

Read candid and sometimes surprising views of KPMG's audit leaders on the value of an audit – its strengths, weaknesses and the changes they believe must take place to **meet the needs of the capital markets.**

Value of Audit

Shaping the future of corporate reporting



cutting through complexity

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Foreword

“For all large public companies, the audit report is now not just a binary pass/fail report, but one that includes a specific commentary by the auditor highlighting areas of heightened risk of material misstatement, and how the audit effort addressed those risks. This is but one step in an evolution which demonstrates that the profession is more than capable of delivering a narrative based audit report that demonstrates the value in audit.”

Conall O'Halloran, Head of Audit, KPMG in Ireland

Audit has proved its worth over the years, to investors and companies alike. But as the events of the last decade have shown, in Ireland as well as globally it's time for change – for a revolution in audit thinking and execution. Business has changed, shareholder needs have evolved, and audit needs to keep up. That's why we created this project.

When we started thinking about the future of audit, we wanted to find out where we are now: whether lead partners from KPMG member firms in different regions thought there was value in audit today, and if so, what this value is. But more importantly, we wanted their ideas on audit's current weaknesses and on how we, as a profession, can address these to make the audit more relevant to twenty-first century business.

The comments made in the following pages by partners from across KPMG's network of member firms are their own and made in the context of their role as experienced auditors. Though the partners' responses were clearly defined by their personal ideas and experience, a number of common messages emerged.

All felt that audit still has relevance and value. This value mainly derives from confirmation over historic financial information, as shown by the resulting reduction in the cost of capital. They also affirmed that audit quality has been improving since the Enron collapse. The financial crisis has put renewed focus to push these improvements along, but it is basically furthering an agenda that was already well underway.

The value of an audit, however, highlights its major limitation: it only deals with historical financial data. Although an audit reduces the cost of capital, it has less – some would say declining – relevance to capital markets. Investors are more concerned with what drives share price and organizational value than with annual reports.

For audit to stay relevant, we need to start looking at what creates value in a business. More integrated thinking so that companies consider how they report more holistically will help. But we need to get involved in understanding entities' real business value drivers so that we can give assurance over these drivers, as this is where we personally believe market demand is going to take us.

This leads to the final point: innovation. Until recently there has been little impetus for the audit profession to develop. But all those interviewed for this project are adamant that innovation around inputs and outputs is absolutely critical in order for the audit to stay relevant. Regardless of legal and liability implications, the profession needs to get moving on creating a new reporting and assurance model that works for tomorrow's business world.

The profession as a whole is furthering this public policy debate, and KPMG intends to be a leading voice in this discussion. We are serious about change and about having an open dialogue to see how that change can happen in the best possible way. We invite you to join in the conversation by visiting us at kpmg.ie and helping us shaping the future of corporate reporting.



Conall O'Halloran
Head of Audit,
KPMG in Ireland



Larry Bradley
Global Head of Audit,
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THE AUDIT MODEL AND THE PROFESSION

INTRODUCTION by Rupert Bruce

... financial statements no longer give insight into companies' changing fortunes. So auditors must evolve themselves in order to remain relevant as a profession.

Historically, the audit profession's conservatism has been a strength. Auditing company accounts has required a cautious approach. Yet now the rapid change in the nature of how companies create value and how investors judge them demands change and innovation from auditors. In many cases, financial statements no longer give sufficient insight into companies' changing fortunes. So auditors must evolve themselves in order to remain relevant as a profession.

All five KPMG partners interviewed for this chapter about the audit model and the profession express this view to some degree. They concur that at a time when quarterly investor conference calls may shed more light on the way companies are growing than the financial statements, the audit profession must widen the scope of the information that it offers assurance over in order to give the investor community – and other stakeholders – what they need.

How the profession might do this is a topic for debate. Some of our interviewees are in favor of giving assurance over non-financial measures such as drug pipelines, like-for-like store growth or website traffic. Others would like to communicate more information about some of the insights gained during an audit, such as the quality of controls or risk management.

In general our interviewees believe that the exponential increase in the complexity of accounting standards has resulted in the profession spending a disproportionate amount of time focusing on compliance. Training is perhaps the area where this is most apparent. In order to make sure companies are audited to a single set of rules and consistently high standards across the world, auditor training concentrates on compliance. Yet this approach can eliminate originality. Indeed, it may deter questioning people – who arguably make the best auditors – from entering the profession, in the view of one interviewee.

So what can be done? The sentiment from our interviewees is it's time to act dramatically differently. The auditing profession must go out on a limb. It must suggest changes to the audit report and any supplementary information it could provide assurance over. There will be resistance to this from some constituents. But the profession must be brave if it's to stay relevant.

Rupert Bruce is an experienced financial copywriter. From the late 1980s to late 1990s, Rupert was a business journalist with some of Europe's leading newspapers and periodicals, including *The Independent*, *International Herald Tribune* and *Institutional Investor* magazine.

INTERVIEW

In conversation with:

Larry Bradley

Global Head of Audit,
KPMG International

Larry Leva

Global Vice Chairman,
Quality and Risk Management,
KPMG International

Mark Vaessen

Global Head of IFRS,
KPMG International

Jean-Paul Vellutini

Head of Audit,
KPMG in France

Conall O'Halloran

Head of Audit,
KPMG in Ireland

Q. Has the quality of the audit improved since the 2007 financial crisis? If so, have stronger regulatory oversight and standards driven the improvement, or has the profession done so?

