10 Shelley Street
Sydney NSW 2000

PO Box H67
Australia Square 1213
Australia

ABN: 51 194 660 183
Telephone: +61 2 9335 7000
Facsimile: +61 2 9335 7001
DX: 1056 Sydney
www.kpmg.com.au

Our ref 111028 Final KPMG response to Audit Enhancement ED doc_21820972_1(Admin)

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

28 October 2011

Dear Sir

Audit Enhancement Bill 2011

KPMG is pleased to provide its written submission on the exposure draft of the Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Exposure Draft).

KPMG supports audit quality and transparency

KPMG acknowledges Treasury's conclusion that Australia's audit regulation framework is robust and stable, and welcomes the proposed amendments in the Exposure Draft as appropriate policy responses which address the important issues raised in Treasury's Consultation Paper *Audit Quality in Australia: A Strategic Review* in March 2010 (Strategic Review). We broadly support the amendments, subject to the detailed comments below, as measures likely to further enhance the quality and transparency of auditing in Australia.

To ensure every partner and employee concentrates on the skills and behaviours needed to deliver an appropriate, robust and independent opinion, KPMG has developed a global Audit Quality Framework. The seven drivers in this framework provide us with a common language to describe what we believe drives audit quality, and importantly, to highlight how every partner and staff member at KPMG contributes to the delivery of audit quality.

Our drivers of audit quality were developed from the same research that informed Treasury's conclusions in its Strategic Review. While our drivers of audit quality look different to those identified by Treasury, they are similar in essence, and KPMG fully supports the use of key drivers of audit quality in ongoing policy debates. We remain happy to engage further in discussions on a set of principles which could be used by all firms to articulate drivers of audit quality.

1. Auditor rotation requirements

As noted in our submission to Treasury's Strategic Review, KPMG believes that extending the period before rotation is required from five to seven years in certain circumstances can safeguard audit quality without adversely impacting independence, by striking the right balance between relevant knowledge and experience, and auditor objectivity.

We believe there will be limited circumstances where directors of listed companies or of responsible entities of registered schemes[1] will need to extend the eligibility term beyond five years to safeguard the quality of the audit, given the strength and depth of partner resources in the large audit firms. However, there may be situations in certain specialised industries with smaller audit firms or smaller audit markets where the extension will be appropriately utilised. We fully support this amendment.

2. Annual transparency reports

KPMG has been a long standing supporter of transparency reporting that enhances stakeholder understanding of the audit and of the measures that the firms take to enhance audit quality.

Our commitment to public transparency is illustrated by being the first global network to publish a Transparency Report (2005) and, in November 2010, we were the first Big Four firm in Australia to voluntarily publish a Transparency Report *Audit Quality in Focus*.

We believe that audit firm governance has a significant influence on audit quality. Accordingly, we fully support public disclosures regarding policies and structures that comprise how the firm is organised as well as the systems, controls and procedures established to achieve and maintain audit quality. We believe that insight into our commitment to audit quality in turn promotes confidence in financial reporting and contributes to stable capital markets. We support the amendment mandating publication of annual transparency reports.

Based on the Explanatory Memorandum published with the Exposure Draft (Explanatory Memo), we understand the Regulations will prescribe a form of transparency reporting very similar to Article 40 of EU Directive 2006/43/EC on statutory audits (Article 40). We encourage Treasury to ensure the final Regulations are directly comparable to Article 40, to minimise the cost burden on networks needing to produce these reports in multiple jurisdictions. Convergence to a globally agreed framework for public transparency disclosures will allow both regulators and regulated entities to focus on the substance of such regulatory and reporting requirements rather than managing multiple reporting regimes.

One aspect of the proposed Regulations does not appear to be directly comparable to Article 40, being the proposal for firms to disclose "fees for Corporations Act audits". This would place a disproportionate burden on audit firms compared to the likely benefits of disclosure, as our systems do not currently track fees split between Corporations Act audits and other audits.

