Advancing trust in audit

A submission to the Parliamentary Joint Committee on Corporations and Financial Services on regulation of auditing in Australia

1. Introduction

The audit profession is under significant scrutiny in a number of markets around the world by regulators, politicians and civil society. High profile market events, such as corporate collapses, have raised questions about the role of the auditor and whether the auditor could, and should, do more. As the issues differ country-to-country, so do the potential responses.

Auditors play a crucial public role within society. To serve the public interest, the work of auditors must engender confidence in capital markets. Despite evidence indicating satisfaction with the work and function of auditors among companies and shareholders in Australia[1], there is a gap between what the public expects from statutory audits and what auditors do.

There is always room to improve, develop and evolve. Understanding this, our submission focuses on the following areas, linking to a number of key elements of the Committee's terms of reference:

- We begin by presenting some actionable ideas for strengthening trust in audit today, relating to **independence**, **tenure** and **transparency of audit regulatory oversight.**
- Next, we turn the light on ourselves. Recognising that greater transparency is needed for the public to gain good insight into audit services, we outline KPMG's approach and commitment to **audit quality**.
- Finally, we look to the future of audit, canvassing how the **role and scope of audit** relating to **fraud**, **going concern** and **corporate governance and culture** might develop to meet the evolving needs of the market.

Throughout this document we have identified areas for consideration for change. In doing so, we emphasise the importance of further research and consultation to avoid unintended consequences, or negative impacts on the market and organisations' productivity resulting from any changes.

Thank you for the opportunity to contribute to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the regulation of auditing in Australia by presenting our ideas for advancing trust in audit.

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[1] a. The 2018 survey by the Financial Reporting Council (FRC), with the AUASB, of Audit Committee chairs of top 300 ASX listed companies to gather their perspectives on audit quality. Overall, 92 per cent of respondents rated their external auditor as either "excellent" or "above average". We consider this to be significant given Audit Committee chairs observe first-hand the workings and output of the company's external audit team and are therefore ideally placed to make this assessment. b. The March 2019 survey by the FRC and AUASB of professional investors. Over 90 per cent of respondents rated audit quality as average or above average. c. The 2019 survey of retail investors by CAANZ, showing 87 per cent are confident about the quality of audited financial information, and auditors are ranked Number One as the most effective entities in advancing investor protection.

2. Strengthening trust in audit today

As auditors, we understand we have an important responsibility to the public. We know that continuous quality improvement is fundamental to advancing the public's trust in the profession and the work we deliver. It is fundamental to meeting the expectations of investors, regulators, the organisations we audit, our people, the capital markets and the communities we live in.

We need to do a better job demystifying the role of audit and the audit process to the public.

Auditors, audited companies and regulators all have important roles to play in strengthening trust in audit. When considering opportunities for strengthening trust in the current audit framework, we have focused on auditor independence (which includes conflicts of interest) and on audit tenure – both areas of significant international focus. We also believe that trust can be strengthened by providing the public with greater transparency and clarity on the process and results of regulatory oversight.

Below, we outline our perspectives.

2.1 Independence

2.1.1 KPMG's approach to independence

Auditor independence is a cornerstone of international and domestic professional standards, and of legal and regulatory requirements.

In Australia, independence requirements have been enshrined in the Corporations Act. The audit profession is legally required to be mindful, not only of actual conflicts of interest, but also of the perception of conflicts of interest. Compliance with these obligations requires us to continually reinforce the importance of independence.

At KPMG, we have globally prescribed policies, procedures and guidance, combining global and local regulatory, independence and ethical requirements. These include:

- KPMG International's independence policies and procedures, which incorporate the IESBA (International Ethics Standards Board for Accountants) Code of Ethics requirements, are set out in the Global Quality & Risk Management Manual. KPMG Australia's independence policies and procedures, with Australian-specific provisions, including those relating to APES 110 (Code of Ethics for Professional Accountants) are set out in the Australian Quality & Risk Management Manual.
- The Partner-in-Charge of KPMG's Global Independence Group is supported by a core team of specialists who help ensure the firm has robust and consistent independence policies and procedures globally, and assist member firms and their partners and staff to comply with the requirements.
- KPMG Australia also has its own designated Ethics & Independence Partner and team, which has primary responsibility for the oversight of compliance with Ethics & Independence policies and procedures.
- All KPMG Australia partners and client service professionals must complete independence training upon joining the firm, and on an annual basis thereafter.
- Upon commencement with the firm, all KPMG partners and staff are required to confirm that they understand and will comply with the Ethics & Independence policies. Thereafter, all KPMG people are required to complete an annual declaration stating that they have remained in compliance during the previous year. One specific example is personal financial relationships: KPMG partners and relevant staff (including their immediate family members) must be free from prohibited financial relationships with audit clients, their management and directors. All Australian partners (including their immediate family members) are prohibited from owning any financial interest (e.g. shares, options, warrants, mutual funds) with any KPMG audit client, globally.

KPMG's Ethics & Independence team undertakes an ongoing process of conducting independence compliance audits of the firm's partners and staff. Non-compliance is subject to internal sanctions, including the possibility of dismissal from the firm.

All KPMG partners and staff are required to report an independence breach to the Ethics & Independence Partner as soon as they become aware of it. Any breaches of auditor independence regulations or standards are required to be reported to Those Charged With Governance at the related client.