Larry Bradley (LB): In my opinion, there's absolutely no doubt that audit quality continues to improve significantly. But the answer to your question is far more complex. We've recognized as a profession, and certainly at KPMG, that we have to step back and evaluate not just financial institutions but other companies from a more holistic risk perspective. The entire world learned what can happen if there's a crisis of confidence and liquidity. But there's much more work to be done. One of the knee-jerk reactions to the crisis was to increase our level of rigor over compliance and I'm not convinced that we're focusing our efforts in all the right areas. We're not getting the "biggest bang for our buck." In addition to compliance issues, there are significant business issues that give rise to audit risk.

Larry Leva (LL): I didn't see a big problem with the quality of audit in 2007. It was a market crisis, a bubble that burst. The significant improvement in audit quality started in the days of Enron and WorldCom. That was an accounting crisis that triggered the creation of the Public Company Accounting Oversight Board, which has been followed up by national accounting regulation in most large and medium-sized countries. That has been accompanied by a refocusing by the profession, which needed to regain credibility. All of this led to a tremendous improvement in the quality of audit, which has continued through the global financial crisis.

Mark Vaessen (MV): I agree that the quality of audit has improved since 2007. As a profession we've reflected and learned from the crisis. Commitment to quality excellence is an imperative because without this there will be no trust and no profession. Although audit quality didn't contribute to the crisis, it has become clear that the outside world expects the audit profession to give early warnings of what's happening in the system. One of the criticisms we hear is that the profession was the watchdog that did not bark. The world expects more from us in terms of communication, both about our findings in individual audits and early warnings of what's happening in the system as a whole. So, in my view, better and more communication about what matters to our stakeholders is the way in which we can improve our relevance and restore trust, and that's what we are committed to do.

Jean-Paul Vellutini (JPV): One thing I say is that an audit cannot be more relevant than the information that is subject to the audit. In my view, the quality of the audit is one thing and the relevance of the information we audit is another. I think that audit quality has improved, to some extent because of stronger oversight and also because the profession has decided that quality is essential for driving our efficiency. What has not been addressed so far is the relevance of the financial information we audit. We were expecting a lot from the European Commission's green paper, but it only challenged the independence of the auditors. In my view, the main question should have been what information independent auditors should look at.

Q. Do auditors have the capability to give anything more than a binary pass or fail audit opinion? Is the profession sufficiently sophisticated to deliver a more narrative-based opinion?

LB: Yes, because as the auditors of a company, we have broader access to a company than almost any other entity or profession. I've been an audit partner my entire career and I've been the lead signing partner on major global multinational companies, and in that role you look across so many different things – IT, HR, legal, compliance, finance, control, etc. So, to me there's no question that we're in a unique position to deliver more than a binary report. I think what we're finding is delivering a binary report is not providing investors with all of the insight that they need in order to make their investment decisions.

Investors are making their decisions based on adjusted non-GAAP earnings and non-financial metrics. They're making decisions based on a company's pipeline, same store sales growth, oil and gas reserves, etc., all of which might be derived from the historical financial statements but they're not in accordance with GAAP or necessarily derived from financial statements or systems. It's those non-GAAP measures, both financial and non-financial, that are driving the market capitalization of the world's biggest companies. But those metrics typically have no form of independent attestation. I think in the future the market and investors are going to need, or potentially demand, some form of independent assurance.

LL: We support providing more information relating to the audit. The International Auditing and Assurance Standards Board has just issued a formal proposal that would recommend moving away from a binary report and require the auditor to discuss the most important elements of the audit. Auditors certainly have the skills to provide more information. In the more difficult judgmental areas where ultimately you come down to a number, for example when there's an exchange of one asset for another, informing readers of the financial statements about the key assumptions used gives a better idea of the key judgements in the accounts. Investors would like a seat at the audit committee table but that's unrealistic. But it's very hard in a one-way communication to replicate the discussion that goes on in the audit committee meeting.

CO'H: The training that auditors receive, coupled with their experience in their role as statutory auditors, gives us a unique position to provide independent assurance across a broad range of areas including, but not limited to, statutory audit. The market for these services is growing as Audit Committees and management recognise that statutory audit has its limitations, yet they do require independent assurance on identified areas of risk in their business processes. But in Ireland and the UK, audit reporting has itself evolved significantly in recent years. For all large public companies, the audit report is now not just a binary pass/fail report, but one that includes a specific commentary by the auditor highlighting areas of heightened risk of material misstatement, and how the audit effort addressed those risks. This is but one step in an evolution which demonstrates that the profession is more than capable of delivering narrative based audit reporting that demonstrates the value in audit.

MV: I think we already do more than give a pass/fail. If you look at the views and insights we provide to audit committees about internal controls, risks and IT systems, we're doing more. We also indicate where we think they're on the aggressive side or conservative side in their accounting. But we don't say any of that to the readers of our reports, who are principally the shareholders. So I don't think we lack the sophistication to do more and we can comment on our findings and views during the audit. I think the challenge for us will be to make sure we say things that add value, rather than falling back to boiler-plate language.

Q. Does the common compliance-based training that auditors around the world receive encourage them to take a ‘tick-the-box’ approach, rather than the more inquisitorial approach that is required?

