



# **Audit Quality Review Board Ltd**

## **Report Review of KPMG Australia**

**December 2007**

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## **1. Introduction**

- 1.0.1 AQRB (the Audit Quality Review Board) is a not-for-profit company whose objective is to help improve the quality of auditing for public interest entities. In doing so, AQRB aims to enhance the credibility and integrity of the Australian auditing framework, to improve public confidence in that framework and to contribute to the continual improvement of the audit profession for the benefit of the Australian public.
- 1.0.2 The member firms of the Australian auditing profession, in financially supporting AQRB, wish to demonstrate their commitment to ethical and professional standards relating to auditor independence and audit quality. AQRB has been established as a body which will operate independently of the profession to monitor compliance with these standards. Other firms who audit public interest entities are eligible to participate in the monitoring process.
- 1.0.3 This report contains the results of AQRB's second review of KPMG which was undertaken in 2007 and follows the initial review performed in 2006.
- 1.0.4 A general description of AQRB, its role and review processes is available on its website at [www.aqr.org.au](http://www.aqr.org.au).

## **2. Scope and objective of the review**

- 2.0.1 The key objective of the review was to assess the adequacy and effectiveness of the policies, systems and procedures that KPMG uses to ensure its compliance with regulatory and professional requirements with respect to their audit of public interest entities in Australia.
- 2.0.2 In 2006, five publicly listed company audit files were examined. This year the scope of the review was expanded beyond that of publicly listed entities to encompass other public interest entities, defined by AQRB as listed entities, unlisted disclosing entities, APRA regulated bodies and large proprietary companies (as defined in the Corporations Act). This increase in scope necessarily entailed an increase in the number of audit files reviewed from five to twenty.
- 2.0.3 The AQRB review starts with examination of the firm's Quality Control Report ("QCR") (see Section 4 of this report) in order to update our understanding of KPMG's systems and processes, in particular in regard to any changes to policies, procedures and systems that have occurred since the prior year. Thereafter we meet with those KPMG personnel responsible for maintaining these systems and processes and other senior members of the firm's management.

- 2.0.4 In the next stage of the review we examine a number of audit files (20 in 2007) from selected KPMG offices (Sydney, Melbourne and Wollongong in 2007) to seek evidence of the practical application of the policies and procedures. The audit files examined are selected so as to obtain a representative coverage of public interest entities but also so as to include clients assessed by KPMG as “higher risk” and audit files previously examined by KPMG’s internal monitoring team.
- 2.0.5 Having completed our examination of the QCR and audit files, we document our findings, develop our conclusions and recommendations which are discussed with KPMG before being finalised and presented in this report.
- 2.0.6 AQRB did not, as part of its review, examine the merits of a particular audit, the conclusions reached in that audit or the appropriateness of the audit opinion issued.

### **3. The firm under review**

#### *(a) KPMG in Australia*

- 3.0.1 KPMG is one of the four major Australian accounting firms (Ernst & Young, Deloitte, KPMG and PricewaterhouseCoopers) colloquially known as the “big 4”, which collectively audit approximately 88% by composition and 96% by market capitalization of the 300 largest entities listed on the Australian Stock Exchange (“S&P/ASX 300”).<sup>1</sup>
- 3.0.2 Details of the structure of KPMG are set out in Para’s 1.1 and 1.2 of its QCR. Key points are:
- KPMG is a member of a global network (KPMG Global) of practices in 140 countries;
  - In Australia, KPMG operates nationally across 14 offices with over 300 partners and 4000 staff;
  - The firm has offices in each state capital and a number of regional centres, six of which are affiliated offices;
  - The Australian firm has an elected Board of Partners with a separately elected chair and an appointed CEO who is accountable to the partners of KPMG. The Chairman of KPMG plays a senior role in KPMG Global as does the CEO, the National Managing Partner Audit (“NMP-Audit”), and the National Managing Partner Risk and Regulation (“NMP-R&R”);

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<sup>1</sup> ASIC “Audit inspection program Second report to FRC August 2006”

- There are four divisions in KPMG (Audit, Risk Advisory Services (“RAS”), Tax and Financial Advisory Services) with each having a designated divisional risk management partner for each of their service lines.

***(b) Responsibilities for quality, risk and regulation within KPMG***

3.0.3 In considering the findings of this report it is useful to understand the roles of those charged with direct responsibility for quality, risk and regulation, both firm wide and within audit.