Confirmation of our independence is provided at least annually to our clients' Audit Committees to inform their evaluation of our compliance with all relevant independence requirements.

2.1.2 Managing conflicts of interest

Sentinel, KPMG's proprietary global web-based application, facilitates compliance with auditor independence requirements and identifies potential conflicts of interest for prospective engagements.

All KPMG partners and staff are responsible for identifying and managing conflicts of interest. KPMG engagement teams are required to use Sentinel to identify potential conflicts of interest so that these can be addressed in accordance with legal and professional requirements. For example, any non-audit services proposed to be provided to audit clients are required to be entered into Sentinel, which assigns proposed engagements for consideration by the Lead Audit Engagement Partner prior to any approval.

2.1.3 The important role of Audit Committees

No discussion of auditor independence would be complete without acknowledging the increasingly important and beneficial role that company Audit Committees play. Audit Committee oversight provides a valuable safeguard in preventing conflicts of interest from occurring in the provision of other assurance and audit-related services and non-audit services.

All public companies are required to have an independent auditor. Audit Committees closely scrutinise and challenge auditors' work, including considering the relationship between auditing and consulting services, and potential conflicts of interest. The focus of Audit Committees on independence and audit quality is driven by the need to meet fiduciary responsibilities as directors, which relies on the robustness of the financial reporting and auditing carried out, as well as reputation management.

Audit Committees have an important role to play in the governance of a company by overseeing the work of auditors and ensuring they are rigorously held to account. The increasingly prominent role of Audit Committees means companies are now highly analytical when considering auditor appointments and managing stakeholder expectations.

Guidance published by ASIC[2] has provided useful direction to Audit Committees in the performance of their roles and in particular in relation to assessing the independence and quality of their auditor.

2.1.4 Non-audit services provided to audit clients

The regulatory rules and systems relating to the provision of non-audit services to an audited entity are extensive and, in our view, effective in safeguarding auditor independence.

The Corporations Act and Code of Ethics for Professional Accountants[3] restrict certain non-audit services, for example certain tax planning and other tax advisory services, designing or implementing certain IT systems and acting in an advocacy role in resolving a dispute or litigation. All other services require careful evaluation to ensure they do not create, or appear to create, an independence issue.

Certain information on all prospective engagements, including service descriptions and fees, must be entered into Sentinel as part of the engagement acceptance process.

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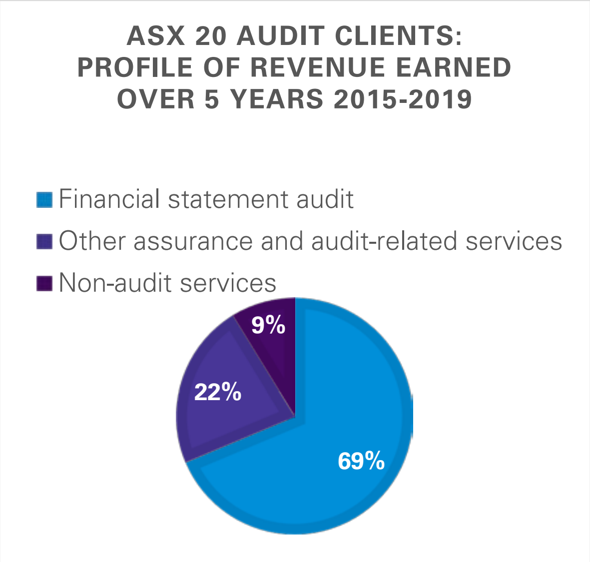
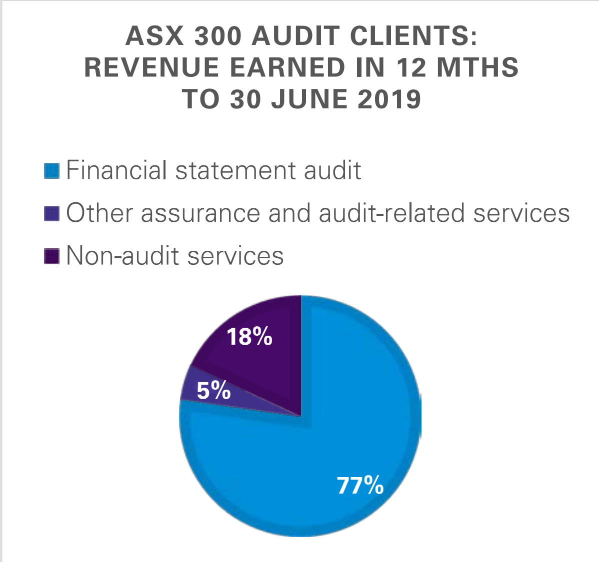
[2] ASIC information sheet INFO 196, Audit quality – the role of directors and Audit Committees, June 2017
[3] APES 110 Code of Ethics for Professional Accountants

Lead Audit Engagement Partners are required to maintain group structures for their publicly traded and certain other audit clients, as well as related entities of these audit clients, in Sentinel and to annually confirm compliance through a declaration process. They are also responsible for identifying and evaluating any independence threats that may arise from the provision of a proposed non-audit service, and the safeguards available to address them. For entities where group structures are maintained, Sentinel enables Lead Audit Engagement Partners to review and approve, or deny, any proposed service for those entities worldwide. From 1 November 2019, the approval of the Ethics & Independence Partner is also required for all non-audit services to listed audit clients.