CO’H: It is disappointing, but perhaps not surprising, that auditors have allowed the perception of audit as a box-ticking exercise develop, as we have made very little effort to really communicate the added value in what we do. Yes, of course there is an explicit requirement to comply at a minimum with the extensive and proscriptive requirement of International Standards of Auditing (ISAs), but perhaps the most valuable attribute of a good auditor is the mindset of relentless scepticism. It is this more intangible attribute that requires an auditor to go beyond mere compliance with ISAs that we need to continue to emphasise and embed in the training of the next generation of auditors.

LL: We’ve been focusing on the importance of exercising professional judgment and skepticism, so that you don’t simply take information from the client as good. One needs to be a respectfully questioning business person and when the economics of a transaction don’t make sense you need to continue to dig until you understand what’s happened. At that point you understand whether the information is reasonable or not. Ultimately our work benefits the users of the financial statements – the investors. You need the respect and cooperation of the management, but you must respectfully challenge what they give you.

MV: I think we should not short change our people, because auditors have to have all-round skills. Nonetheless, there’s a perception that we have too much of a compliance mindset. For example, International Financial Reporting Standards have become more complex over time and people say we focus purely on the complexities of the standards. Similarly, we have introduced electronic tools to aid the audit – and there’s a risk that they become an end in themselves. But I would say that our people are more all round than they’re given credit for.

JPV: It’s not a question of formal training alone. It’s also on-the-job, informal training you get, spending time with people at your clients. We should not limit the training to what is provided formally. I think training has to evolve. In France we’ve done it. We’ve put more emphasis on internal control aspects and IT aspects. We believe our people need to have a much better understanding of IT and internal controls. I believe these two examples should be made a greater part of a normal auditor’s training.

“ The key question is how do we remain relevant when a greater and greater part of a company’s value is either an intangible asset that’s on the balance sheet or some kind of intangible value that’s not even recorded? ”

Larry Leva

Q. What meaningful improvements or innovations in the audit has the profession made recently? What is the **most** meaningful improvement or innovation?

LB: I can't tell you that we've been hugely innovative, but we have a mandate to be innovative now which is coming in part from the global financial crisis. Let's look at one example – how we can use predictive data analytics. Is there a way that auditors can use external information to try and derive a predictive amount that they would expect to see in a company's financial statements with respect to, say, revenue? Predictive analytics can test what the company's telling you. If what it tells you is materially different from what the data has predicted, then you need to understand why.

LL: I think technology has greatly improved the efficiency of the audit. The focus on professional skepticism we have just talked about has been the most important improvement. Looking into the medium term, we are very excited about how we can use data analytics to help identify problems that more traditional techniques might not.

MV: I think we have been lacking in innovation and that's why we're reviewing what the audit of the future should look like. How should we make more use of data analytics? How can we assess risk to identify the next crisis? And how should we expand our role beyond the financial statement, if that's where market demand will take us? I would hope we will see innovation now because otherwise the profession will be left behind.

JPV: If the question is in relation to the profession, I don't see anything in terms of major improvements or innovations. Based on our skills, we can provide much more than a binary report. KPMG has some innovative vision. For example, our data and analytics initiative is critical. In my opinion we need to expand the scope of the audit.

Q. What is the single largest weakness remaining in the audit (or the profession) and what could be done to rectify it?

LB: As auditors, our primary product is based on a historical set of statutory financial statements. However, stakeholders are clearly increasingly basing their decisions on information that resides outside of those statutory accounts. That is the single biggest issue, I think, that we have as a profession. We have the opportunity to provide more significant insight to investors and other stakeholders.

LL: The single largest weakness is that the scope of the audit has not changed for 100 years and is limited to historical financial statements.

MV: The biggest weakness of the profession in my view is that we're not communicating as well as we should do. We don't show the outside world how much we add value. We have insights and knowledge, but we are not brave enough to share them with the outside world.

Q. Is there merit in extending the audit beyond the financial statements or even the annual report? If so, what would you suggest? Who wants this? Who will pay for it?

LB: I believe that we recognize we have a broader role to play in society and have to find a way to deliver on that. We can do so by giving broader assurance on information that matters to stakeholders. I apologise if I sound a little 'Pollyannish' but people have high expectations of us, so we have to broaden our service offering and delivery. We have to provide assurance on areas beyond the financial statements if we're going to meet society's expectations.

LL: The realm of opportunity is very great in terms of what more auditors could do. The key question is how do we remain relevant when a greater and greater part of a company's value is either an intangible asset that's on the balance sheet or some kind of intangible value that's not even recorded? You take a drug pipeline in the case of a pharmaceutical company. If the auditors are going to remain relevant we have to provide assurance on some of these areas. We're starting to identify these areas and talk to the regulators and folks in the public arena to see if there's an interest. We do think there's an interest. Ultimately the company will have to pay for this. But investors have to make clear they want this.

MV: I think there's a growing consensus that the current financial reporting model has led to a narrow focus on compliance and not enough on broad communication. So part of the answer is to look at the reporting model. For example, looking at integrated reporting and how companies make money for the longer term in a sustainable way, what their key performance indicators are. That is my vision. If we do that I would say that it's natural for the auditor to provide assurance on some of the information outside the financial statements, like risk management or the key performance indicators. I believe demand for assurance should develop because people believe that it really adds value. If we don't change it's a question of whether we will be relevant in ten years time.