3. Auditor independence functions of FRC

We remain supportive of eliminating any duplicated regulatory effort and believe that ASIC's audit inspection program covers both independence and audit quality comprehensively, without the need for similar oversight by the FRC.

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[1] There is an inconsistency in the draft legislation at s324DAA(1), i.e., a registered scheme has no directors and therefore an approval cannot be granted for the two year extension. We suggest the legislation refer to the directors of the scheme's Responsible Entity for approval of extension.

Consideration could be given to mechanisms which would allow the FRC to evaluate the effectiveness of ASIC's audit inspection program in relation to independence and audit quality, in addition to its proposed high level strategic policy advisory role on audit quality and auditor independence in relation to Australian auditors and the professional accounting bodies. This would allow the FRC to consider ASIC's audit inspection program against global leading practice, and provide reports to the Minister to ensure our audit regulation framework remains in line with international best practice.

4. Audit deficiency reports

We are fully supportive of increased transparency. To promote the aim of enhancing both audit quality and transparency, our submission to Treasury's Strategic Review supported the "Canadian approach". That is, ASIC would make public relevant portions of inspection reports that deal with any weaknesses, deficiencies or recommendations for improvement in a firm's quality control systems that are not addressed to ASIC's satisfaction within an appropriate time following the issue of the final inspection report to the firm. We note from the Explanatory Memo that the legislation is intended to follow the Canadian approach and reiterate our support for this model.

However, in our view the "audit deficiency report" amendments differ in a number of key aspects from the Canadian approach. In finalising the proposals we request Treasury to consider rules 414 and 416 of the Canadian Public Accountability Board, and the points below, to ensure the process is robust and provides for adequate review and challenge:

- The audit deficiency report appears to be a separate communication to a firm from ASIC, additional to the audit inspection report, and could therefore increase the time and costs associated with audit inspections for both ASIC and the audit firms. The Canadian approach is structured on the basis of one report agreed with the firm from which extracts are taken if remediation is not satisfactory or timely, rather than the subsequent preparation of a separate report.
- The definition of an "audit deficiency" is broadly drafted under section 50A(1)(b) and does not contain any threshold measure of significance. The Canadian approach refers to "significant potential weaknesses in the system of quality control or significant deficiencies in specific engagements". While 'significant' is open to different interpretations, we strongly believe there should be a threshold measure to avoid all alleged deficiencies, regardless of importance or impact, being considered for publication. A threshold measure would help avoid a lengthy reporting process that has the potential to act against quality by diverting firms' attention to debating issues of form rather than focusing on remediation efforts.
- There is no requirement for ASIC to notify the firm of the audit deficiency in writing (section 50B(1) "ASIC may, in writing, notify..."). We strongly believe that notice of the audit deficiency must be provided in writing to ensure clarity of the issue and to ensure that the firm can design appropriate remediation actions. The receipt of the written notice should then clearly identify the deadline for the 6 month remediation period.
- Some potential deficiencies in the system of quality control or in specific engagements can take more than 6 months to address, given the cyclical nature of audit work and the complexity of changing behaviours (which is often what remediation efforts require). We note from the Explanatory Memo that the audit deficiency report measures are aimed at "the very few audit firms that may fail or refuse to cooperate with ASIC in relation to taking remedial action to address concerns identified by ASIC". We therefore request Treasury to include an option to extend the remediation timeframe where firms have already taken, within the 6 month timeframe, demonstrable steps to address the deficiency.