Over the past five years, 69 per cent of revenue for KPMG's six audit clients in the ASX20 was earned from the financial statement audit, 22 per cent from other assurance and audit-related services and 9 per cent from non-audit services. In FY2019, 5 per cent of the revenue earned from our ASX 300 audit clients was from other assurance and audit-related services and 18 per cent from non-audit services.





2.1.5 Areas for consideration

While we consider our controls and processes to be robust and the regulatory framework to have served Australia's capital markets well, we recognise that there is room for improvement. Here, we outline some ideas for improving transparency and clarity relating to auditor independence.

Consideration: Enact industry-wide definitions of other assurance and audit-related services and non-audit services

There are no industry-wide definitions of other assurance and audit-related services and non-audit services. This can result in public confusion, as well as inconsistencies when companies are considering the nature of permitted services performed and related fees paid to their auditor. To enable transparency, we strongly favour the national standard setters issuing proposals to define specifically what is meant by "financial statement audit", "other assurance and audit-related services" and "non-audit services."

Consideration: Mandate clearer disclosure of 'financial statement audit', 'other assurance and audit-related services' and 'non-audit services' in company annual reports, and specify the nature of any non-audit and assurance services provided

While disclosure of auditor's remuneration is already required in company annual reports, we believe additional transparency and clarity can be added to the system by mandating more specific and consistent disclosures in line with industry-wide definitions (mentioned above). This could be accompanied by more details on the defined types of permitted assurance and audit-related services, and non-audit services that have been provided by the financial statement auditor.

Consideration: Expand requirement that audit partners cannot be remunerated for selling non-audit services

KPMG has a clear policy of not remunerating any audit partners for selling non-audit services to any audit clients of the firm. There is zero financial incentive for audit partners to put revenue ahead of audit quality.

By contrast, actions taken – or not taken – by an audit partner that risk impairing audit quality can, and do, have a direct negative impact on remuneration.

Given audit partners in Australia are required to sign both audit reports and a personal attestation of independence in their own names annually, there are also reputational incentives and legal obligations requiring the delivery of quality audits while being independent in both fact and appearance.

We believe our remuneration policy builds trust in our client engagements and in the system more broadly. We consider this approach should be extended across the profession. We support revising the Code of Ethics standard, APES 110, to include the concept that no audit partner can be remunerated for selling non-audit services to any audit clients of a firm, as a mandatory safeguard that all firms need to apply to mitigate risks of potential conflicts of interest.

Consideration: Cap non-audit services (excluding other assurance and audit-related services) for ASX300 listed companies

The provision of non-audit services by auditors is currently managed by a combination of the law, regulators, Audit Committees and audit firms. In general, we consider this works effectively, however we acknowledge there is increased focus on ensuring the provision of non-audit work does not compromise independence, in reality or perception.

Currently, auditors perform an important role in providing a defined range of services beyond, but closely related to, the financial statement audit. These services are provided in a manner that leverages existing knowledge, processes and cost efficiencies, while being fully compliant with all legal and professional independence requirements. Auditors are also, subject to compliance with legal and professional independence requirements, permitted to provide non-audit services.

To help provide clarity and certainty, consideration could be given to capping non-audit services (excluding other assurance and audit-related services) for ASX 300 listed companies. Capping would involve allowing permitted non-audit services to be provided by the statutory auditor up to a set percentage of the fee paid for the statutory audit.

2.2 Tenure

There has been much debate over the years, internationally and domestically, about individual auditor and audit firm tenure with clients. Questions have been asked as to whether longer tenure may lead to over-familiarity and, through that, the erosion of professional scepticism.

For listed company audits in Australia, key audit partners are required to rotate every five or seven years. There is no requirement for the mandatory rotation of audit firms.

We believe that current auditor rotation requirements, together with the increasing rotation that occurs naturally amongst CEOs and CFOs, and the frequency of change in membership of Audit Committees, significantly reduce familiarity risk.

We note that the European Parliament's Committee on Economic and Monetary Affairs recently published the findings of a study on the impact of audit reform in the EU on costs, concentration and competition[4]. The study noted that: "When we focus on firm rotation and auditor tenure in the auditor independence literature, the evidence generally shows that a longer tenure is not associated with lower quality audits and that mandatory rotation does not necessarily lead to enhanced audit quality."

[4] *EU Statutory Audit Reform: Impact on costs, concentration and competition, study requested by European Parliament's Committee on Economic and Monetary Affairs (ECON), April 2019*

2.2.1 Areas for consideration

While we don't advocate mandatory audit firm rotation, we do have suggestions for improving transparency and clarity relating to audit firm tenure and tendering.

Consideration: Mandate explicit disclosure of auditor tenure in company annual reports

US PCAOB auditing standards require specific disclosures relating to auditor tenure in the auditor's report. Mandating explicit disclosure of auditor tenure should be considered for the Australian market.

Consideration: Mandate time-bound 'comply or explain' tendering regime

We believe there is merit in considering a transparent process requiring Audit Committees to put their audit out to tender within a specified timeframe.

This could be done on the basis of a 'comply or explain' regime, where audits are put out for tender based on a certain timeline or companies are required to explain to shareholders why this has not occurred.

Consideration: Introduce mandatory tendering

We are aware that in overseas jurisdictions, mandatory audit firm rotation has been proposed and, in some cases, introduced. Some nations, for example Canada, South Korea, Spain and Brazil, have subsequently repealed it. In July 2013 the US House of Representatives passed a bill to prohibit mandatory firm rotation, although rules requiring mandatory audit firm rotation have been implemented in the EU.

