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Ref: DAH

28 October 2011

The Manager
Corporate Reporting and Accountability Unit
Corporations and Capital Markets Division
The Treasury

By email: auditquality@treasury.gov.au

Dear Sir

EXPOSURE DRAFT: CORPORATIONS LEGISLATION AMENDMENT (AUDIT ENHANCEMENT) BILL 2011

Thank you for the opportunity to provide comments on the proposed legislative changes. Pitcher Partners is an association of independent firms operating from all major cities in Australia. Our clients come from a wide range of industries and include small to medium enterprises, government entities, large private businesses, publicly listed companies and family groups. Consequently our audit practices provide audit and assurance services to a wide range of different size entities, with differing governance structures and user needs for financial information.

We appreciate that the draft bill seeks to enhance audit quality in respect of audits conducted for listed entities. However as previously advised, in response to matters raised by Treasury in the strategic review of audit quality, we believe audit quality is required in all market segments and is particularly important for growing businesses. Entities transition from small and medium sized businesses that may be family owned, to more diverse ownership (and activities) prior to entering the capital market. At each stage of growth it is important that the entity has an appropriate governance structure, including internal controls to identify and mitigate risk, and reliable financial information for decision-making purposes. Consequently, we are concerned that this bill will continue to promote audit market segmentation such that audit quality becomes the focus of attention in the listed market segment only. To promote economic prosperity, capital markets need to have a supply of well governed, growing

businesses that wish to enter that market. Therefore audit quality should be promoted in all market segments.

Our response to each area of proposed reform is provided below.

1. Auditor rotation requirements

We concur with the proposal to permit an auditor who has played a significant role in the audit of a listed entity, to continue to play a significant role for up to a further two years provided requirements are satisfied in relation to the safeguarding of audit quality and auditor independence.

We note the draft legislation does not include any specific criteria in respect of the basis for decisions made by the audit committee or board of directors to approve extension of the rotation period for up to a further two years. We are concerned that the Regulations should *not* contain prescriptive requirements or criteria, but rather that the APESB or accounting bodies should develop appropriate guidance.

We also note that the draft legislation does not amend the two year 'time-out' period and concur with this action. A two year 'time-out' period is appropriate where there is no extension to the five year auditor rotation period. We expect that 'best practice' guidance should address appropriate periods for 'time out' where rotation exceeds that five year period.

2. Annual transparency reports

While we recognise the need for Australia to align with global practice, we have a number of concerns in relation to the annual transparency reports. In particular we consider that Australia should not be following the US Treasury Committee, PCAOB or EU recommendations without careful consideration of their impact, as our economy is very different to those of mature, aging markets. In addition, competition (which includes consideration of audit quality) is already much more transparent in a small market such as Australia, in comparison to large economies.

Calendar year

We note that the proposed legislation requires various disclosures in respect of 'calendar years' even though the Explanatory Memorandum acknowledges that larger audit firms are usually structured as partnerships. Partnerships in Australia will ordinarily compile accounting information that satisfies their taxation obligations for a financial year ending on 30 June. We consider that where a partnership has financial information systems that report for the financial year, the reclassification of information to a calendar year will be both onerous and costly. Further, the information may not be as reliable if estimated interim figures are used for disclosures rather than final year end results.

All our internal reporting systems and procedures are based on a 30 June financial year, and would require significant changes to enable the type of reporting that is anticipated in the exposure draft.

We recommend that the disclosure requirements should be consistent with the financial year of the audit entity and should be made within the period four months after the financial year end.

Omitted information and exemption orders

Proposed section 332B permits omission of information that would otherwise be included as prescribed by the regulations, if inclusion of that information is likely to result in unreasonable prejudice to the transparency reporting auditor. Also, under proposed section 332D, ASIC is able to make an order in writing relieving the auditor from compliance with all or specified requirements of sections 332A and 332B, after applying the criteria in proposed section 332E. It is unclear how these sections might operate in practice, and whether or not the issues noted in the following sections of this submission, could be deemed as providing reasonable cause to omit information or to apply for relief.

We are concerned that Big 4 firms will use their Transparency Reports as marketing documents as these large firms are already dominant in the listed entity audit market. For example, we question how a small audit firm with ten small listed entity audits will be able to demonstrate their capability in a Transparency Report, when they are competing with the marketing capability of the largest firms. There is a serious risk that 'audit quality' in these circumstances will be judged inappropriately. We consider that the operation of the proposed sections granting relief may be subjective, on a case by case basis without consideration of the impact of individual firm disclosures on the market for audit services.

