KPMG

Key Audit Matters

Auditor's report snapshot 20 September 2017

Our fourth auditor's report snapshot[1], provides insights and observations on Key Audit Matters from 128 entities in the ASX 200[2] with 30 June 2017 year ends. Key Audit Matters (KAMs) are those matters that required significant auditor attention in performing the audit, and are communicated in auditor's reports of listed entities[3].

Reports by industry

Consumer & Retail	Other Corporates	Real Estate	Financial	ENR	IGH
18	30	17	25	21	17
	Technology, Media & Telecommunications (TMT) and Industrials		Other Financial Services	Energy and Natural Resources	Infrastructure, Government and Health

KAMs by industry sector

	Consumer & Retail	Other Corporates	Real Estate	Financial	ENR	IGH	Total ASX 200 June 17	Total ASX 200 Dec 16 & June 17
Goodwill (and related CGU assets)	11	28	5	11	7	18	**80**	101
Revenue	6	13	6	4	4	4	**37**	46
Taxation	1	5	2	2	10	6	**26**	35
Acquisitions	10	9	2		1	3	**25**	34
Inventory	8	5	5		5	1	**24**	30
Provisions	2	4		5	10	1	**22**	26
Property investment			17	1		2	**20**	24
Receivables & allowances	6	3	1	3	4	2	**19**	21
Investments in related entities		6	2	1	3	2	**14**	19
Investments		1		13			**14**	16
Insurance related				11		1	**12**	16
PPE & finite life intangibles	4	4		1	1	2	**12**	**12**
Exploration & Evaluation		1			10		**11**	**14**
Financial instruments			3	2	3	1	**9**	**14**
Other	2	2	1	3		1	**9**	**11**
Disposals & assets held for sale	3	3			1	1	**8**	**10**
Interest bearing liabilities		3	1		1	1	**6**	**8**
IT systems	2	2		2			**6**	**7**
Trade & other payables		3			2	1	**6**	**7**
Expenses		1		3			**4**	**6**
Going concern related								**1**
TOTAL	**55**	**93**	**45**	**62**	**62**	**47**	**364**	**458**

With 128 audit reports released[2] the top 5 Key Audit Matter (KAM)[3] topics are:

KAM topic

Goodwill

(and related CGU assets such as intangibles and PPE)

Industry sector

Observations

- The most common KAM relates to carrying value assessments or impairment of goodwill and related CGU assets such as intangibles and PPE ("Goodwill KAM").
- About half of the entities with a Goodwill KAM present it as the first KAM, giving it prominence and significance.
- The most common reason communicated as driving auditor attention was the entity's responsibility in the accounting standards to test goodwill annually for impairment. There is significant judgment associated with forward-looking estimations in these valuation models, and when combined with the quantum of the balances, garnered attention. These assessments can be particularly challenging in sectors experiencing constrained or volatile economic conditions.
- The majority of Goodwill KAMs communicate involving Valuations or Corporate Finance specialists to assist addressing the KAM.

Industry specific insights

- Infrastructure, Government & Healthcare (IGH) and Corporate sector entities are more than twice as likely as Financial Services (FS) and Energy and Natural Resources (ENR) entities to include this KAM, with an approximate 80% inclusion rate.
- 25% of all Goodwill KAMs identified an impairment charge was booked.

The sub-sectors with the highest rates were:

  - Infrastructure 50%: attributed primarily to loss of specific contracts, particularly in the volatile Western Australian markets facing high operating costs and low forecast iron ore prices.
  - Technology Media and Telecommunications (TMT) 39%: attributed as arising from declines in revenue for entity's traditional business resulting from the changing nature of the industry, technologies and customer preferences.
- Healthcare: Pharmaceutical pricing pressures in the US was the most common cited economic reason for additional focus of the auditor. Where intangibles relating to product developments in-process were communicated, specific mention is made of the implications to forecasts of milestone achievement, regulatory approval and updates of market viability thereof.
- See Consumer & Retail deep-dive analysis for further insights.

KAM topic

Revenue

Industry sector

Observations

Revenue is a key driver of an entity's performance and shareholder value. It is reasonable to expect auditors will choose to focus procedures on gathering evidence regarding its accuracy. When might this result in proportionately more audit effort once weighed up against other areas of the audit?

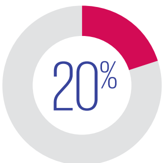
- Answer: the significance of revenue, high volume of transactions, complexity of underlying IT systems, varieties of revenue streams, or diverse ranges of products and services offered are common reasons. Simply, the more going on, the more audit attention.
- How the auditor addresses this: the auditor is likely to split the different pieces into separate populations and apply a range of testing techniques to the unique attributes.