Over the years, the majority of academic studies have concluded that the research in relation to audit firm tenure and audit quality do not support mandatory firm rotation. One such study[5] concluded: "Considering all research… it can be concluded that mandatory audit firm rotation certainly increases audit costs, decreases audit quality and reduces competition in the audit market… Because mandatory audit firm rotation decreases audit quality it cannot be justified."

Given this context, and as an alternative to the 'comply or explain' tendering regime suggested above, consideration could be given to a mandatory tendering regime rather than audit firm rotation. We believe this may increase transparency and better safeguard audit quality than mandatory audit firm rotation. It should be noted that a tendering process may, appropriately, result in a company's current auditor being reselected.

2.3 Transparency of audit regulatory oversight

2.3.1 The importance of regulatory oversight

We believe it is the responsibility of audit firms to invest in continuous improvement and rectify any identified deficiencies in audit quality capable of eroding trust in the system. We also believe that the regulator has a vital role to play in enhancing public confidence in the audit process.

We take findings from ASIC's inspection process seriously and believe that process provides valuable insights to improve the quality of our audits. We conduct an evaluation of all matters identified by ASIC, including through a process of root cause analysis. We take action to address the findings in an appropriate manner, consistent with auditing standards and our policies and procedures. This includes timely and appropriate remediation of audit files, where inspection findings indicate concerns.

In terms of identifying which audits to inspect, ASIC understandably skews its sample selection to the most complex and high-risk audits. We therefore welcome the regulator's approach to clearly warn against the extrapolation of its results to make wider conclusions about a firm's audit quality.

[5] Mandatory Audit Firm Rotation: A cure or a placebo?, Onur Aslan, Tilburg University, Netherlands 2011/12

ASIC's audit inspection process compares well to international best practice[6]. We commend ASIC for its continued willingness to engage with the profession about ways in which the audit inspection program can be improved.

2.3.2 Areas for consideration

The following considerations are noted as a basis for advancing this discussion.

We outline some ideas for improving transparency and clarity relating to regulatory oversight of auditing.

Consideration: ASIC's inspection findings to be graded

We suggest a system of 'grading' or rating be introduced in order to help the public interpret ASIC's findings. This should help shareholders distinguish between findings that indicate an audit opinion may be unsupported and other, less significant findings such as areas for improvement in documented audit evidence.

The current system used by ASIC can result in inspection findings that vary markedly in terms of significance being presented as like-for-like. Formally stratifying or grading the significance of ASIC's findings would help provide more clarity to all stakeholders.

A system of contextualising ASIC's findings in relation to the overall audit opinion on the financial statements would also be useful, providing a better overall picture of the relative significance of the regulator's findings.

In considering this change, ASIC might refer to the inspection processes in jurisdictions including the UK, Canada and France, where inspections are categorised to reflect the overall significance of the findings on each audit[7].

Consideration: Establish an appeals process with formal protocols to provide clarity to all parties

Given the expertise, experience and judgement involved in conducting an audit, and considering the application of accounting requirements, the inspection process conducted by ASIC could be strengthened through more transparent protocols that involve a final determination of any areas of disagreement. At present ASIC and the firms are not always aligned in their respective views and positions. Misalignment may impact trust.

As acknowledged by the OECD, "well-publicised, adequate and trusted possibilities to appeal decisions"[8] are an important part of any inspections regime. We consider there is an opportunity to clarify the process for appeal or other escalation procedures to enhance transparency and trust in the system. Current possibilities for appeal are limited to the ASIC inspection team itself, are time-consuming for all parties, and often fail to resolve the differences in opinion.

ASIC's submission to the Inquiry proposes that it should be granted powers to compel auditors to remediate deficiencies on individual audits and across the firm, or to remove firms from specific audits[9]. Should this new power be created the need to efficiently and effectively resolve any areas of disagreement would have even greater importance.

We encourage ASIC to establish formal protocols to provide clarity to all parties in relation to the appeal process, and to consider involving a third party expert, who is independent to the firm making an appeal, to support procedural fairness.

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[6] See IFIAR Core Principles for Independent Audit Regulators; OECD Best Practice Principles for Regulatory Enforcement and Inspection (2014); and OECD Regulatory Enforcement and Inspections Toolkit (2018)
[7] The UK regulator uses Good / Limited improvements required / Improvements required / Significant improvements required; Canada refers to files with significant findings, files with other findings, and files with no findings.
[8] OECD Regulatory Enforcement and Inspections Toolkit (2018)
[9] Table 2, Page 13, ASIC submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into the regulation of auditing in Australia

Consideration: Mandatory publication of individual firm inspection reports on the ASIC website

Greater transparency is needed to give more insight into the quality offered by the audit sector in Australia. Currently ASIC publishes findings from audit firm inspections and financial reporting surveillance program of companies.

We note ASIC's decision to report individual percentage findings from its audit file reviews in its next public audit inspection program report, due by December 2019. However, we encourage the mandatory publication of individual audit firm inspection reports on the ASIC website to provide important context to the percentage finding. This would bring Australia in line with other jurisdictions including the UK and US.

Consideration: Review the effectiveness of Transparency Reports and identify means of improvement

KPMG was the first firm in Australia to voluntarily publish a report giving greater insight into the role and quality of audit (a transparency report). Transparency Reports are now a legal requirement[10] for reporting on audit firms and audit quality in Australia (they are also required in the EU) and should be used to help build public confidence.