We recommend, as described in the section below, that the threshold for reporting should be raised to capture only those listed entities that are comparable with listed entities in overseas markets, and thereby reduce the level of subjectivity to permit exemptions.

Application of new law when conducting audits of ten or more listed entities, ADIs and insurance companies

Except for listed entities in the top 300, the Australian listed market comprises relatively small businesses, which are more likely to be second board listings in larger jurisdictions. Audit fees for these entities are unlikely to be significant, and the time taken to complete these audits is unlikely to be dominant in the audit entity's client base. We consider that the threshold has been set ***much too low*** and is likely to result in many non-Big 4 audit firms exiting the listed audit market, rather than incorporating costly reporting systems for public disclosure. This will lead to further audit concentration in Australia, which we consider will be detrimental to audit quality. The impact of audit firm concentration on audit quality is an area of continuing concern that is still being considered by the European Union.

In order to maintain a broad base of listed entity auditors, we recommend that transparency reports should be required where an individual auditor, audit firm or authorised audit company conduct an audit of ten or more listed entities, ADIs and insurance companies ***that are included in the S&P/ASX 300 index*** at the beginning of the audit entity's reporting period. We consider that this recommendation will

recognise differences in the size and nature of the Australian business environment and will reduce the risk of continuing concentration of listed entity auditors.

Proposed disclosures in the transparency reports

We are concerned that the proposed disclosures should not be extended in the Regulations when finalised, beyond the scope of disclosures identified in the Explanatory Memorandum.

Overall, with one exception, we consider the disclosures to be reasonable. However, we have serious reservations concerning: "summary financial information for the auditor, showing total revenue, fees for Corporations Act audits and fees received from audit clients for other assurance services and other non-audit services".

- These disclosures presume that a firm's primary source of income is derived from statutory audit fees. This may be the case for the Big 4 firms but for general practice firms it is unlikely that audit fees will be the primary source of revenue. We consider that these disclosures are an invasion of privacy of general practice firms and may be instrumental in causing firms to exit the listed audit market segment, and particularly where listed entity audit fees are not even a dominant source of audit fee income.
- Internal financial reporting systems will not necessarily distinguish between fees for Corporations Act audits and fees for other voluntary audits. Not all entities have a corporate legal form and, in our experience there are significant numbers of non-corporate entities that have voluntary external audits as an important part of their governance practices. We will need to make significant changes to our internal reporting systems to distinguish between the different types of audit and assurance services provided. As a minimum, this factor should be taken into account when determining an operative date for the new legislation.
- As previously indicated in earlier submissions to Treasury, we recognise that while approximately half of Australia's GDP may be contributed by Australia's 500 largest companies, half of the wealth generated in Australia is contributed by other market segments which comprise neither listed, nor corporate entities. Overly onerous regulation for listed entities and their auditors will encourage more activity in the non-regulated market segments, and more particularly non-Big 4 auditors are likely to exit from listed entity audits.

While all listed entity auditors are included in ASIC Inspections, we consider that financial transparency should only be mandated where an audit firm is earning a large portion of their revenue from listed audit fee income.

To promote a varied and diverse audit profession and to encourage general practice firms to remain in the listed audit market, we recommend that transparency disclosures in respect of summary financial information should be required only where an individual auditor, audit firm or authorised audit company conduct an audit of ten or more listed entities, ADIs and insurance companies ***that are included in the S&P/ASX 300 index*** at the beginning of the audit entity's reporting period.

3. Auditor independence functions

We have some concerns regarding the proposed changes. While we concur with changes to the FRC's monitoring functions, we question how the FRC will provide *strategic policy advice* to the minister, when it is separated from the oversight function. Further, we note that membership of the FRC is dominated by representatives from large audit firms, or those with prior connections to large audit firms, and those with listed entity interests. We have serious concerns that there is the potential for vested interests (inadvertent or otherwise) to underlie any strategic policy advice. Consequently there is a risk that the strategic policy advice provided will promote a regulatory environment that will effectively limit the number of listed company auditors outside the Big 4 firms.

The listed market should be dynamic, with new participants entering that segment. This means there needs to be quality audits conducted for privately held businesses to enable them to prosper, so that as they grow they are able to seek funds in capital markets. The FRC should also be concerned with audit quality in the market segment that contains growing businesses, to enable the recommendation of regulation which will promote diversity and growth. We are not confident that the current structure will promote regulation that encourages future economic growth. We consider that there is a serious risk that audit firms outside the Big 4 will be forced out of the audit market in Australia through overly onerous regulation.