Industry specific insights

- Over a third of entities in the Consumer & Retail, TMT and Real Estate sub-sectors communicated a KAM on Revenue.
- Revenue KAMs in TMT were high due to the industry prevalence of multiple-element arrangements such as bundled offers and/or competitive market forces with constantly changing pricing.
- See Consumer & Retail and Real Estate deep-dive analysis for further unique insights.

KAM topic

Taxation



Industry sector

Observations

Taxation KAMs feature in approximately a third of entities in the TMT, ENR, and IGH sectors.

Featuring in 60% of Taxation KAMs in these sectors and most heavily in ENR is specific auditor focus assessing recoverability of deferred tax assets. This is judgemental based on likelihood of future taxable profits. The risk of inaccurate forecasting is greater given the recent industry experience of fluctuating commodity prices, increasing the range of possible outcomes.

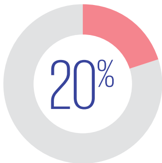
Have the calls for tax transparency locally and internationally given rise to additional attention by entities and their auditors?

Maybe. One KAM specifically called-out tax transparency. We previously predicted a greater number of Taxation KAMs given the complexity in the Australian taxation system and calls for transparency. Quoted often in the IGH sector are entity-specific taxation complexities, such as multiple tax jurisdictions including transfer pricing.

Given these complexities, it is not surprising 60% of the Taxation KAMs in these sectors communicated the involvement of Tax specialists.

KAM topic

Acquisitions



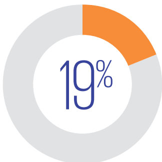
Industry sector

Observations

- Over 75% of all Acquisition KAMs in the ASX 200 arise in the Corporates sector. More exceptional is one single sub-sector, Consumer & Retail, communicate 40% all acquisition KAMs.
- Auditors focus on acquisitions was due to their size and significant judgments associated with separately identifying intangibles and fair valuing assets acquired. These assessments involve estimates of future performance expectations and attract greater auditor effort as the entities often do not have the benefit of historical experience operating the acquired business.
- Almost half of the Acquisition KAMs cited complexities with measuring consideration and contingent consideration from current and past acquisitions as a factor in why it is a KAM.

KAM topic

Inventory



Industry sector

Observations

- Nearly half of Consumer & Retail entities, a third of Real Estate and a quarter of ENR communicate a KAM on inventory.
- In ENR, judgements regarding future commodity prices, costs of completion, and estimation techniques to assess the quantity and quality of stockpiles, drive auditor attention to evaluating inventory net realisable values. Unique to ENR inventory KAMs is the auditor challenging the correct treatment of mining costs against the features in the accounting standards. The outcome could swing between development cost expenses or capitalising them to the inventory value.
- See Consumer & Retail and Real Estate deep-dive analysis for further insights of the impact of changing customer preferences and large longer development projects.

Consumer & Retail industry sub-sector deep-dive

Consumer & Retail is the single largest sub-sector in our analysis, comprising 14% of audit reports reviewed. It is also the sub-sector with the greatest concentration of the top 5 KAMs. The ASX 200 top 5 KAMs make up 65% of all KAMs in Consumer & Retail.

1

Almost 30% of Consumer & Retail **Goodwill KAMs** referred to an impairment charge booked during the year, due to underperformance of certain businesses and markets.

3

44% of Consumer & Retail entities communicate an **Inventory KAM**. The common macro-trend of uncertainty of changes in consumer preferences and spending patterns appears to impact audit focus on inventory in a variety of ways, including challenging:

- Identification of slow moving, excessive stock or over-valued stock, and then ascribing a value based on forecast demand at an acceptable price point. This was particularly evident in KAMs for entities with diverse product ranges and markets, merchandise which is seasonal in nature, or products with a limited shelf life.
- Estimations of the shift in demand to alternate or new products, perhaps launched by the entity itself, cannibalising existing products and values, impacting estimations of stock holding values.
- Forecast accuracy of expected selling prices, particularly for businesses with significant time lapse between manufacture and ultimate date of sale of product to the consumer. For example KPMG stated in the KAM for wine company Treasury Wine Estates Limited, *"..these include inherently subjective judgements about forecast future demand and estimated market sales prices at the time the [product] is expected to be sold."*

Inventory values are at greater risk as more products or markets or entire sectors are impacted by disruption domestically and internationally. Replacement products or the promise thereof will reshape consumer spending, increasing wastage of outdated but perfectly functional inventory. Will secondary channels exist to offload this inventory and what value will they erode from those recorded in financial statements?