CO'H: For audit to remain relevant, I think it is essential that we do extend the areas that we are asked to give comfort on. When you think about what types of public announcements from companies result in movements in its share price, they are as likely, if not even more likely, to be based on unaudited information such as trading updates than on the audited financial information in the two hundred page annual report. Yet the investor community tells us that it places more reliance on audited information. So there must be an opportunity for auditors to be asked to provide some form of assurance or comfort on critical financial information outside of the annual report. There is already precedent for this in certain capital market transactions.

JPV: Companies may be hardly willing to pay for more assurance if it is only compliance or regulatory driven. But I think investors will eventually demand they do so. The more sophisticated investors' decision-making process is, the more they need to rely on information that's not covered by the financial statements. If companies can only access capital or clarify their value to investors by providing this assurance, then they will do so. In addition, if we can demonstrate that bringing additional comfort on areas such as risk, internal control, contracts, etc. contributes to the company's performance, they will seek out such assurance.

AUDIT QUALITY AND VALUE

INTRODUCTION by Caroline Biebuyck

How does audit add value to the capital markets? While this has always been an issue for companies and their auditors, the financial crisis has brought the question into the full glare of the global public spotlight.

Beyond meeting legal and regulatory requirements, audit derives its value – perhaps even its legitimacy – from the quality of its processes, from the probing, independent and skeptical approach which auditors should take, and from the trustworthiness of its outcomes. The economic turmoil of the past half decade has led to serious questions over how those processes and outcomes could be improved.

In the following conversation, senior KPMG partners from countries with different experiences of the crisis give their frank and direct personal take on audit's performance. But this piece isn't just about looking backwards – the focus is really about seeing how audit can and should evolve to make it a higher value proposition for all involved. The partners have put forward some intriguing ideas for changes which they see as driving quality higher and their personal opinions on improvements, which can increase the relevance of the audit report and hence its value to the company, to its shareholders and to the wider communities in which the companies operate.

Can audit quality coexist with increased fee pressure? How can auditors engage better with users of financial statements? How can auditors ensure their unique insights can be best used to drive value within their clients? You may be surprised at some of the partners' answers to these questions and at their visions for the evolution of audit – I certainly was. And yet while different individual threads and focuses run through their answers, one unifying theme abides: delivering what markets want.

Caroline Biebuyck is a business writer and editor with extensive experience of communication in accounting, finance and related areas for her multinational client base. Earlier in her career she spent several years in audit and taxation. Currently located in the UK, her work has taken her to Hong Kong, India and Central Europe.

INTERVIEW

In conversation with:

Jim Liddy

Head of Audit, KPMG in the US

Rod Devlin

EMA Head of Quality & Risk Management, Global Audit Quality & Risk Management Partner, KPMG International

Ingmar Rega

Head of Audit, KPMG in Germany

Duncan McLennan

Head of Audit Australia and Asia Pacific Region, KPMG in Australia

Benny Liu

Head of Audit China and Hong Kong, KPMG in China

Hideki Amano

Head of Audit, KPMG in Japan

Q. It's being said that the quality of the audit process has not changed recently, despite the fallout from the financial crisis. What are your views on this?

Jim Liddy (JL): Over the last decade, I think our focus on audit quality – our emphasis on objectivity, independence and professional skepticism – has improved significantly. However, the financial crisis did teach us that a quality financial statement audit cannot be expected to address a flawed business model or less-than-robust risk management processes. For example, many companies had a “velocity business model,” with their business model and compensation schemes grounded in originating or acquiring assets, restructuring them for distribution, often in complex structures and derivatives, and getting them off the balance sheet as quickly as possible while retaining nominal amounts of residual risks.

While financial markets were receptive to these structuring and distribution activities, everything was fine. But the moment the market lost confidence, access to capital disappeared and it all came crashing down. Before the crisis, people generally assumed resilience of funding sources. Now people understand that this is not always the case and not all assets or structures are created equal.

Rod Devlin (RD): I think the quality of auditing has significantly improved over the last decade. Post-Enron we went through major regulatory upheaval and revision, and that contributed to an increase in the rigor of audits. There have been concerted efforts in revising standards, looking at the extent of work that auditors need to perform over risk assessment, the forward-looking information that underpins the preparation of financial statements and the judgments that underpin critical assertions in financial statements.

Ingmar Rega (IR): We are adopting a more stringent audit approach as we are moving towards a more standardized approach in which some things are being done automatically using data analytics, and others are being done by professionals or semi-professionals in remote destinations. Many tasks are being done differently because we have found that certain audit procedures reveal no audit findings while others reveal much more. This change and investment is improving audit quality significantly.

Duncan McLennan (DM): There is a renewed focus on areas of judgment, which is where we are likely to see the biggest problems. Since the financial crisis, more senior and experienced personnel time is being spent on the audit, with more probing questions and discussions with companies around key assumptions and about where the business is going. Our training is better focused on how professional skepticism is demonstrated in the questions auditors ask and in the thinking they apply to a problem.

Benny Liu (BL): We are far more focused on risk now, and on the need for greater skepticism, especially when dealing with relatively unknown entities. We stress that our people need to consider the behavior of their clients – their motivation and business drivers. We cannot just listen to what clients tell us. We need to be robust about obtaining independent evidence.