- It is not clear how ASIC will satisfy itself whether the auditor has or has not taken appropriate remedial action to remedy the audit deficiency, or what the position would be if there was disagreement as to the nature, severity, prioritisation or process for remediation of the deficiency. The Canadian approach requires that the firm submit evidence or otherwise demonstrate that it has remedied the deficiencies, and after reviewing any such evidence, that the regulator notifies the firm whether in the opinion of the regulator the firm has satisfactorily addressed the deficiencies and, if not, why not. We suggest refining the legislation to provide for more certainty about the operation of the process.
- We note the comments in the Explanatory Memo about the intended use of the measures to be "a powerful incentive for the few recalcitrant audit firms to take remedial action" rather than as a default position. We request that more of the underlying themes in the Explanatory Memo are reflected in the final legislation to ensure greater clarity regarding the extent of operation of ASIC's powers to issue audit deficiency reports.
- The proposals require ASIC to give a copy of the report to the audit firm at least 7 days prior to publication, but do not otherwise appear to contain procedural fairness provisions or processes for appeal or review of ASIC's decision to publish. Whilst we accept that there are a number of important reasons for holding the audit profession publicly accountable for the quality of its work, it is our view that this has to be done in a constructive way in order to promote positive quality outcomes and help ASIC fulfil its mandate to "promote the confident and informed participation by investors and consumers in the financial system". Unless ASIC strikes the appropriate tone and provides adequate balance in its public reports, damage to investor confidence and reputational damage for audit firms could be disproportionate to the issues publicised. We note the comments in the Explanatory Memo that appeal to the Administrative Appeals Tribunal (AAT) was considered and rejected as being too time consuming and contrary to the aims of the proposals. However, the Explanatory Memo goes on to say that "Furthermore, the audit firm is also given the opportunity to comment on any proposed deficiency report as ASIC is required to give the audit firm a copy of the report at least seven days prior to publication." Our interpretation of the proposals is that provision of the report does not also provide the opportunity to comment, and there is no requirement for ASIC to take any comments into account. We suggest replicating the requirements in sections 50B and 50C for written notification, written submissions and consideration of responses, in section 50D. We also suggest including a provision for the firm to require inclusion of all or part of its submission in the public report.
- We also request inclusion of a confidential appeals process, notwithstanding the comments in the Explanatory Memo. In our view, the potential commercial, legal and reputational consequences of publication, coupled with the broad regulatory discretion outlined, merit the protection afforded by a confidential appeals process, particularly when these measures are only intended to be used in exceptional cases.

5. Communications with corporations, registered schemes and disclosing entities

We are supportive of ASIC being able to communicate directly with audited bodies in relation to significant matters which it identifies during the course of the exercise of its statutory functions in relation to an audit. However, we request that communications be restricted to the Audit Committee where there is one, or otherwise to the Board of Directors of the audited body or of the Responsible Entity. In our view it is not appropriate to allow disclosure to a senior manager of the company.

Additionally, while the Explanatory Memo talks about this discretion applying to "significant matters", the draft legislation does not provides a filter or restriction on the type of information which can be communicated. We suggest 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 the discretionary disclosure powers outlined in the Explanatory Memo.

We expect ASIC's need to use this power to be restricted to very limited circumstances. We would certainly prefer to communicate directly with audit committees in relation to any audit-related matters that ASIC brings to our attention. Therefore, while we support ASIC being able to raise its concerns with the audited body, we would like to see the legislation require that prior to entering into direct communication with the audited body, the auditor be notified, and either provide the auditor with the opportunity to raise the issue themselves with the audited body, or be present at the discussion, as well as receive copies of any material presented to or discussed with the audited body by ASIC. In our view, the legislation 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.

Finally, we had understood from stakeholder consultations that ASIC was seeking changes to s127 of the ASIC Act not just to be able to inform the audit committee (or the board of directors) of significant matters in relation to the audit, but also to be able to communicate with audit firms on significant matters in relation to the compliance of the company. We would support an amendment along these lines.

We therefore suggest expanding the proposal to give ASIC the power to disclose to the auditor of the company, registered scheme or disclosing entity, information about a company's, scheme's or entity's compliance with the requirements in Chapter 2M of the Corporations Act to prepare financial statements and reports, or with the continuous disclosure requirements of section 674 and 675 of the Corporations Act.

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We would be pleased to discuss any of these points further; if you have questions please contact me on 02 9335 7182.

Yours faithfully

Duncan McLennan
National Managing Partner, Audit