Transparency Reports are intended to provide relevant, reliable and useful information to stakeholders. They aim to facilitate engagement between firms and users of financial information, and promote confidence in our systems, processes and governance.

The UK Financial Reporting Council recently released a review of Transparency Reports in which it noted:

- Transparency Reports are not being read:
  - there is a lack of awareness amongst investors and Audit Committee Chairs – with 84 per cent of Audit Committee Chairs unaware they exist; and of the 16 per cent who were aware, few had actually read the report relevant to the firm they engage with;
  - those who know about them think the reports are too long and overly positive to be useful; and
  - Transparency Reporting currently is not effective.

We believe there may be an opportunity to conduct a similar review of the effectiveness of Transparency Reports in Australia, with a view to implementing changes that contribute to better, clearer and more useful reporting on audit firms and audit quality.

[10] Under section 322A of the *Corporations Act 2001* (Cth).

3. Our commitment to audit quality

Audit quality is fundamental to maintaining public trust in the capital markets and the financial reports issued by audited organisations. When we talk about how we are striving to maintain and improve quality, it is not an abstract aspiration. Quality is fundamental to our purpose, and we constantly monitor and evaluate it.

In this section, we focus on audit quality – how we as a firm drive quality, our systems of quality control, and the initiatives we are continuously pursuing to improve it.

Although there is no agreed industry definition, KPMG globally believes that 'audit quality' is the outcome when audits are:

- executed consistently, in line with the requirements and intent of applicable professional standards, within a strong system of quality controls; and
- undertaken in an environment of the utmost level of objectivity, independence, ethics and integrity[11].

Our firm-wide commitment to audit quality is founded upon and delivered through our governance structures, the role of leadership and management, our culture, our people, our systems and processes and our organisation.

We comment on each of these areas below. Additional detail can be found in our Transparency Report, publishing 31 October 2019.

3.1 Governance

Our governance structure sets the formal framework for establishing, managing and monitoring audit quality.

KPMG's Global Board last year made a number of significant governance changes squarely focused on improving audit quality. This included appointing a Global Head of Audit Quality, reporting to a new Global Audit Quality Committee (GAQC) of the Global Board.

GAQC plays a critical role in setting the quality agenda, working with regional and member firm leadership to:

- establish and communicate audit quality and risk management policies - KPMG's Global Quality and Risk Management Manual;
- enable effective and efficient processes to promote audit quality, including a strong focus on consistency of our methodology;
- drive strategy implementation in member firm's audit functions, including standards of audit quality; and
- evaluate audit quality issues - including those arising from internal quality performance and external regulatory reviews - and communicate learnings and best practice back to member firms.

Domestically, the Board of KPMG Australia is the principal governance and oversight body for the firm. The governance structure includes committees that have risk and quality responsibilities to oversee and influence the firm's audit quality.

[11] KPMG's definition is consistent with and builds on ASIC's definition of audit quality – see ASIC information sheet INFO222 *Improving and maintaining audit quality,* June 2017.

3.2 Leadership and Management

In our view, strong leadership and management are critical for audit quality. Setting the tone and establishing responsibility at the top builds accountability and consistency through the complete chain of leadership and our teams.

In Australia, our CEO has overall responsibility for our system of quality control and the performance of the firm. All KPMG Australia's initiatives to improve audit quality are underpinned by strong leadership from the firm's National Executive Committee. From 1 July 2018, our CEO assigned every member of the firm's National Executive Committee an audit quality-focused goal, which feeds directly into annual performance and remuneration outcomes. This is to ensure that all our senior leaders – not just auditors – understand, and are held accountable for audit quality.

As an example, the audit quality goal for the National Managing Partner of the firm's Management Consulting division is:

"Monitor and report bi-annually to the Chief Executive Officer the division's activities that have assisted in the enhancement of audit quality. (This may include activities such as training, accreditation and competency of specialists involved in the delivery of external audit services, client risk assessment approval and monitoring, and the monitoring of other services that may impact auditor independence). Additionally, any issues or actions arising from this reporting will be included in the Audit Quality Action Plan, to enable subsequent monitoring and remediation."

Our National Partner in Charge of External Audit is directly accountable to the National Managing Partner of KPMG's Audit, Assurance & Risk Consulting division for the delivery of the firm's audit quality strategy.

Our National Head of Audit Quality is responsible for monitoring internal and external audit quality signals and driving actions for continuous improvement. The National Head of Audit Quality is a member of the Global Audit Quality Steering Committee and responsible for leading the implementation in Australia of initiatives determined by the Global Audit Quality Steering Committee. Together with a dedicated Divisional Risk Management Partner, they are accountable to the Chief Risk Officer, who retains overall operational responsibility for our system of quality control and risk management.

An Engagement Quality Control (EQC) reviewer is appointed for all listed company audits. The EQC review is an important part of KPMG's framework for audit quality. These reviewers are independent of the engagement team and have the appropriate experience and knowledge to perform an objective review of the more critical decisions and judgements, including the appropriateness of the financial statements and audit report. An audit is completed only when the EQC reviewer is satisfied that all significant questions have been resolved.

Audit quality is also integral when we appoint and promote new partners in our audit practice. We require audit partner candidates to have specific audit quality oversight experience as part of their progression to partner.

