in the timely resolution of a matter and helping to ensure that investors and the market are properly informed. It is unclear how the recipients of ASIC’s communications will deal practically with the information. In light of directors’ obligations and consideration of directors’ liability, it is possible Board members may interpret the information as requiring disclosure to the market. Such an outcome may have unintended consequences in terms of impact on share price and/or unwarranted public concerns about the quality and dependability of financial reports and audits. It is not inconceivable that ultimately a reaction to ASIC’s communication might lead to an increase in legal actions.</li> <li>In seeking to resolve concerns in a more timely manner, ASIC may be putting the onus on the recipient of the information to take action that would ordinarily have been taken by the regulator. Directors, audit committees and senior managers are likely to seek external advice to understand their obligations and options. This appears likely to add to costs.</li> </ul> <p><u>Recommendation 10</u>: KPMG recommends that ASIC should expand the guidelines to cover what information should be provided in its communications as well as its purpose in making the communication. Further, ASIC should provide guidance about appropriate responses to its communications.</p> <ul style="list-style-type: none"> <li>We note that subsection (2G) of the ASIC Act provides that on disclosing information to a senior manager of the company, responsible entity or disclosing entity, ASIC must, as soon as possible after making the disclosure, provide a copy to the directors and audit committee of the company, responsible entity or disclosing entity. We contend that for greatest impact, such communication would be better directed in the first instance to the Audit Committee where there is one, or otherwise to the Board of Directors rather than communicating with a senior manager. In our view it is not</li> </ul> |

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|          |          | <p>apparent that direct disclosure to a senior manager of the audited body or of the Responsible Entity would serve the objective of enhancing audit quality.</p> <p>Recommendation 11: KPMG recommends that communication by ASIC on matters related to audit quality should be directed in the first instance to the Audit Committee where there is one, or otherwise to the Board of Directors rather than communicating with a senior manager.</p> <ul style="list-style-type: none"> <li>• At paragraph 16 in CP265 it is stated ASIC’s audit inspections and financial reporting surveillances:           <ul style="list-style-type: none"> <li>• ...</li> <li>(b) exclude matters that are within a range of reasonable judgement; and</li> <li>(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.</li> </ul> </li> <li>• In our experience, ASIC routinely raises issues as part of its audit inspection process that are within a range of reasonable judgement, and relate to the interpretation of accounting and auditing standards. There are a number of examples we could quote that relate to KPMG. In addition, the six largest firms have provided ASIC with two “audit methodology” papers in an attempt to resolve differences of opinion between the firms and ASIC in relation to aspects of interpretation of auditing standards.</li> <li>• In our submission to Treasury dated 28 October 2011, in response to its consultation on the Audit Enhancement Bill 2011, we suggested refining the proposals to help provide objectivity in the assessment of what would be viewed as a significant matter requiring communication. The concepts of significance and materiality are familiar themes in auditing and should be embodied in any framework implemented by ASIC.</li> </ul> <p>Recommendation 12: KPMG recommends the wording in paragraph 16 should be expanded to provide a basis for objective assessment of “matters that are within a range of reasonable judgement” and “genuine issues relating to the interpretation of the accounting and auditing standards”.</p> |