2

One third of entities in Consumer & Retail communicate a **Revenue KAM**. Specific features reported as driving reasons for the KAM include audit effort to address:

Multiple arrangements, such as agency arrangements, franchise agreements, supplier and distributor arrangements

Bespoke customer contracts, renegotiations and rebates, including volume incentives

Multiple IT systems, their various interfaces and risks associated with manual involvement

These features are consistent with KPMG's observations[4] of a dynamic Consumer & Retail marketplace. This environment is demanding entities transform their traditional business models, to increase their agility in meeting evolving customer needs and market disruptions. This may be achieved through the increased emphasis on ecommerce, integration with platform models, and developing more personalised goods and services for the consumer.

4

Exceptionally, in one single sub-sector, Consumer & Retail, reside in **40%** of all **Acquisition KAMs** of the ASX 200. This is consistent with KPMG's observations[5] regarding opportunity for portfolio acquisition strategies being greater for organisations in an economic environment driven by digital disruption and the explosion of data. There is increasing consolidation and globalisation activity impacting Consumer & Retail entities, combined with rapid innovation. Approximately **90%** of the entities communicating an acquisition KAM in Consumer & Retail also communicated a KAM on goodwill assessment. Does this suggest the competitive acquisition market combined with the uncertainty of consumer preferences and spending patterns risk the value of goodwill recorded from (previous) acquisitions. Only time will tell. For now it is attracting the attention of the auditor.

Real Estate industry sub-sector deep-dive

Real Estate is the second largest sub-sector in our analysis, comprising 13% of audit reports reviewed.

1

One third of entities in Real Estate communicate a **Revenue KAM**.

- Real Estate contractor revenue KAMs result from the audit effort applied to assessing forecast revenue and total costs to complete estimates inherent in the contractor's stage-of-completion revenue recognition policies. There appears to be a multiplication effect for entities offering bespoke contract terms and accepting differing project risk profiles. This is consistent to our observations of trends where major infrastructure projects use bespoke construction contracts. Estimating costs to complete for that construction program can be difficult. Judgement is commonly challenged relating to revenue recognition of variations and claims that may not have been formally approved by the customer.
- Real Estate developer revenue KAMs focus on the audit effort assessing contractual terms of sale and settlement risk. For example, KPMG stated in the KAM for property and infrastructure LendLease Group, *"For residential apartments we note that in the current year market commentary suggests potential heightened settlement risk of residential apartments compared to prior year."*
- Real Estate Investment Trusts revenue KAMs commonly arise from the significance of performance fee revenue and judgements to assess whether the criteria has been met to recognise the revenue.

2

In **5 of the 17** Real Estate entities, auditors communicate a KAM on **Inventory**, assessing their net realisable values. Auditors cite reasons for their significant attention including judgements associated with estimating future market and economic conditions, which for larger developments can be relatively long dated. This is consistent to our observations of marketplace trends towards large scale, mixed use property developments which often span 3 to 5 year timeframes.

3

It appears to be a given for Real Estate entities to communicate a KAM on **Property Investment** assets. **100%** of entities in this sub-sector communicate this KAM. Observations:

- Property Investment comprises investments in property either directly or indirectly by the entity.
- Common reasons cited as driving the greater auditor attention include: sheer quantum of the assets, the judgement associated with selecting the most appropriate valuation methodology, the sensitivity of key valuation assumptions, such as capitalisation rate, discount rate, future rental income, occupancy levels, and the presence of unique property attributes. Market commentary indicates significant wealth has been accumulated by real estate investors over the last 5 years.
- Most common valuation method is the capitalisation of income method. The discounted cashflow method is also used by auditors as an alternate to challenge the reasonableness of the capitalisation method and asset value ascribed by the entity.
- External valuers are commonly engaged by entities to value Property, most commonly once every 2 years, and ranging between 1 to 3 years. Most entities use both Director and external valuations to determine fair values in financial statements. Auditors communicate involving Real Estate valuations specialists in approximately **45%** of reports with Property Investment KAMs.

Other key statistics

5.7

Average # pages

Observations

– **Audit report length** has increased almost half a page from our previous snapshot despite more firms taking advantage of the option[6] of removing standardised text from the auditor's responsibilities section and cross referring to the full descriptions contained on the website of the Australian Auditing and Assurance Standards Board.

– We attribute the overall increase in pages to more in-depth and insightful KAMs. Auditors are tailoring narratives of the performance of their audit in the areas attracting most significant auditor attention to the unique client circumstances.