3.3 Culture

Our commitment to audit quality is underpinned by our values, which form the foundation of our culture and set the tone for governance and leadership. They define our diverse and inclusive culture and our commitment to personal and professional conduct.

Our values emphasise that, above all, we act with integrity. We uphold the highest professional standards and provide sound advice – while rigorously maintaining our independence and complying with laws, regulations and professional standards. We communicate our values clearly to our people and embed them in people processes including induction, performance development and reward.

Building on our values is the KPMG Global Code of Conduct. All partners and staff are required to act in line with this. Everyone at KPMG is required to take regular training covering the Code, and to confirm their compliance. Adherence is monitored and managed.

The firm has clear procedures and established channels of communication in place so that anyone can report ethical, quality or other issues. In addition, KPMG International has a Whistleblower Hotline for all KPMG partners, employees, clients and other external parties to report any concerns they may have. We encourage speaking up so that we can take action when inappropriate behaviour is identified and seek to learn and improve from feedback.

Our culture promotes consultation, challenge and open discussion of issues and is a fundamental contributor to audit quality. This encourages partners and staff to debate and discuss difficult or contentious matters.

We have embedded a culture of continuous improvement, as evidenced through initiatives including:

- An independent team that reviews and challenges the work of audit teams as the audit is taking place, focusing on higher risk companies and audit areas where formal inspection and monitoring processes suggest we can do better. We call this our 'second line of defence'.
- Mandatory policies and data monitoring processes to ensure our teams plan their public company audits, and understand significant risk areas earlier and more consistently so senior team member input is delivered when it most matters.
- Dedicated teams that centralise and standardise certain audit procedures, freeing up senior audit team capacity to focus on high-risk audit areas.

3.4 People

Our people have a direct impact on the planning and performance of our audits, and therefore audit quality. Their calibre and integrity are key to us being considered trustworthy. Our people's knowledge and experience, enabled by technology, are essential to meeting the challenges of evolving stakeholder expectations.

We invest significantly in equipping our people to do the best job by building their skills and capabilities. We cultivate a continuous learning environment and support a coaching culture.

On-the-job development and training includes participating in interstate and overseas assignments, secondments and community involvement through pro-bono and volunteering opportunities. Our learning curriculum offers programs focusing on maintaining and developing capabilities in technical competence, building industry knowledge, innovation and emerging technologies and leadership behaviours.

Technical courses covering independence, financial reporting and auditing topics are mandatory at all audit staff levels. These range from independence learning as part of induction (and annually thereafter), through to audit partners and qualified staff attending mandatory accounting and auditing technical updates. We develop specific learning to address priority audit quality areas. For example, our learning forums are heavily weighted to reinforcing ASIC's messages and addressing their findings from recently completed inspections and preliminary observations from current inspections. In recent years this has included auditing revenue and auditing impairment[12]. These courses also instil in our staff the importance of professional scepticism and ethical behaviour in conducting our audits.

KPMG partners and staff must also successfully complete a post course assessment for mandatory technical learning. The assessment tests their understanding of the topics covered and has a minimum pass rate and completion deadline.

KPMG's recruitment process for audit is focused on attracting people from diverse backgrounds with capabilities and values that will help drive audit quality, be able to constructively challenge our clients and maintain professional scepticism. In addition to accounting professionals, technologists and data scientists are increasingly being hired, reflecting the changing needs of our audit processes.

To deliver audit quality, our audits are undertaken with input from a range of other experts called upon from within KPMG. These can include IT specialists, actuaries, tax experts, forensic accountants, experts in financial instrument valuation, cyber experts and macro economists. The input from skilled

[12] Refer to KPMG's Transparency Report 2018, page 21.

and experienced specialists in an audit for a large multi-national company is critical for audit quality. For our ASX300 audit clients, specialists represent around 13 percent of the time spent on the audit.

Audit partners consider the competence and capabilities of their team, including specialists. This includes considering whether the team has the appropriate resources, with the experience, skills and time to conduct a quality audit.

3.5 Systems & processes

We use technology to improve audit quality by driving better audit insights, creating greater consistency in the performance of audits and to strengthen monitoring of engagements. We believe that audit quality is best achieved when the power of smart technology is matched with inquiring minds and professional scepticism.

We are updating our audit methodology and embedding it in our recently launched 'smart' audit platform, known as KPMG Clara. KPMG Clara unites, in a single platform, our data and analytic capabilities, innovative new technologies, audit capabilities and workflow to enhance quality and efficiency. It also includes collaboration capabilities that improve data flows between the audit team and the company. Our new audit workflow, KPMG Clara Workflow, is being deployed globally from 2020.

From a shareholder perspective, KPMG Clara Workflow will enhance audit quality through:

- enhancing global consistency;
- allowing audit teams to access a deep wealth of information and resources relevant to the company's industry and circumstances, resulting in better understanding of client risks and a more targeted audit approach;
- enabling audit teams to easily access auditing standards and guidance through the workflow; and
- enhancing data and analytic capabilities to allow audit teams to quickly identify data or transactions that warrant further investigation.

Our increasing ability to use data and analytic techniques allows us to audit entire data sets, instead of using sampling techniques, giving greater coverage.