We recommend that Treasury should carefully consider the nature of our economy and its potential for growth within the Asia-Pacific region, and should not promote a regulatory environment that responds to the needs of a mature market. In Australia we need a diverse and varied audit profession, so that businesses of all sizes can receive quality audits as 'the most important' clients of an appropriately structured audit firm.

4. Auditor deficiency notifications and reports

Our experience to date with ASIC Inspections has been positive. ASIC follow a due process to communicate and consult on issues arising during the course of their Inspections, which we consider is beneficial to improving audit quality in Australia. We consider that if ASIC continue their existing practice to communicate and consult, then publication of a public report in relation to an auditor who has not taken remedial action on a timely basis, will be in the public interest. Further, we concur that a six month period is adequate for taking remedial action.

However, we are concerned that where there is disagreement with ASIC's findings, firms should have an avenue to justify, and have ratified the position they have taken. For example, this situation could arise when new audit requirements are introduced, practice is not yet established, and ASIC have unrealistic expectations.

We recommend that ASIC should continue to follow a due process to communicate and consult with firms on matters arising during the course of an audit inspection. Further we recommend that there should be an Audit Panel (equivalent to the Financial Reporting Panel) to provide an independent view so that the auditor can seek ratification (or otherwise) of the position they have taken, prior to the publication of the ASIC public report.

5. Communications with corporations, registered schemes and disclosing entities

Although we generally concur with the proposed legislation we consider that there should be a mechanism in place to address disagreements with ASIC. Given that both financial reporting requirements and audit requirements require the application of professional judgment, we consider that the auditor should be able to appeal to an "Audit Panel" to seek ratification of the position taken if appropriate.

We recommend that ASIC should continue to follow a due process to communicate and consult with firms on matters arising during the course of an audit inspection and that where there is disagreement the matter should be referred to an Audit Panel for independent consideration of the facts, prior to communication to the client.

Out-of-court settlements

While we are not against the proposed public reporting by ASIC and/or communications with audit committees where a deficiency in audit quality is observed, we would question whether these proposals are consistent with the lack of public disclosure for actions against auditors that are settled out of court. Where auditors settle out of court there is no public disclosure of the matters arising that resulted in a private settlement. Further, we would not expect the ASIC Inspections to include audit files that are subject to legal action. This means that for major corporate failures there is unlikely to be any public reporting of audit deficiency. In contrast, for smaller firms that are not able to fund out of court settlements, perceived audit deficiencies may be made public. This situation does not promote a level playing field for listed entity auditors.

We recommend that Treasury should consider whether ASIC should be required to examine and make public their findings relating to audit deficiency for any corporate failure, and not only those relating to smaller audit firms.

General comments

We support the views that:

- Audit quality plays an essential role in maintaining an efficient market environment;
- External audit helps to ensure that financial statements are reliable, transparent and useful in the marketplace;
- External audit can help to reinforce strong corporate governance, risk management and internal controls in businesses, thus contributing to financial stability.

However, we strongly believe that these attributes should be upheld in all market segments, not only capital markets. We consider that Treasury should take a holistic view of the economy and should support a broad and diverse audit profession. Treasury should be mindful that the Australian capital market is less than 5% of global markets and includes many entities that would be part of a 'second board' in other jurisdictions. Consequently, applying regulatory standards, equivalent to those

in dominant world economies, to the young Australian market will not always be beneficial.

Treasury should recognise that businesses will transition from one market segment to another and therefore Australia needs auditors that understand each stage of business development. Commensurate with our economic development, Australia has many 'general practice' firms that provide audit services, who understand the governance and risks in growing businesses. We consider that there is a real risk that many firms, whose major source of revenue is ***not*** from listed audits, may exit the audit market if the requirements of the "Transparency Reports" are unduly onerous and intrusive in respect of their non-audit income. There is a clear distinction between the size and nature of businesses in the ASX/S&P 300, in contrast to the remaining smaller listed entities and we consider that audit fees derived from the audits of the top 300 listed entities should be the driver of summary financial information disclosures.

Please do not hesitate to contact me if there are any matters arising that you would like to discuss further.

Yours sincerely
PITCHER PARTNERS

S D AZOOR HUGHES
Partner