Risk management is under the leadership of the NMP-R&R, who reports directly to the firm’s CEO. The NMP-R&R has Divisional Risk Management Partners who report directly to him on risk issues. This structure is supplemented by the Department of Professional Practice (“DPP”) which reports to the NMP-Audit, and the firm’s General Counsel and the Ethics & Independence Partner, each of whom report to the NMP-R&R.

The NMP-R&R leads quality and risk management for the firm and is supported by the following groups:

*National Risk Management Group*

The National Risk Management Group comprises partners and other professionals who are charged with promoting quality and managing risk by focusing on the firm’s risk management processes. This group also has responsibility for conducting compliance testing of KPMG Australia’s policies in areas such as the independence of the firm’s professionals and advising on policies contained in its risk management manual.

*Risk Management Committee*

The Risk Management Committee has ultimate responsibility for the architecture and design of the risk management process. It oversees the development and monitoring of policies and the dissemination of guidance designed to enhance the firm’s risk management and quality control process.

This Committee, chaired by the NMP-R&R, consists of the firm’s General Counsel, the partner in charge of DPP, and the heads of the Shared Services areas (Human Resources, Information Technology Services, Marketing, Finance and the National Secretariat). Other persons may be invited to attend meetings as determined by the committee.

*Service Delivery Risk Committee*

The Service Delivery Risk Committee has oversight of the risk management procedures of specific practice areas. It oversees the identification of key business risks facing the firm arising through the professional services that it provides. This committee is chaired by the NMP-R&R and includes risk management partners from each division of the firm.

***(c) KPMG participation in AQRB***

3.0.4 KPMG is, along with the other big 4 firms, an initial subscriber to the AQRB process. It has willingly allowed the AQRB review team to undertake its task within the firm and has both provided the review team with the material requested and facilitated access to KPMG personnel as requested. KPMG has filed an appropriate QCR for inclusion on the AQRB website.

**4. KPMG Quality Control Report (QCR)**

4.0.1 KPMG has prepared a QCR which summarises the policies and processes by which it seeks to comply with standards and laws relating to audit quality and independence. The QCR relevant to the current KPMG review is at [www.aqrb.org.au](http://www.aqrb.org.au). It is useful source material to assist in a better understanding of the KPMG policies and procedures and the findings of this report.

4.0.2 AQRB reviewed the contents of the QCR and a more detailed non-public QCR together with associated reference material in order to assess the suitability of these quality control systems to provide reasonable assurance as to compliance with regulatory and professional requirements.

4.0.3 AQRB is satisfied that the QCR fairly describes KPMG's quality control systems.

**5. Recommendations Made as a Result of AQRB 2006 Review**

5.0.1 Arising from the review performed in 2006, AQRB made certain recommendations to KPMG. Given that AQRB only reported to KPMG on these recommendations in February 2007 and the audit files selected for the 2007 review primarily had a year end of 30 June 2006, it was not possible this year for AQRB to determine the extent to which its recommendations relating to the conduct and documentation of audits had been adopted.

5.0.2 Certain of AQRB's 2006 recommendations related to other matters such as quality control processes. Where it has been possible for KPMG to implement these recommendations prior to commencement of the 2007 review, AQRB has sought to follow up whether they have been implemented.

5.0.3 Reference is made to the 2006 recommendations in this report and, where appropriate, the action taken by KPMG in respect thereof. In future reviews AQRB will follow up on the implementation of its recommendations which are still to be applied.

- 5.0.4 Based on the information provided by KPMG and our own observations, AQRB is satisfied that where possible, in the time available since receipt of the 2006 report, appropriate action has been taken on the recommendations made.

## **6. Review process**

- 6.0.1 The AQRB team performed the review in accordance with the review methodology set out in *“The AQRB and its Review Processes”* which can be found at [www.aqrb.org.au](http://www.aqrb.org.au). The work was carried out in KPMG’s Sydney and Melbourne offices and at one of the regional offices, Wollongong.
- 6.0.2 As this was the second review of KPMG, the AQRB review team updated their knowledge of the firm, re-visited areas where recommendations had been made in the prior year and focused in greater depth on other key areas.