Hideki Amano (HA): The financial crisis had less impact on Japanese financial institutions than on their European or American counterparts. But audit scandals had a very big impact on the audit practices of all Japanese audit firms. Our regulators have developed a new auditing standard requiring serious skepticism and more audit procedures focusing more on the possibilities of detecting fraud or mistakes in the preparation of the financial statements.

Q. How can you quantify the commercial value of the audit – both to the company being audited and to the wider capital market?

RD: The bigger picture view of assigning a value to the audit is lowering the cost of capital. This cost is higher for entities that are not audited. There's also the public interest angle, although it's more difficult to place a precise value on that. If audits were not useful in reducing the cost of capital, and if there were no public interest value in doing them, they would have been abolished a long time ago.

DM: What would happen if there were not an audit? The audit plays an important part in giving people comfort and there is massive commercial value in that. If companies didn't have somebody independent saying this company's historical financial condition is what it says it is, then the level of trust around the business community would be much lower than it is.

HA: A clean audit opinion means the company should have at least fair or reasonable standards of corporate governance, management control and internal controls. If a company cannot be audited, or receive a clean opinion, this will have an effect on stakeholder's perception of that company. From that point of view, I would estimate that a company with a clean audit opinion should be valued significantly more than one without.

JL: A company's view is generally that if it's audited by a Big 4 firm it's going to get a quality audit, and there is value in that from investors' and other stakeholders' perspective. Having said that, we also add value by delivering insight and perspective across a wide array of financial, regulatory, operational and technology topics.

“ I'd like to get to the point where we have a continuous audit process and provide assurance on information on a contemporaneous or real-time basis. Say a company issues a press release or a financial data supplement containing information outside of normal financial statement information but entirely related to the financial performance of its products, business functions or geographical locations, should you attach an audit opinion to that? I think you can and should. ”

Jim Liddy

Q. How can audit quality be ensured in an environment where delivery costs are rising but prices falling?

IR: We tend to see a conflict between quality and cost. The reverse is true and this is something that can't be overemphasized. In many cases where we have standardized, modularized and offshored procedures we are obtaining a much higher quality. Using these processes, we are on track to manage our costs effectively in Germany. If you go further down the road, to data analytics and looking at patterns from big data, I can see a quantum leap in terms of cost and what we provide, through benchmarking and much deeper insights into how a company functions. That will not only save costs but provide more value and increase the relevance of the audit.

DM: A quality process is one that can focus on the right things and which can be repeated. If you go from country to country and partner to partner, there are differences in how audits are executed. There is real scope for doing audits better by getting increased consistency around the thinking and judgments in how you do the audit. This should get rid of inefficiencies, cut costs and improve quality.

RD: I believe that audit quality is fully compatible with efficiency. It's incumbent on the profession to drive efficiency throughout the process. Over the last decade developments in technology have reduced the costs of delivery at no detriment to quality. That is reflected in the fee structure. Some efficiency gains can be reinvested and distributed. But ultimately these gains find their way through into the marketplace and into firms' fees.

JL: Our statutory mandate as auditors is grounded in having confidence in the quality of what we do. Declining profit margins cannot come at the sake of the quality of the product. That puts the onus on us to better demonstrate the value of the audit and to argue for and obtain a fair fee for the quality work we do. On the operational side, we need to explore and capitalize on opportunities to improve audit quality and drive efficiencies in how we execute an audit.

BL: The outside world sees China growing and many companies coming out and so they assume professional service firms must be earning a lot of money. But we have a problem here: professional auditors and accountants don't get the same respect as in more developed countries. Chinese companies still need to understand the value audit firms can provide, and that quality service comes at a cost.

Q. What would auditors do differently if unconstrained by regulation and able to deliver solely what the capital markets want?

JL: Currently an audit opinion is given on past financial information. I'd like to get to the point where we have a continuous audit process and provide assurance on information on a contemporaneous or real-time basis. Say a company issues a press release or a financial data supplement containing information outside of normal financial statement information but entirely related to the financial performance of its products, business functions or geographical locations, should you attach an audit opinion to that? I think you can and should. Isn't that the type of real-time information that investors want? I also think there is an opportunity to expand the nature and use of the audit and assurance product. For example, in industries like health care or financial services, there are new and evolving financial, demographic or salient business disclosures that the external auditor can and should be associated with.

HA: During our audit we recognize several risk areas and we focus on these in our procedures. I think the stock market would appreciate it if we were to prepare a longer report in which we explain risk areas which came to our attention during the audit. This is not yet being discussed in Japan but I think that if different reporting around the audit which is being discussed elsewhere, such as in the US or in Europe, is brought in, then our regulators will consider implementing it.

IR: Currently we say yes or no in our audit opinion. We could express our opinion on many more things if the liability regime and regulation were different. It would be good for the capital market to have an additional statement on the robustness of the model and the risks and opportunities associated with the business model. Maybe, like a rating agency, we could give a grading on the company itself. These things would help audit become more relevant again and enable audit to be the institution that people trust, because of auditors' independence and professionalism.

BL: Auditors need to understand a company's management, controls and business strategy. But under existing standards we don't need to mention these in our audit report or in any of our deliverables to the company. I think some think some kind of assurance or more detailed report on these would be helpful to the market.