We will continue to scale and enhance our audit technology platform, enabling us to incorporate emerging technologies such as AI (artificial intelligence), predictive analytics, machine learning and cognitive technologies as they advance and mature. The KPMG global audit development team has spent approximately $175m over the past year on enhancing audit technology, which directly benefits the Australian firm. In FY19, KPMG in Australia invested approximately $20m in technology, innovation, training and technical support focused on audit quality.

3.6 Organisation

Audit is the foundation of our firm. Throughout our history, our audit clients have been key beneficiaries of significant investment made by the firm into new services, technology and leading edge talent. Today, we bring the best of our diverse firm, to our audits. As a multi-disciplinary firm, audit is a critical part of our business, which we want to expand and grow.

We strongly believe that being a multi-disciplinary firm enhances audit quality, allowing us to:

- **Attract the best talent:** allows us to attract, develop and retain people who have a wide range of skills, interests and backgrounds. Giving great people the opportunity to expand and grow their careers allows us to better serve the evolving needs of the market and our clients.
- **Access specialists:** allows us to utilise people from across audit, tax and advisory to build balanced and high performing audit teams. This gives us access to talent that would not be available to clients in an audit-only firm.
- **Invest:** allows us to invest in the development and deployment of new technology, which in a digital world is critical to ensuring that quality and consistency is at the heart of everything we do.

- **Access industry and country expertise:** allows us to offer the market deep industry and country knowledge, from multiple perspectives. This is only possible through a global, multi-disciplinary firm.

Maintaining specialist skills would pose significant challenges to an audit-only firm. Indeed, this expertise is necessarily developed from undertaking a variety of work. Sourcing such expertise from outside an audit-only firm would likely result in additional costs, which would ultimately be borne by shareholders of the client company. Utilising experts from external parties would also pose significant regulatory challenges[13].

4. The future of audit

With the market rapidly changing, and expectations along with it, we believe there are opportunities to evolve the function and scope of audit. Given the rapid rise of technology and the increasing sophistication of auditor and specialist skills, there are a range of possibilities to constructively expand the role of audit and auditors where there is market demand and it is beneficial to the operation of capital markets. Our vision is for audits that are more digitally enabled, data-driven and ultimately more real time.

We outline some areas for consideration, pertinent to the Inquiry's terms of reference that could realistically expand and enhance the role of audit in the public interest; and potentially help to better meet public expectations in the future.

4.1 Fraud

According to a recent independent survey, 40 percent of the Australian public expects auditors to always detect any fraud[14]. While we understand the public's notion that detection of fraud should be a priority within an audit, in reality the nature of fraud means that it is typically identified from other sources.

KPMG International's most recent global study, *Global Profiles of the Fraudster 2016*, found that 14 percent of frauds were detected by internal audit, 22 percent by company management reviews and 44 percent through tips offs and formal whistleblower hotlines[15].

So why don't external auditors find more frauds?

KPMG's forensic and fraud specialists refer to the "Fraud Triangle"[16], which identifies the three key conditions allowing fraud to take place as being 'motivation', 'justification' and 'internal control breakdown'.

Further, our global research has shown that:

- individual motivations/rationalisations are very strong drivers of fraud;
- collusion is common, including with people outside of the organisation;
- fraud events are continually changing;

[13] Within a multidisciplinary firm, experts working on individual audit engagements maintain personal independence in accordance with legal and ethical requirements, just like any member of staff or partner in the audit profession. If these experts were sourced from another firm, these independence requirements would be significantly more difficult to satisfy. There would be significant potential for trust in audit integrity to be eroded under such a system. Similar regulatory challenges would exist around the need to regulate the potential for inappropriate use of audit knowledge post audit completion.
[14] *What the public wants from audit*, May 2019, ACCA, CAANZ.
[15] These findings are consistent with those identified in the Association of Certified Fraud Examiners, Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse, April 2018
[16] Based on the work of American criminologist Dr Donald Ray Cressey.

- almost a quarter of fraudsters rely on technology, with cyber fraud emerging as the largest growing threat;
- anti-fraud controls are not strong enough and weak internal controls are a contributing factor in around 75 percent of frauds;
- even if controls are strong, ever more sophisticated fraudsters evade or over-ride them; and
- 44 percent of fraudsters have unlimited authority in their company and are able to override controls.

Fraud often involves sophisticated and carefully organised schemes designed to conceal it – forgery, deliberate failure to record transactions, intentional misrepresentations being made by company representatives and more. Such attempts at concealment may be even more difficult to detect when accompanied by collusion – which can cause auditors to believe audit evidence is persuasive when in fact it is forged or false. Ability to detect fraud depends on many factors including the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated and the seniority of those involved.

Today, auditors' duties in relation to fraud detection are limited. The auditor's role plays peripherally into 'motivation' and 'justification', with the key link to our role being involvement with 'internal controls'. Corporate governance, management of risk, and fraud prevention are primarily the responsibility of the company's board and executive management.

The independent auditor plays a role in detecting certain material types of fraud relevant to financial reporting, but this role is driven directly by the requirements of existing legally enforceable standards, which auditors must follow in performing each audit. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is often very difficult to determine whether misstatements in judgement areas, such as accounting estimates, are caused by fraud, or error. Auditors select samples for testing, rather than whole populations of transactions – meaning fraudulent transactions may go undetected through the external audit process.

An audit today therefore provides reasonable, not absolute, assurance in relation to detecting material fraud, rather than all fraudulent activity.

We believe that there are opportunities to revisit these responsibilities. In particular, the following initiatives may warrant further consideration.

