Ernst & Young Building
8 Exhibition Street
Melbourne VIC 3000 Australia
GPO Box 67 Melbourne VIC 3001

Tel: +61 3 9288 8000
Fax: +61 3 8650 7777
www.ey.com/au

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The Manager
Corporate Reporting and Accountability Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

by email: auditquality@treasury.gov.au

Corporations Legislation Amendment (Audit Enhancement) Bill 2011 - Comments on Exposure Draft

Dear Sir/Madam

Ernst & Young is pleased to provide its response to the Exposure Draft and Explanatory Material of the Corporations Legislation Amendment (Audit Enhancement) Bill 2011.

We are generally supportive of the proposed amendments to the Corporations Act, which are consistent with international trends in relation to auditor oversight and which will, in our opinion, contribute to the further enhancement of auditor independence and audit quality. We set out below our detailed comments on the proposed amendments.

1. Auditor rotation requirements

Whilst we remain of the view that a seven year rotation period is sufficient and appropriate to achieve the objectives of protecting auditor independence and safeguarding audit quality, we support the proposed move to a "five plus two" model.

We believe the following aspects of the draft legislation could warrant clarification:

1. Draft Section 324DAB(4) provides that directors can only approve an extension if *"the auditor agrees, in writing, to the approval being granted"*. Is it intended that the auditor is signifying an agreement to serve for the extension period, or is it intended to signify the auditor's agreement with the decision to extend? The latter would not, in our view, be a reasonable requirement, as it requires the auditor to, in effect, second guess a decision of the Board.

2. The Explanatory Material notes (para 1.28) that in circumstances where an approval has been granted other than in accordance with the requirements of Sections 324DAA-DAC:

   'if an individual auditor to which the purported approval relates relies on the purported extension that has not been properly granted by the directors, the individual auditor, a partner in the audit firm, the audit company or the directors may commit an offence"

We do not think it reasonable that the auditor and his/her partners could be exposed to sanction if, for example, the directors of a company without an audit committee approve an extension in circumstances where they are not, in fact, *"satisfied that the approval is necessary to safeguard the quality of the audit..."* (Draft Section 324DAB(3)). This is a subjective criterion, the truth of which cannot be known to the auditor.

2. Annual transparency reports

We support these amendments, and in particular support the alignment of the specific disclosure requirements with those of the EU. We would be concerned if the regulations that are eventually promulgated pursuant to Draft Section 332B differed significantly from those set out in the Explanatory Material. In the interests of international consistency, we would expect that future amendments to EU transparency reporting requirements would be carefully considered for adoption in Australia.

We have the following comments on the details of the draft legislation:

1. The draft legislation appears to require reporting in respect of calendar years. Many firms, including ourselves, have fiscal years ending other than on 31 December. Those firms would be required to incur significant additional costs in order to produce financial information at a date other than financial year end that was of sufficient rigour to be appropriate for public reporting. We see no reason why all firms' transparency reports should be required in respect of calendar years (which, we note, is not the requirement in respect of, for example, listed companies). We strongly recommend that the relevant provisions of the draft legislation are redrafted to allow firms to report in accordance with their own financial periods.

2. We question the utility of requiring firms to list all relevant entities audited in the period. This is publicly-available data that adds considerable bulk to the report without, in our view, providing significant additional information to users.

3. Auditor independence functions

We support the proposed changes to the roles and responsibilities of the Financial Reporting Council.

4. Audit deficiency notifications and reports

We support the underlying principle of ASIC being entitled to make public disclosure of defects in an individual firm's quality control systems. We agree that it is appropriate for ASIC to be able to issue reports in respect of any matter coming to its attention during the exercise of any of its functions or powers in relation to audit, as opposed to only matters arising from its inspection programme.

There are two aspects of the draft amendments that in our view require further consideration:

1. We question whether the six month time frame for discussions between the audit firm and ASIC is sufficient. There are aspects of firms' quality control systems that are complex and, in many instances, technology-based. Making necessary changes to these systems can take a significant period of time. There may also be responses to some issues raised that require the delivery of targeted training, or other Learning & Development responses, across the practice. Again, the timelines required for designing and delivering these responses could well be longer than the proposed time frame permits.

   In our opinion, a twelve month time frame would be appropriate. We note that this is the time frame allowed by the PCAOB in equivalent circumstances.

2. We are concerned at the lack of due process in the proposed arrangements. The draft amendments allow for no dispute resolution process if ASIC and the firm are unable to agree on either ASIC's identification of a material weakness, or ASIC's assessment of the adequacy of the firm's response. Because of the very serious impact that the issuance of an audit deficiency report would have on the standing and reputation of the firm, we believe further consideration is required of an appeal or review process.

One possible process is by way of appeal to the Administrative Appeals Tribunal; another would be to a body modelled on the Financial Reporting Panel. Based on our observations of the Financial Reporting Panel, we think a process structured along similar lines would provide appropriate rigour, without undue delay.

We also believe that if ASIC chooses to publish a report, the Firm should be permitted to provide a response and, if the firm does so, ASIC should be required to publish the response together with the report.

5. Communications with corporations, registered schemes and disclosing entities

We have communicated to you previously, through our membership of the Australian Public Policy Committee, our view that ASIC currently has the requisite powers to make the types of communications to clients that are addressed in the draft legislation and explanatory material.

We agree that it is appropriate that ASIC is able to initiate such communications. We are, however, concerned at the lack of due process in the proposed arrangements. These arrangements contain no requirement for the auditor to be notified that ASIC intends to communicate – or, indeed, has communicated – a matter to the firm's client. We believe it is in the interests of all parties – the client, ASIC and the firm – that any such communications are soundly based and take account of all relevant information and views. We therefore believe that provision needs to be made for interaction between ASIC and the firm, before any such matters are communicated to the client.

We also believe that consideration should be given to placing a mirror responsibility on ASIC to communicate information to the auditor that ASIC is in possession of in respect of the auditor's client, and that is relevant to the discharge of the auditor's statutory responsibilities.

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We would be pleased to discuss our comments further. Please contact me on (03) 9288 8647, or Denis Thorn on (03) 8650 7637.

Yours sincerely

A J (Tony) Johnson
Managing Partner - Assurance