DM: In my experience, capital markets are more interested in cash flows than anything else. They are also more interested in the forward-looking than in the backward-looking figures, so assurance work over projections might be appropriate. Can we verify the information the company is putting into the market about its prospects? I'm not sure our current regulatory structures make it easy to do that without creating another set of legal issues for everybody. But we should beware: it's dangerous for anyone to assume that the auditors should be reporting on how well the company is being run. That's asking too much.

RD: People point to regulation and say because of the standards we can't do things differently. I think that's wrong. There's nothing in regulation which precludes innovation around the audit process and audit delivery. There's nothing in regulation which constrains you from providing insights and added value to shareholders through audit committees. The insight one gains from performing audits really does need to be shared with audit committees and through expanded reporting to audit committees – that's where companies get real value from the audit.

Q. Of all the parties that have an interest in an audit, which do you think feels most short-changed by the value it provides, and why? Are their concerns justified, and how can they be addressed?

DM: I think institutional investors understand that the world would be a very different place without an audit. They understand that if things go wrong it is not the auditor making decisions around business activities. Retail shareholders don't understand that. They don't read audit reports or understand what an audit is. The question with retail shareholders is: do they actually care? I don't think they do until something goes wrong. If they don't care, then it's hard to improve engagement with them.

RD: Shareholder relations could improve by strengthening audit committees and by ensuring a healthy dialogue between the audit committee and investor groups, and between the audit committee and the auditor. Audit committees often don't play the role they should: understanding what their investor groups want and then challenging the auditor and providing investors with that information. The profession is relatively unconstrained in providing expanded audit reporting to audit committees around risks and controls based on the work they have done in the audit. If the audit committees play their role properly then we should have happier shareholders.

IR: Because of confidentiality rules, we cannot provide wider stakeholders with information other than the audit opinion, so they may feel short-changed. The IAASB is currently discussing whether we could say more in our opinion. This is not easy. If we were to include more judgmental matters in the audit opinion, there would be a natural conflict with clients who might not want us to express certain things. Will we then be better off or will our statements be watered down to nothing? This will depend on how strong the profession is, and how tough the regulators are on us and on the companies as well. But we are in the sensitive position here and it's not a good place to be!

JL: The biggest issue we face is a lack of understanding of what we do as auditors and how to interpret our audit opinion. Far too many people look on the audit as an insurance policy – a “guarantee” against all things of a financial, risk, management or regulatory nature that may befall a company. We have an opportunity to better communicate what exactly we do in an audit and what our opinion really means. There may be an opportunity to describe more prominently matters that warranted a substantial amount of audit attention, including significant estimates and judgments made in the preparation of financial statements that are subject to interpretation and the work we performed in relation to them.

In the current model we do report on these items to the audit committee and management, but there may be an opportunity to better communicate those matters to external stakeholders. The regulators in the US are looking at this topic and I am interested to see how this debate will take shape.

BL: One of the reasons we are talking about this is because of the financial crisis when people started pointing the finger at auditors wondering why they did not give a warning that some of the banks were facing problems. This all stems from the fact that many people don't understand our responsibility and our role. This is what needs to change.

RELATIONSHIPS AND THIRD-PARTY PERCEPTIONS

INTRODUCTION by Andrew Mills

The main focus is on improving the understanding of clients and investors, but there was also agreement that the profession should do more to contribute to the transparency of public interest clients.

This section summarizes my conversations with five KPMG partners occupying leadership roles in member firm audit practices around the world.

Most of the questions I asked were implicitly or explicitly critical of the audit product and profession. I expected my interviewees to respond defensively. In fact they were candid – sometimes brutally so – about how the profession is perceived by external stakeholders. And while they staunchly defended the value of an audit, they argued that much of the damage has been self-inflicted. Several identified an existential threat to the profession if negative perceptions continue to go unchallenged.

Each of the partners had their own ideas of how firms should respond to this situation, but several themes emerged consistently.

It was no surprise that improving communication with a range of users was identified as the profession's most urgent challenge. The main focus is on improving the understanding of clients and investors, but there was also agreement that the profession should do more to contribute to the transparency of public interest clients.

I was more struck by interviewees' certainty that better communication alone is not a sufficient response to poor perceptions. They were clear about the long-term need for significant, visible changes to auditing processes and reporting. Nor did they shy away from admitting that this sort of evolution would require major changes to audit firms' capabilities, training and business models.

Less positively, every partner identified legalism as an obstacle to improving audit perceptions. Although they all felt that the profession needs to think beyond legal threats, there was also agreement that these are impossible to ignore. Sadly, there was no common view on how to square this circle. To sum up, my interviewees seemed to accept that – fairly or unfairly – the audit profession is widely perceived as having fallen behind the rapid economic, technological and cultural changes of recent years. And while better communication is vital to closing this perception gap, strategic changes will be essential if the audit profession is to safeguard its future existence.

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INTERVIEW

In conversation with:

Charles Krieck

Head of Audit, KPMG in Brazil

Marc Hogeboom

Head of Audit,
KPMG in the Netherlands

Joachim Schindler

Former Global Head of Audit,
KPMG International

Sai Choy Tham

Head of Audit,
KPMG in Singapore

John Gordon

Head of Audit,
KPMG in Canada

Q. Can auditors ask the truly tough questions? Aren't they simply too beholden to management?

Charles Krieck (CK): Auditing is a human science. We should admit that close client relationships, combined with the wrong mind set, can make asking tough questions a problem. But a good relationship is essential – is a bad one supposed to make asking tough questions easier? In 28 years as an auditor, I have never seen a critical situation where an auditor failed to ask the necessary questions of management.