## **7. Findings of the review**

- 7.0.1 Corporations Act requirements for auditors, arising principally from the CLERP 9 legislative process, the revision of auditing standards and certain significant overseas legislative requirements (such as the Sarbanes-Oxley Act of 2002 in the US), have required audit firms in recent years to review and upgrade their policies and processes. These firms must have in place quality control systems that provide reasonable assurance that all legal and professional requirements are met.
- 7.0.2 As noted earlier, a summary of how KPMG describes the manner in which its quality control system operates is contained in its QCR and this has been reviewed by AQRB. The findings below, which address the principal issues that emerged, result from consideration of the various matters observed by AQRB using, as general analysis benchmarks, the “Major Review Themes” set out in *“The AQRB and its Review Processes”*.
- 7.0.3 In its findings the AQRB review team has identified a number of issues to be addressed by KPMG and in other cases, best practice recommendations to be considered. These relate to those areas where AQRB believes further progress to be desirable.
- 7.0.4 The findings of the review should be read in the context of an overall view which AQRB formed that the audit files were generally well documented. All the partners and managers interviewed as part of the review process and with whom the audits were discussed demonstrated a good understanding of their clients’ businesses and of the consequential audit requirements.

- 7.0.5 For those areas where the KPMG initiatives appear to be working effectively, or are being further developed to achieve their purpose, this report contains observations that are of a general nature.

## **8. KPMG Policies and Systems**

- 8.0.1 KPMG has developed clear and comprehensive policy requirements. The development of these requirements has been influenced by global as well as national requirements. There is clear evidence of policy revision in response to changing requirements. These appear to AQRB to be comprehensive.
- 8.0.2 Many recent changes to auditing standards and legal requirements have caused auditors to review their work practices. KPMG continues to revise its tools, systems and procedures in order to assist audit staff manage compliance with firm policies.
- 8.0.3 The development and introduction of new and revised tools and systems takes some time, needing appropriate training and embedding into the firm's culture for them to be fully effective.
- 8.0.4 A new SAP Module (LMS) which has been brought on line this year is expected to enable the Learning and Development team to manage training and development programmes considerably more efficiently. AQRB notes that core KPMG training, both induction and ongoing, includes units on quality and independence matters.
- 8.0.5 AQRB acknowledges that KPMG has in place tools and systems to enable policies to be applied. Some of these such as the audit methodology (KAM) require ongoing reinforcement to ensure their importance as well as their necessity is well understood and applied in matters such as documentation, the role of the EQCR partner and providing evidence of reviews having been properly completed at the appropriate time. AQRB observes that KPMG is well aware of this and has a program of enhancement which includes the regular release of technical bulletins and training programmes.
- 8.0.6 AQRB notes that successful implementation of policies depends upon several factors other than systems and tools. In particular, partners and staff:
- need to understand, appreciate and support the intent of policy;
  - need to be clear about what the policy expects of them;
  - need to have their performance monitored; and
  - need to be held accountable – rewards for good behaviour and sanctions for failure.

- 8.0.7 In formulating its findings, AQRB has addressed these issues, with particular emphasis on those policies that AQRB regards as most important.

## **9. Leadership and Values**

- 9.0.1 KPMG leadership continues to evidence a serious commitment of senior partners and staff to specifically allocated risk management oversight roles at both national and local levels. These risk management functions are assisted by other support functions as set out above in paragraph 3.3. The key function from an audit practice viewpoint is the leadership role played by DPP. The partners in this and other risk management departments are supported by significant staff resources.
- 9.0.2 Leadership has taken a position firmly endorsing the importance of adherence to the statutory and professional requirements and to KPMG values. It demonstrates this through the messages consistently given to the firm and by the adoption of incentives and sanctions through the various performance appraisal and compensation systems. They are further reinforced through the recruitment, induction and promotion processes to ensure that at each stage of progression, partners and staff are given a clear and consistent message about the firm's values, expectations and policies. These messages appear to be strong and sincere.
- 9.0.3 AQRB notes that KPMG values, including quality, are considered and assigned weightings in partner and staff performance appraisals.

