PROPOSED APPENDIX 2

The Due Diligence Committee, each of its members
and their representatives

Board of Directors
[Insert name of issuer]
[Insert address of issuer]

[Date]

Dear [ ]

Materiality guidance in relation to [Issuer]'s [Public Document] due diligence process

We refer to our Engagement letter with [ ] dated [ ].

The purpose of this letter is to set out guidance with respect to the quantitative materiality thresholds for consideration by [Client and/or Issuer] and the Due Diligence Committee ("DDC") for the [Prospectus/Product Disclosure Statement/Bidder Statement/Target Statement/Explanatory Memorandum/Cleansing Notice or other Public Document] proposed to be issued in connection with [describe proposed transaction] (the "Public Document") by [Issuer].

Decisions as to qualitative materiality in relation to specific potential or proposed disclosures are the responsibility of [Client] after consideration by the DDC. This letter does not contain any specific guidance in relation to qualitative factors.

Relevance of materiality guidelines

The guidance contained within this letter is based on guidance available in Australian Accounting, Auditing and Assurance Standards and Guidance Statements, and may not necessarily be directly applicable to all circumstances which may arise in relation to the Public Document.

Also, in the event of an alleged deficiency in the Public Document due to an alleged misleading or deceptive statement or omission or otherwise, the relevance or application of the concept of materiality may be dependent on the law that is alleged to have been breached, the available defences and the nature of the legal proceedings (i.e., criminal or civil). We recommend [Client and/or Issuer] seek legal advice on the extent to which materiality may or may not be relevant to the Public Document due diligence process in this instance.

[Insert name of issuer]
Materiality guidance in relation to [Issuer]'s [Public Document] due diligence process
[Date]

Available guidance

Guidance on materiality, with respect to historical financial information, is contained in Auditing Standard ASA 320 “Materiality and Audit Adjustments” (“ASA 320”) and Accounting Standard AASB 1031 “Materiality”. ASA 320 explains the role of materiality in planning an audit and evaluating audit evidence. ASA 320 defines materiality, in relation to information, to mean *“in relation to information, that if information is omitted, misstated or not disclosed, that information has the potential to affect the economic decisions of users of the financial report or the discharge of accountability by management or those charged with governance.”.*

Auditing Guidance Statement AGS 1062 “Reporting in Connection with Proposed Fundraisings” (“AGS 1062”) *[to be updated when ASAE 3400 is issued]* indicates, in relation to pro forma adjustments to historical financial information, that materiality should be considered with regard to both:

- ASA 320; and
- S728 of the *Corporations Act 2001* (“the Act”) which determines that an offence has occurred if a misleading or deceptive statement, omission or new circumstance is materially adverse from the point of view of an investor[1],

with the provisions of the Act overriding the requirements of ASA 320 should the application of the ASA 320 yield a different result[2].

The guidance contained in ASA 320 is also applicable to prospective financial information.

There is a relationship between materiality and risk. That is, the higher the risk of a statement being misleading or deceptive, or of an omission, the lower the materiality level. The DDC should take this relationship into account when determining the nature, timing and extent of due

1 There is no definition of "materiality" or "materially adverse" in the *Corporations Act 2001* (Cwlth). Given the absence of a legislative definition of materiality, it is widely accepted practice in Australia to consider the accounting definitions of materiality as defined in “Accounting Standard AASB 1031: Materiality”.

2 If the Public Document is a Cleansing Notice, it may be desirable to include the following wording since S728 applies only to Disclosure Documents.

Section [708AA/1012DAA] of the Act refers to the notion of “material” under subsection 11, which states that the Cleansing Notice to be lodged with the Australian Securities Exchange is defective if the Cleansing Notice is false or misleading in a material particular; or if the notice has omitted from it a matter or thing, the omission of which renders the notice misleading in a material respect. Given the similarities in references to the concept of materiality being applied to a misleading statement/particular or omission in both sections [708AA/1012DAA] and 728, AGS 1062 is still considered a useful source of guidance with regard to materiality where an offer is made under section [708AA/1012DAA].

diligence procedures. The DDC should make a preliminary assessment of materiality to establish an appropriate quantitative materiality level to plan due diligence procedures.

Quantitative factors

Quantitative thresholds used as guidance for determining the materiality of the amount of an item or an aggregate of items are, of necessity, drawn at arbitrary levels. ASA 320 states that, when establishing a preliminary materiality level, consideration needs to be given to:

- the reliability of management information;
- any factors which may indicate deviations from normal activities; and
- qualitative factors.