Marc Hogeboom (MH): I completely agree that auditing is a people profession. So standards will never be completely uniform. Independence has been high on our agenda for years, but we have failed to engage in the public debate. As a result in the Netherlands we now have mandatory auditor rotation. Rotation certainly brings a fresh perspective, but I'm not sure it actually improves independence or audit quality.

Joachim Schindler (JS): I think there is a tension between the need for a critical perspective and for positive relationships. We should not shy away from this difficulty. A lot depends on the audit committee or supervisory board; if it is as independent as it should be, the tension goes away. In reality this is not always the case. But a lot of regulatory and professional safeguards have been built up over the last 10 to 20 years.

Sai Choy Tham (SCT): I don't see independence as today's most pressing issue. Does independence still need to be monitored, and if possible improved? Absolutely. And safeguards continue to be strengthened. But to me this is a bit of a red herring. It should not be the profession's greatest priority.

John Gordon (JG): My perspective comes from watching and talking to more than 200 working audit partners. In my experience, they believe their lot in life is to help clients get to the right answers. To do that they need relationships that are professional, but allow them to ask tough questions. Management and audit committees have front row seats, and they absolutely believe that auditors are independent.

Q. Is it fair that the audit profession has been blamed for failing to predict the financial crisis?

SCT: It is unfair to blame auditors for failing to prevent the financial crisis. But I think we deserve to be criticized in other areas. One is that we have not challenged the view that we should only talk about historic information. Another is that we don't use fully the vast amount of information we gather in the audit. Auditors are capable of communicating much more information than simply an audit opinion over historic financial data – we know a lot about the companies we audit and can use this information to help other stakeholders fulfil their roles.

CK: If governments, regulators, the IMF and the World Bank failed to prevent the crisis, it is unfair to blame auditors. But the profession has been shy – maybe even afraid – to discuss what an audit can and cannot do. If we had communicated better in the past, skepticism towards the profession would be less than it is today.

JG: Financial statements are like looking in the rear view mirror of a car. It can be interesting to learn about a place you're never going to see again. But it's not so relevant to where you're going. So yes, I think a lot of the criticism is understandable. The challenge is to move away from the historic focus, but without blanket protection from liability. I don't think society is quite ready to provide that yet.

MH: If auditors had the ability to predict financial markets, then we would not be auditors at all – we would be making a fortune as investors! Still, I think that most of the criticism the profession has received is an understandable reaction to our failures of communication. There are a number of expectation gaps that we need to bridge in order to rebuild our reputation.

Q. If audits were not required, would we have them anyway? Do they create real value?

JS: The value of an audit is something that never gets talked about. The profession should take the blame for this. We are always on the defensive. An audit helps to identify icebergs – potential hazards that otherwise wouldn't be seen. And who would buy an unaudited company? The world may be changing, but audits are still needed, not least because of their preventative role. But the changing world also means that the audit profession needs to develop existing and new services that clients want and require.

JG: In Canada, there is no statutory requirement for unlisted firms to have an audit. But banks considering a loan, private equity firms and other potential investors demand them. So there are lots of very smart stakeholders who insist on audits. That shows they attach a lot of value to the product. But is some of it negative value? Maybe – the feeling is that if something goes wrong you would wish you had demanded an audit.

SCT: If audits did not already exist, we would certainly need to invent them. Management, shareholders, banks and capital market participants would want them. But would we invent the audit product in its current form? I doubt it. We would report not just on results but also on risks, not just on numbers but also on narratives, not just once a year but continuously. The output would change, and as a result so would the process.

CK: In Brazil, the number of companies required to have an audit is far smaller than the number that choose to have one. So I do think the audit is seen as having inherent value. Whatever the failures of our communication, investors think a third party attestation is vital. But are audits seen as having as much value as they should? I'm not so sure.

Q. In that case, how can the profession enhance the value of the audit?

CK: We need to do more to explain our ability to detect fraud to the marketplace and to society. We need to be clear that when we issue a report on a particular piece of information, we are not giving an assurance on the whole business. And I think we could make our overall approach more predictive. This could never be insurance against the future – unless someone is willing to pay for it. But it could happen.

JS: I think we should concede that an expectation gap has developed, particularly over fraud and going concern. A lot of people believe that an auditor's signature means that no fraud has taken place. This is not possible. But if society expects us to do more on fraud, I'm sure we could find a way to say more without issuing a guarantee. And on the going concern side, I agree that we need to become more future-oriented in our work.

MH: It is not enough to say that we should communicate better. We must communicate better. But in the long run, we need to be more innovative and increase the quality of our audit services. This is not only the best way to create value for our clients. It will also allow us to address fee pressure and ensure the long term future of the profession.

SCT: I don't think we can add much value just by changing how we audit. We need to focus on what we audit. Some of my clients issue so many reports that I can hardly keep track, and they would like to see them all audited. But again and again I see firms running away from assignments because they don't have cover from a specific auditing standard. It is up to us as a profession to adapt. We need to maximize the potential value we can provide to our clients.