## **10. Independence and threats to independence**

- 10.0.1 KPMG has a number of systems and processes in place to identify and, where appropriate, manage potential threats to the objectivity and independence of auditors. Core features of these systems include the maintenance of interactive databases designed to identify potential threats to independence, review mechanisms where non-audit services are being contemplated for an audit client and partner rotation policies. EQCR partners also have an important role to play in reviewing the audit teams' management of independence threats.
- 10.0.2 Reliance cannot be placed on systems and processes to identify potential areas where the interests of the auditor or the firm may be placed in potential conflict to the conduct of the audit unless the underlying processes and associated databases are kept up to date and procedures are being followed. Sign-offs by senior KPMG personnel are designed to ensure policy requirements are met and AQRB notes that this is included within the scope of the quality review processes.

- 10.0.3 Breaches of the firm's independence policies are regarded seriously and dealt with in a number of ways which seem to AQRB to be appropriate.
- 10.0.4 KPMG has set out guidelines that seek to identify risks that have the potential to threaten independence through the provision of non-audit services to audit clients. A number of services are specifically prohibited.
- 10.0.5 AQRB has made some observations to KPMG regarding the implementation of these guidelines and individual compliance declarations.

## **11. Audit Quality**

- 11.0.1 Audit quality depends upon an audit team with the right skills, following policies and using tools that guide them to conduct the work appropriately and with the capacity to make sound, objective ("independent") judgements.
- 11.0.2 KPMG has invested significantly in personnel recruitment, development and retention in recent years. Partners and staff are required to meet their professional development requirements and monitoring arrangements are in place to track their attendance at training sessions. Particular training initiatives are launched in support of emerging requirements such as the roll out of the new A-IFRS accounting standards and the new audit standards. Equally important however, is the refresher or development training given in specialist industries to staff performing audits of clients in those industries. Such development is often not subject to the same formal recording or monitoring and in its 2006 report AQRB suggested, given that it is an important element of ensuring that auditors understand the industry and its risks, that there is consequently a sound reason for monitoring processes to be extended to capture such activities. It is noted that the new Training and Events database includes the facility to track such education but that it is only used to identify staff members who have not attended core training sessions. Additional industry/Line of Business and "topic specific" technical training/workshops are conducted in local audit groups as required.
- 11.0.3 AQRB noted in the course of the 2006 review that KPMG has a continuous process of improvement for its quality monitoring systems. Significant developments have occurred since that time in the learning and development, performance management, partner rotation and client acceptance systems. This is an ongoing process.
- 11.0.4 In the 2006 review AQRB identified, and focused upon, three areas, the effectiveness of which it believes to be crucial in achieving audit quality. These are:
  - the Client Acceptance and Continuance/Risk Assessment process;

- quality control reviews conducted by the EQCR partner; and
- the firm's internal monitoring processes.

11.0.5 AQRB has focused again on these three areas in the 2007 review. Additional areas of focus this year have been audit procedures directed towards detecting the risk of material misstatement in the financial report due to fraud and the sufficiency and appropriateness of audit documentation.

## **11.1 The Client Acceptance and Continuance/Risk Assessment process**

11.1.1 The Accounting Professional and Ethical Standards Board's "Quality Control for Firms" (APES 320) requires that firms shall establish policies and procedures for the acceptance and continuance of client relationships. Auditing standards (AUS 206, and for reporting periods commencing on or after 1 July 2006, ASA 220, "Quality Control for Audit of Historical Information") require that the engagement partner shall be satisfied that a risk assessment has been conducted prior to acceptance of a client or an engagement. The purpose of this assessment is to ascertain whether the engagement poses an unacceptable risk to the firm and should therefore be declined, or to identify what resources and procedures the firm should bring to bear in order to ensure that the risk is appropriately managed.

11.1.2 KPMG policies reflect the requirements of the audit standards and require that all audit engagements be assessed for risk initially prior to acceptance, and subsequently at each annual audit if the conditions have significantly changed. The assessment requires consideration of matters such as client-related matters (financial strength, reputation and character of management personnel), business-related matters (industry, products and competitors), service-related matters (firm competency and technical risk associated with services requested), and, independence-related matters (employment-related matters, financial relationships, investments, loans and non-audit services).

11.1.3 AQRB, in the course of its 2006 review, made recommendations to KPMG regarding the application of firm policy in this area. Further recommendations have been made in 2007.

## **11.2. Role of Engagement Quality Control Review ("EQCR") partner**

11.2.1 The role of the EQCR partner is well defined in auditing standards. ASA 220 paragraphs 40-44 and APES 320 paragraphs 60-73 deal with EQCR policies and procedures, nature, timing and extent of reviews, the criteria for eligibility of reviewers and the documentation of reviews. The EQCR function is

regarded as an important quality control feature within the audit process. It is clear that EQCR partners carry a significant responsibility for which they should be accountable. In particular, they play an important quality maintenance role particularly in engagements of increased complexity or risk.