A percentage is ordinarily applied to a chosen benchmark as a starting point in determining materiality. When identifying an appropriate benchmark, regard is normally given to factors such as the elements of the financial information, items users are likely to focus on, the nature of the entity, its life cycle, industry and economic environment, the size of the entity, ownership and financing and the relative volatility of the benchmark. For uncorrected misstatements that are below the materiality level, an assessment is required of whether the cumulative result of these misstatements could have a material effect.

ASA 320 does not contain definitive guidance on the setting of the quantitative materiality threshold, but such guidance is contained in Accounting Standard AASB 1031 "Materiality" ("AASB 1031"). AASB 1031 adopts the similar definition of materiality as ASA 320 and explains the role of materiality in making judgements in the preparation and presentation of financial reports.

AASB 1031 states that in determining materiality both the qualitative and quantitative factors need to be considered together and in particular circumstances, "either the nature or the amount of an item or aggregate of items could be the determining factor".

AASB 1031 provides a quantitative methodology as guidance for the determination of materiality in financial statements that states that:

- *an amount which is equal to or greater than 10% of the appropriate base amount may be presumed to be material unless there is evidence, or convincing argument, to the contrary; and*
- *an amount which is equal to or less than 5% of the appropriate base amount may be presumed not to be material unless there is evidence, or convincing argument, to the contrary.*

As the above represents an aggregate materiality threshold the due diligence process should seek to identify individual matters or items that could have a material effect in aggregate. To facilitate this, the DDC should consider adopting an appropriate threshold for individual items to be identified and collected to assess whether in aggregate they may be material. General practice is to identify and collect individual items in a range of X% to Y% of the aggregate materiality threshold.

This quantitative methodology is in addition to, but not a substitute for, any qualitative assessment. The appropriate base amount will depend on the particular circumstances and AASB 1031 provides the following guidance in this respect:

(a) the amount of an item or an aggregate of items relating to the balance sheet is compared with the more appropriate of:

(i) the recorded amount of equity; and

(ii) the appropriate asset or liability class total; or

(b) the amount of an item or an aggregate of items relating to the statement of financial performance is compared with the more appropriate of the:

(i) profit or loss and the appropriate income or expense amount for the current reporting period; and

(ii) average profit or loss and the average of the appropriate income or expense amounts for a number of reporting periods (including the current reporting period); or

(c) the amount of an item or an aggregate of items relating to the statement of cash flows is compared with the more appropriate of the:

(i) net cash provided by or used in the operating, investing, financing or other activities as appropriate, for the current reporting period; and

(ii) average net cash provided by or used in the operating, investing, financing or other activities as appropriate, for a number of reporting periods (including the current reporting period).

Clearly trends in key operating performance measures are as important as the absolute numbers.

AASB 1031 states that materiality "is a matter of professional judgement influenced by the characteristics of the entity and the perceptions as to who are, or are likely to be, the users of the financial report and their information needs. Materiality judgements can only be properly made by those who have the facts". It is within this context that the quantitative threshold guidelines noted above should be used.

[Insert name of issuer]
Materiality guidance in relation to [Issuer]'s [Public Document] due diligence process
[Date]

Recommendations on quantitative materiality thresholds

Our recommendations on quantitative materiality thresholds to be adopted by the Due Diligence Committee are as follows:

Financial performance and cash flows

The process of due diligence should seek to identify, in respect of the financial performance and operating cash flows, misstatements in excess of $[ ] million on the [net profit/profit before tax/EBITDA] of [Issuer]. This level represents approximately [ ]% of the [average] [net profit/profit before tax/EBITDA] of [Issuer[for the year[s] [ended/ending] [ ] 20XX.

To ensure due consideration is given to individual items affecting the income statement and cash flow statement, which may aggregate to $[ ] million, all individual items greater than $[ ] million should be identified for consideration.

Balance Sheet

The process of due diligence in respect of the balance sheet should seek to identify a misstatement or reclassification of [Issuer]'s balance sheet or net assets of more than $[ ] million. This level represents approximately X% of [the appropriate base] as at [ ] 20XX.

To ensure due consideration is given to individual items affecting the balance sheet, which may aggregate to $[ ] million, all individual items greater than $[ ] million should be identified for consideration. These are items which are expected to affect the balance sheet only.

The quantitative materiality recommendations in this letter are provided as a guide only as recommendations covering every possible scenario, event or matter cannot be made. The overriding consideration in relation to each matter should be whether:

- the omission of the matter from the Public Document; or
- a misleading disclosure in relation to the matter,

would be likely to be considered to render the Public Document deficient in light of the legal disclosure requirements relevant to the Public Document.

Yours faithfully