“...as a profession we have to balance the needs of external stakeholders with our duty of client confidentiality. So these improvements will only be achieved with the consent and support of management and supervisory boards.”

Marc Hogeboom

Q. So how much of this is about investor perceptions and the demands of capital markets?

JG: Wholesale investors see the information auditors hold as largely irrelevant. They would like us to opine on management's forward looking statements. But boy, that's hard to do. Even so, I think auditors could share more of the insights we get from our access to management. In the long term, we need to focus on all the information that investors value. Companies regularly disclose lots of valuable information – like airlines' load factors or natural resource companies' production volumes. I believe auditors should focus on validating all this financially relevant information.

SCT: I look at the financial information that capital markets need, and I see very little overlap with what we audit. If an audit is useful, why is it only useful every fourth quarter? Ideally, auditors would be able to state that all financial information is accurate. Doing this in real time is probably impossible. But the first step could be to retrospectively check all financial information released to the markets. People have traded on this data – was it accurate? That would put more scrutiny on how data is compiled and released. And over time the process would become quicker and quicker.

JS: I'm not sure that asking what professional investors want will lead us down the right road. For example, auditors can't discuss alternative accounting treatments – as I often hear investors ask. But we could certainly make our work less backward looking. If clients want us to we could analyze risks, budgets and business plans and discuss them with audit committees. But this is difficult to imagine in today's litigious environment. We also need to think about how this could be communicated to the public.

MH: In the Netherlands we are working with shareholder groups to understand their needs. We have already taken a small but significant step by talking about our role as auditors at annual meetings. But the real goal should be to move beyond our traditional focus on the financial statements. This means auditing other statements and metrics that our clients publish, and perhaps doing more work on sustainability. It might also involve auditing soft controls, such as the influence of individuals or organizational culture. But for now that remains something for the future.

Q. How about public perceptions and the needs of the wider community?

JG: Poor public perceptions of auditors carry a real risk – the risk of intervention in the industry. Talking more with the users of our reports is one way to address this. After all, if you're buying a house, you would welcome the chance to talk to the surveyor. Regulators could easily gain some insight from talking more with auditors, but communicating with large groups like retail investors could be harder to manage.

JS: I agree there should be a wider debate over the availability of auditors to shareholders and analysts. Perhaps all auditors should be required to take questions at an AGM, as they already are in the US and the Netherlands. However, a fair number of issues would need to be resolved, especially confidentiality and other legal questions that differ from country to country.

MH: Public communication is vital. As well as saying more about our own work, we would like to discuss management statements and board reports at shareholders meetings. But as a profession we have to balance the needs of external stakeholders with our duty of client confidentiality. So these improvements will only be achieved with the consent and support of management and supervisory boards.

CK: I certainly believe auditors should be more available for informal discussions with external groups. A forum connecting auditors with economists and regulators could help to stabilize capital markets, if a working group could identify the key indicators to monitor before they turn red. If the profession could diminish the impact of future crises, it would create great value for the economy at large.

Q. What about audit opinions and public reports? Should they move beyond the current pass/fail format?

MH: In my view, introducing extended audit opinions that say more about going concern, materiality and risk assessment is one of the most important steps the profession needs to take. There is no question that this is a difficult road to go down. The more that we disclose, the more likely we are to trigger claims and legal proceedings. But taking an entirely legalistic approach is not an option.

JS: There is no doubt in my mind that we as auditors should communicate more. The way we currently issue pass/fail opinions is certainly not sufficient. One thing we could do is to talk more about critical areas of the audit – if it could be done without giving away too much commercially sensitive information.

JG: The key question is whether the profession is willing to be open minded about the product of an audit. The public are skeptical about the value of binary audit reports. If we provided the kind of conclusions and explanations that investment advisers do, our reports might carry greater value. I think much more could be said, including some sort of judgment on solvency. Auditors, with our access and expertise, must be able to do better than something which is little more personalized than a stamp.

CK: I would be very supportive of longer, non-standardized audit opinions. Something closer to a true report that spells out what we have – and have not – done. Perhaps in future we could also look at issuing graded opinions. But users would need to understand that they could not rely purely on an auditor's report when making investment decisions.

SCT: There is a place for pass/fail opinions, but they don't meet all needs. For investment professionals, they are a useful sign that the numbers have been validated. But if we expand the information that we audit, we will also need to expand the range of reports we provide. This means we need to get past a US-based view of legal risks that is counter-productive in many markets. The profession needs to recognize that we are living in a changing, multi-polar world.

Q. Do you have any final thoughts?

SCT: We need to stand up and be willing to try to meet clients' needs in the ways they want, as unrestricted by legal risks or auditing standards as possible.

JG: We should focus on all data that companies put out. And we should communicate better with investors, regulators and other audiences. We need to broaden our communication and our deliverables.

CO'H: We must recognise that there is a wider societal role in what we do and focus our efforts in rebuilding the public's trust in us as a profession.

MH: Greater openness – in a range of areas is the single most important improvement the profession can make. But openness is not the whole story. In the long term, we need to up-scale our abilities.

JS: At the end of the day, we need to be clear that auditors are running a business. We can't rely on regulation or legal requirements to sustain us. If the profession doesn't evolve, it risks repeating the fate of other industries that failed to realize the world had changed.

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