- 11.2.2 Paragraph 42 of ASA 220 says that an engagement quality control review shall include an objective evaluation of the significant judgements made by the engagement team and the conclusions reached in formulating the auditor's report. Paragraph 60 of APES 320 includes similar wording to that of paragraph 42 of ASA 220.
- 11.2.3 The requirement for EQCR objectivity is further reinforced in paragraph 70 of APES 320 which states "The Assurance Practice's policies and procedures are designed to maintain the objectivity of the Engagement Quality Control Reviewers. For example the Engagement Quality Control Reviewer (a) is not selected by the Engagement Partner..."
- 11.2.4 AQRB made recommendations to KPMG in its report on the 2006 review regarding the role of the EQCR partner and has made further recommendations in 2007.

### **11.3. Monitoring – the audit quality review process**

- 11.3.1 AQRB observes that KPMG makes a large time and financial investment in its quality review monitoring programs. Its review framework is both local and global. Some reviews such as the Risk Compliance (RCP) and Quality Performance ("QP") programs are conducted annually. Others such as the Global Compliance Review are conducted every three years. There are clearly assigned responsibilities for quality monitoring and there are comprehensive policies, instructions and checklists, together with a training program for reviewers. The firm takes the review findings seriously and takes action where needed, both in terms of sanctions for underperformance and in identifying the need for changes in work practices, training and guidance.
- 11.3.2 AQRB believes that effective monitoring via the audit quality review process is an essential component of KPMG's quality control system and has therefore sought to identify any areas for further improvement.
- 11.3.3 AQRB made recommendations in 2006 regarding the monitoring program and makes further recommendations in 2007.

## **11.4 Fraud**

- 11.4.1 An area of focus for the AQRB review was the policies and procedures that KPMG has put in place to respond to the requirements of AUS 210 “The Auditor’s Responsibility to Consider Fraud in an Audit of a Financial Report”. This auditing standard was replaced for reporting periods commencing on or after 1 July 2006 by the legally enforceable standard ASA 240.
- 11.4.2 KPMG’s planning documentation includes a mandatory audit program for the review of the risk of fraud. In AQRB’s view this comprehensive program appropriately deals with the requirements of ASA 240.
- 11.4.3 AQRB has made recommendations to KPMG regarding its audit programmes for the review of the risk of fraud.

## **11.5 Documentation**

- 11.5.1 AQRB acknowledges that KPMG has invested heavily in staff and partner education regarding documentation and that the firm’s manuals have been updated to reflect the enhanced documentation requirements.
- 11.5.2 AQRB noted some areas where it may be considered that the quality of working papers could be enhanced and has accordingly made suggestions to KPMG in this regard.

## **12. Reporting on Quality Management Issues to KPMG’s Leadership**

- 12.0.1 KPMG’s leadership has assured AQRB that audit quality is central to the values the firm has established, and that matters that should be drawn to their attention come to them through a variety of means, principal amongst which are:
- the Audit Risk Action Plan presented to the Service Delivery Risk Committee;
  - monthly reports prepared by the NMP R&R to the National Executive Committee (NEC); and
  - quarterly reports provided by the partner in charge of DPP to the NMP-Audit and from that officer to the NEC, the CEO and the Board.

- 12.0.2 In addition to the preparation of local and national reports to the firm's leadership, global requirements include regular reports be prepared for and discussed at the firm's Global Risk Committee. It would appear to AQRB that KPMG has in place adequate monitoring and reporting arrangements to ensure that matters that merit the attention of the firm's leadership come to their attention in a timely manner.

### **13. Overall Conclusion**

- 13.0.1 KPMG has established policies and procedures in Australia that are designed to enable it to complete effective audits within the framework of current Australian legal and professional requirements.
- 13.0.2 As a result of its 2007 review, AQRB has found no reason to believe that the QCR does not reflect, in all material respects, practice within the firm.

Ian Gilmour \*

Nicholas Hullah \*

December 2007

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\* (Biographic information on the reviewers may be viewed on the AQRB website at [www.aqrb.org.au](http://www.aqrb.org.au) )