Consideration: Strengthen the requirement for an auditor to consider the adequacy of company internal controls

A breakdown in internal controls is a common ingredient in the existence of fraud by management. We would support strengthening the requirement for an auditor to consider the adequacy of company internal controls that help to prevent or detect material fraud. Additional guidance or changes to existing auditing standards could be considered, to have auditors report any significant weaknesses to the company's Audit Committee for remediation.

Consideration: Strengthen reporting on fraud in audit reports

We would support additional content being included in audit reports which communicates the auditor's obligations to detect or prevent fraud, and which further specifies the audit procedures undertaken to address the risk of material fraud as part of the audit.

The content should be tailored to the client based on specific knowledge of the relevant industry and avoid the use of 'boilerplate' language. Disclosures should enable a user to understand how fraud might occur, and the specific audit tests designed to enable the auditor to obtain reasonable assurance that the financial statements are free of material misstatement. For example in a major retail client you may see a discussion which refers to customer sales rebates and inventory balances, and the specific audit tests designed to address the risk of a material fraud in those areas. These tests could include confirming directly with customers relevant contract terms and net amounts owing at period end, and observing inventory counts on an unannounced basis.

4.2 Going concern

We appreciate there is a gap between the historical nature of an audit and public concerns about company viability and agree that audit needs to evolve to meet expectations in this area.

We believe that there are opportunities to revisit these responsibilities. In particular, the following perspective is presented for further consideration.

Consideration: Implement a new reporting requirement for auditors to report on management's assessment of going concern

We support implementing a new reporting requirement for the auditor of listed entities to provide a clear statement on whether management's assessment of going concern satisfies the reporting requirements, and to set out the work done in this respect.

This should be accompanied by strengthening the ASX Corporate Governance Principles, so companies are required to provide a 'viability statement' in financial reports. This statement should include disclosures on how the board has assessed the prospects of the company, over what period, and an explanation as to why that time period is appropriate.

The UK regulator has recently issued revised requirements to increase the work auditors are required to do when assessing whether an entity is a going concern. The revisions require more work on the part of the auditor to robustly challenge management's assessment of going concern, thoroughly test the adequacy of the supporting evidence, evaluate the risk of management bias and make greater use of the company's viability statement.

We consider the need to address public expectations through greater transparency outweighs the additional costs that would be associated with these proposals, including those arising from the need for further regulation of both companies and auditors.

4.3 Using auditors to promote better corporate governance

Recent research has shown when retail investors read financial reports they do not just focus on financial performance. Rather, Australian retail investors are keenly aware of the importance of reputation, transparency, ethical behaviour, values alignment and social responsibility.[17] As trust in organisations has fallen, the focus on boards acting ethically and responsibly has intensified.

The findings from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry have heightened focus in Australia around governance and risk-management responsibilities and capabilities – along with the need for the risk culture to address underlying causes of misconduct. Commissioner Hayne noted: "after the Global Financial Crisis financial services entities and regulators, in Australia and elsewhere, gave close attention to financial risk. Until recently, however, too little attention has been given in Australia to regulatory, compliance and conduct risks. Too little attention has been given to the evident connections between compensation, incentive and remuneration practices and regulatory, compliance and conduct risks".

In this context, we believe there are opportunities to revisit auditor responsibilities. In particular, the following initiative may warrant further consideration.

Consideration: Obtain independent assurance over non-financial information

Currently there are standards and principles in place requiring the reporting and auditing of financial information provided to boards. However, the way in which companies capture and report non-financial matters varies considerably, and is not normally subject to any form of independent assurance. These non-financial matters (for example, customer complaints, whistleblower events, and staff and customer satisfaction data) typically support operational risk management and may be leading indicators of underlying control or culture issues within a company.

[17] *Shareholder value: Shareholder values: What motivates Australian retail investors,* KPMG Australia, September 2019

Consideration may be given to encouraging companies to obtain independent assurance on non-financial information in an effort to enhance corporate governance. We would support consultation to identify the governance matters of most value and relevance to shareholders.

4.4 Evaluation of audit quality by Audit Committees

Guidance published by ASIC[18] has provided useful direction to Audit Committees on the performance of their roles and in particular in relation to assessing the independence and audit quality of their auditor. Greater transparency on the interaction of auditors and Audit Committees may be considered of value to shareholders and help engender greater trust in the system.

Consideration: Require companies to report to shareholders on Audit Committees' oversight of the external auditor

Companies could be required to report to shareholders annually on the Audit Committee's oversight of the external auditor. For example, under the Corporate Governance Code in the UK, the annual report of a listed company describes the work of the Audit Committee, including how it has assessed the independence and effectiveness of the external audit process, and how the decision to appoint or reappoint the external auditor was arrived at.

The description of the Audit Committee's work in the UK also includes information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of any re-tendering plans. This model is, in our view, worthy of consideration in the Australian market.

5. Conclusion

At KPMG, audit is core to our business, critical to our brand and fundamental to our identity. We are acutely aware of the vital role audit plays in maintaining trust in the capital markets and society more broadly.

Ranked against the rest of the world, we can feel proud of the strength and integrity of our system in Australia. Nevertheless, there is always room to improve, develop and evolve.

We see the interest in audit as an opportunity to enable fresh thought about traditional practice and stimulate thinking about advancing trust in audit.

[18] ASIC information sheet INFO 196, Audit quality – the role of directors and Audit Committees, June 2017