2.8

Average # KAMs

– No industry sector has a significantly different **average number of KAMs**.

1/6

Lowest/ Highest # KAM

– The variability in **lowest and highest number of KAMs** is a positive indicator auditors are tailoring the selection of KAMs to the conduct of their audit of that client, without influence of absolute size or profile of the entity.

2

MURGC

– Two audit reports included a **Material Uncertainty Related to Going Concern** (MURGC). Each of these reports also communicated KAMs on other topics.

1

EOM

– One audit report included an **Emphasis of Matter** (EOM). There were no Other Matters reported.

– Over 60% of auditors reported receiving all **Other Information**[7] prior to signing the audit report and no audit reports in our analysis reported any material inconsistencies.

The future

The implementation of KAMs is the biggest change to auditing standards and the audit report since the introduction of the clarity standards in 2004. The platform for change was to provide insights to shareholders on the conduct of the audit, previously only viewed by those in the boardroom.

Have we achieved this? Does history predict the future?

Evidence from early adopters of KAMs, some in their second or third year of enhanced audit reports, shows variability. 16 entities reported KAMs for their second year and half communicated a different number or types of KAMs in their second year. Five of these dropped at least one KAM.

Three entities reported KAMs for their third year – two of these have changed the number and types of KAMs to reflect the impact of the entity's evolving operations on the audit. One communicated the same KAMs across the 3 years.

Emerging trends?

We are starting to see audit reports with KAMs linking either the entity's strategic goals or wider macro-economic factors impacting the entity.

For example, KAMs on the implementation of new Information Technology systems, financial reporting reliance on automated processing and controls, and the impact of decentralised operations. These KAMs can provide a broader picture of challenges faced by these entities and the resulting impact to the conduct of the audit. This illustrates the dynamic nature of an audit, and the unbreakable nexus between what is going on at the client goes on in the audit.

Imminently we expect the wide-scale adoption of the new accounting standards, such as AASB 16 *Leases*, AASB 15 *Revenue from contracts with customers*, and AASB 9 *Financial Instruments* to feature in future KAMs given the additional audit effort applied for these significant developments in financial reporting measurement and presentation.

What does all this mean? Will KAMs become boilerplate or continue to be shaped by changes at the entity and their underlying business? Only time will tell which way the verdict will land. KPMG auditors are committed to transparency about our audit, providing shareholders a view behind the boardroom doors.

1. Series 1 *Auditor's Report Snapshot* issued on 31 August 2016 highlighted our observations from 16 enhanced audit reports published for 30 June 2016 audits, adopting early the requirements of ASA 701Communicating Key Audit Matters in the Independent Auditor's Report. Series 2 *Auditor's Report Snapshot* issued on 30 September 2016 updated Series 1 for further early adopters and trends exhibited thereon. Download PDF here. Series 3 *Auditor's Report Snapshot* issued on 28 March 2017 reported our observations from 56 audit reports published from 31 December 2016 audits for the ASX 500. Download PDF here.
2. Based on auditor's reports KPMG viewed between 1 July and 19 September 2017 of ASX 200 with 30 June 2017 year ends applying exclusively the Australian auditing standards.
3. Key Audit Matters (KAMs) are those matters that required significant auditor attention in performing the audit, ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report,* as issued by the Australian Auditing and Assurance Standards Board. ASA 701 is operative for the audits of general purpose financial reports of listed entities with years ended on or after 15 December 2016. Enhanced audit reports are those including Key Audit Matters. The description of the KAM addresses why the matter was considered to be a key audit matter and how the matter was addressed in the audit.
4. Trends reported in *Charting a new frontier,* published by KPMG 1 September 2017
5. Trends reported in *The changing landscape of disruptive technologies Part 2* published by KPMG 1 September 2017
6. The ASAs allow these descriptions to be included in the body of the auditor's report, within an appendix to the auditor's report, or by a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority.
7. In accordance with ASA 720 *The Auditor's Responsibilities Relating to Other Information*, auditors are now required to report on "Other Information". Other Information is defined by ASA 720.12(c) as financial or non-financial information (other than the financial statements and auditor's report thereon) included in an entity's annual report.

Contact us

Carolyn Ralph
Partner
Department of Professional Practice
Audit & Assurance
T: +61 2 9455 9030
E: cralph@kpmg.com.au

Karen Tanner
Senior Manager
Department of Professional Practice
Audit & Assurance
T: +61 2 9335 7290
E: karentanner@kpmg.com.au

KPMG.com.au