Technical Update 2011/2

30 March 2011

APESB issues revised APES 350 Participation by Members in Public Practice in Due Diligence Committees in connection with a Public Document

Accounting Professional & Ethical Standards Board Limited (APESB) today announced the issue of the revised APES 350 *Participation by Members in Public Practice in Due Diligence Committees in connection with a Public Document* (APES 350) to update the existing APES 350 (Issued December 2009).

Please refer to Appendix 1 of this technical update for details of the revisions. The revised APES 350 will be effective for engagements commencing on or after 1 May 2011 with early adoption permitted.

The revised standard is available from APESB's website: www.apesb.org.au

– ENDS –

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Appendix 1

Revision to APES 350 (Issued December 2009)

Accounting Professional & Ethical Standards Board Limited (APESB) has approved the following revisions to APES 350 *Participation by Members in Public Practice in Due Diligence Committees in connection with a Public Document* which was originally issued In December 2009.

Paragraph Reference	Revisions
1.1	Accounting Professional & Ethical Standards Board Limited (APESB) ~~issues~~ <u>has revised</u> professional standard APES 350 *Participation by Members in Public Practice in Due Diligence Committees in connection with a Public Document* (**the Standard**), which is effective for Engagements commencing on or after ~~1 February 2010~~ <u>1 May 2011.</u> Earlier adoption of this Standard is permitted.
2	***Other Specific Information*** means specifically identified information, other than Financial Information, in a Public Document, which has been the subject of procedures performed by a Member in Public Practice as specified in the Engagement Document. Examples include specific tax-related information, environmental matters, <u>and</u> information technology matters ~~and specific metrics or ratios calculated using elements of the Financial Information~~.
4	<u>*A form of the Materiality Letter is given in Appendix 2*</u>
5.7	**A Member in Public Practice shall ~~only~~ sign a report to Those Charged with Governance on:** **a) information in a Public Document of a general nature relating to financial, accounting, tax or any other matters; or** **b) the content of the Public Document as a whole; or** **c) the due diligence process in relation to (a) and (b),** **<u>only</u> as a DDC Member and where that report is a report of the Due Diligence Committee which is approved and signed concurrently by the other members of the Due Diligence Committee.**
5.9	**A Member in Public Practice <u>providing Professional Services to a Client which comprise participation in and/or reporting to a Due Diligence Committee as a DDC Member, DDC Observer or Reporting Person</u> shall bring to the attention of the Client and/or its Due Diligence Committee any significant concerns relating to the matters set out in paragraph 5.7 which come to the attention of the Member <u>in performing the work set out in the Member's Terms of Engagement</u>.**
5.12	**Where a Member in Public Practice accepts an Engagement to assist a Client or its Due Diligence Committee in any verification process in relation to information in the Public Document (~~aside from the verification of reports, or appropriate direct extracts thereof, issued by the Member and included in the Public Document~~ <u>other than disclosures and information relating to taxation law</u>), the Member shall agree the**

	specific procedures to be undertaken with the Client to provide such assistance.
5.13	A Member in Public Practice should only provide verification assistance in relation to information in the Public Document (other than disclosures and information relating to taxation law) by performing an agreed upon procedures Engagement. ~~However, a~~ A Member should not accept responsibility for the verification of information in a Public Document (~~except for reports issued by the Member as referred to in paragraph 5.12~~ other than disclosures and information relating to taxation law). Those Charged with Governance of the Client are responsible for the inclusion of the Financial Information and Other Specific Information in the Public Document and are best placed to know whether there is new or additional information that might affect its proper verification.
5.14	**Where a Member in Public Practice accepts an Engagement to verify or assist a Client or its Due Diligence Committee with the verification of disclosures and information relating to taxation law, the Member shall exercise professional judgement in determining the nature, timing and scope of the procedures taking into consideration the Terms of Engagement.**
Appendix 1 – second paragraph	Our services have been conducted and ~~T~~ this Due Diligence Sign-Off has been prepared in accordance with APES 350 *Participation by Members in Public Practice in Due Diligence Committees in connection with a Public Document*.
Appendix 1 – 2(g)	[*insert scope of work in relation to Other Specific Information being information which was not subject to the procedures in (d) above*.]
Appendix 1 – Scope limitations	The work referred to in paragraph (d) above was undertaken in accordance with Australian Auditing Standards applicable to Agreed Upon Procedures Engagements. The responsibility for determining the adequacy or otherwise of the Agreed Upon Procedures is that of the directors of the Client. That work did not constitute an audit or review in accordance with Australian Auditing Standards and consequently no assurance or audit opinion or review statement is expressed. Had we performed additional procedures or had we performed an audit in accordance with Australian Auditing Standards or a review in accordance with Australian Auditing Standards applicable to review engagements, other matters might have come to our attention that would have been reported to you.
Appendix 1 – 4	In making the Review Statement we only hold ourselves out as having expertise as [designation of applicable professional body] [in advising on Australian taxation matters (if applicable)]. We disclaim any skills or expertise in any other capacity.
Appendix 1 – 5	~~[Insert similar statements in relation to the Other Specific Information if applicable].~~
Appendix 1 – 6	**Other Specific Information** [Insert appropriate statements and the basis for those statements, in relation to the Other Specific Information referred to in 2(g), if applicable.]
Appendix 1 – 7	In making the Review Statement in this Due Diligence Sign-Off, we have assumed that:

Appendix 1 – 7(c)	there were no relevant documents or information other than those which were disclosed, or provided by or on behalf of the Client to us which are relevant to the Financial Information;
Appendix 1 – 8(a)	we ~~will~~ have no responsibility to update this Due Diligence Sign-Off for events and circumstances occurring after the date of this Due Diligence Sign-Off, other than as required under the terms of the Engagement Document;
Appendix 1 – 9(a)	the Client and its~~/their~~ representatives on the DDC;
Appendix 1 – 9	We do not accept any responsibility for any losses whatsoever occasioned ~~to~~ by any Recipient or ~~to~~ by any other party as a result of the circulation, reproduction or use of this Due Diligence Sign-Off contrary to the above paragraph.
Appendix 2	**Materiality Letter** 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 due diligence process of [Issuer]'s [Public Document] 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 on materiality in relation to specific, potential or proposed disclosures are the responsibility of [Client] after consideration by the DDC. This letter contains specific guidance in relation to the quantitative factors of materiality. However, it does not contain any specific guidance in relation to the qualitative factors of materiality which by definition will be unique to the matter being considered. *Relevance of materiality guidelines* The guidance contained within this letter is based on requirements and guidance available in Australian Accounting Standards, AUASB Standards and AUASB 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 depend 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. Requirements and Application and Other Explanatory Material ("guidance") on applying the concept of materiality in the planning and performing of an audit of historical financial information is contained in Auditing Standard ASA 320 *Materiality in Planning and Performing an Audit* ("ASA 320") and Accounting Standard AASB 1031 *Materiality* ("AASB 1031"). The AUASB Glossary contains the following definition for 'Materiality': *"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.".* Similarly AASB 1031 defines 'Materiality' as: *"Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."* In relation to applying materiality to pro forma adjustments to historical financial information, the following pronouncements have been considered: • AGS 1062 *Reporting in Connection with Proposed Fundraisings*[1]; and • Section 728 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[2], with the provisions of the Act overriding the requirements of applicable AUASB Standards and AUASB Guidance Statements should they conflict or yield a different result[3]. The requirements and guidance contained in ASA 320 applies to historical financial information. A Due Diligence Committee dealing with prospective financial information may refer to ASA 320 for guidance when establishing materiality thresholds.

[1] As of March 2011 AUASB is revising this Standard.

[2] 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 definition of materiality in "Accounting Standard AASB 1031: Materiality".

[3] *[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].]

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 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. When establishing a preliminary quantitative 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 requirements that specify how to determine quantitative materiality thresholds, as their determination is a matter of professional judgement. Australian Accounting Standard AASB 1031 "Materiality" ("AASB 1031") adopts a similar approach to 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 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 statement of

	financial position 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 comprehensive income 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. *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 $[ ] 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 $[ ], all individual items greater than $[ ] 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 $[ ]. 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 $[ ], all individual items greater than $[ ] should be identified for consideration. These are items which are expected to affect the balance sheet only.

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<td><u>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:</u>

• <u>the omission of the matter from the Public Document; or</u>
• <u>a misleading disclosure in relation to the matter,</u>

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

<u>Yours faithfully</u>

<u>Member</u></td>
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