Audit Inspection Unit

Public Report on the 2007/8 inspection of KPMG LLP and KPMG Audit PLC

8th December 2008

This report is issued by the Audit Inspection Unit of the UK's Professional Oversight Board ("the Oversight Board"), part of the Financial Reporting Council. It has been approved for publication by the Oversight Board.

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1.1 Introduction

This report sets out the principal findings arising from the inspection of KPMG LLP and KPMG Audit Plc ("KPMG" or "the firm") carried out by the Audit Inspection Unit ("the AIU") of the Professional Oversight Board ("the Oversight Board"), part of the Financial Reporting Council ("the FRC"), in respect of the year to 31 March 2008 ("the 2007/8 inspection"). As a consequence of the firm's structure, organisation and operating procedures, both KPMG entities in the UK that conduct audits are covered by this report. See Section 1.3 for further details. Our inspection was conducted in the period from April to December 2007 (referred to as "the time of our inspection").

This report is based on the AIU's more detailed private report on its inspection of the firm to the Audit Registration Committee ("the ARC") of the Institute of Chartered Accountants in England and Wales ("the ICAEW") with whom the firm is registered for audit purposes. The AIU currently inspects the largest audit firms including KPMG annually[1]. The 2007/8 inspection was the AIU's fourth inspection of the firm. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU's 2007/8 report to the ARC, which was finalised in July 2008, recommended that the firm's registration to conduct audit work should be continued.

This is the first year the AIU has reported publicly on individual firms. In the past the AIU issued an annual public report in which the principal findings arising from its inspections of the major audit firms in the UK were dealt with on an anonymous and aggregated basis.

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU's overall inspection programme for the relevant year.

The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review by the AIU which, in turn, reflects the firm's client base. An issue reported in relation to a particular firm might also apply to other firms without having arisen in the course of the AIU's inspection fieldwork at those other firms in the relevant year. Also, only a small

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[1] The Companies Act 2006, as amended with effect from 6 April 2008 by the Statutory Auditors and Third Country Auditors Regulations 2007, requires that full scope inspections of those audit firms conducting more than ten audits within the scope of independent inspection (as determined by the Professional Oversight Board) are undertaken at least every three years.

sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

All findings requiring action set out in this report have been discussed with the firm together with the firm's proposed action plan to address them. Appropriate action may have already been taken by the date of this report. The adequacy of the actions taken and planned will be reviewed by the AIU during its next inspection of the firm.

The Oversight Board undertook to publish all the reports for the 2007/8 cycle of inspections on a single date. The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied before the AIU's private and public reports are finalised. As a result there is necessarily a significant period of elapsed time between completion of the AIU's inspection fieldwork at firms and the publication of reports on the inspection findings.

The firm was invited to provide a response to this report for publication. The firm's response is set out in Appendix A.

The AIU acknowledges the co-operation and assistance received from the partners and staff of KPMG in the conduct of the 2007/8 inspection.

1.2 Scope and objectives

The overall aim of the FRC is to promote confidence in corporate reporting and governance. One of the strategic outcomes contributing to this aim is for the users of audit reports to be able to place a high degree of reliance on audit opinions, including whether financial statements show a true and fair view. The AIU's programme of inspections is designed to contribute to the achievement of this strategic outcome.

Our inspections of the major audit firms, on which we report publicly, comprise a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year by the Oversight Board.

We review firms' policies and procedures in the following areas:

- Leadership, strategy and communications
- Performance evaluation, promotions and remuneration
- Other human resource matters
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring

- Independence and ethics
- Audit methodology

Our reviews of individual audits place emphasis on the appropriateness of significant audit judgments exercised in reaching the audit opinion as well as the sufficiency and appropriateness of the audit evidence obtained.

Our inspections include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. These comprise the auditing standards and ethical and quality control standards for auditors issued by the FRC's Auditing Practices Board (APB)[2] and other relevant requirements under the ICAEW's Audit Regulations[3]. The standards referred to in this report are those effective at the time of our inspection or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken. (The APB issued revised Ethical Standards in April 2008 which are effective for audits of financial statements for periods commencing on or after 6 April 2008.)

We seek to identify areas in which improvements are, in our view, required to safeguard audit quality, including matters relating to compliance with regulatory requirements, and to agree an action plan with the firm designed to achieve these improvements. We also assess the extent to which the firm has addressed the findings and recommendations arising from its last AIU inspection.

While the AIU's public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. Our inspections are not designed to, nor would it be possible to, identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by us for review and cannot be relied upon for this purpose.

We reviewed the quality of 14 individual audit engagements undertaken by the firm. These related to FTSE 100, FTSE 250, other listed and other major public interest entities, with financial year ends between June 2006 and March 2007. Our reviews covered selected aspects of the audit only. In addition, we undertook one follow-up review to assess the extent to which our prior year findings had been addressed in the following year's audit.

The monitoring units of the professional accountancy bodies in the UK who register firms to conduct audit work are responsible for monitoring the quality of audit engagements

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[2] International Standards on Auditing (UK and Ireland), APB Ethical Standards and International Standard on Quality Control (UK and Ireland) 1

[3] The Audit Regulations are issued jointly by The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

falling outside the scope of independent inspection by the AIU but within the scope of audit regulation in the UK. Their work, which is overseen by the Oversight Board, covers audits of UK incorporated companies and certain other entities which do not have any securities listed on the main market of the London Stock Exchange ("a full listing") and whose financial condition is not otherwise considered to be of major public interest. All matters raised in this report are based solely on work carried out by the AIU.

This report has been prepared for general information only. The information in this report does not constitute professional advice and should not be acted upon without obtaining specific professional advice.

To the full extent permitted by law, the FRC, the Oversight Board, the AIU and their employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.

1.3 Background information on the firm

The UK and German firms of KPMG merged in October 2007 and created a new limited liability partnership, KPMG Europe LLP ("ELLP"). ELLP is a limited liability partnership with its registered office in London but registered for tax purposes in Frankfurt. The former KPMG firms in Switzerland and in Spain also joined the merged firms and the businesses became subsidiaries of ELLP on 30 September and on 1 October 2008 respectively, alongside the former KPMG firms in Germany and the UK.

While ELLP is a UK registered audit entity and controls the UK, German, Swiss and Spanish audit firms, it does not itself conduct any audit work or any other client business; that work is conducted by its operating subsidiaries. KPMG LLP, itself owned by ELLP, continues to be the owner of all operating KPMG entities within the UK and together with KPMG Audit Plc conducts all UK statutory audits. The audit opinions of virtually all listed companies and public interest organisations are issued by KPMG Audit Plc. Both entities share common systems to manage their businesses and to address the requirements of audit regulation. The majority of KPMG LLP audit partners are also employed as audit directors of KPMG Audit Plc. Consequently no distinction has been drawn between these two entities in this report. We refer to both entities jointly as "KPMG" or "the firm" and our comments should be regarded as attributable to both entities.

Within this structure KPMG is organised into three lines of service, being Audit, Advisory and Taxation. All statutory audit work is performed within Audit which is divided into industry and geographical "business units" for operational purposes, based in 22 offices within the UK.

For the year ended 30 September 2007, the firm's turnover was £1,607 million, of which £447 million related to the Audit line of service. The total number of partners and staff was 10,574[4]. There was a total of 563 partners, of whom 204 were authorised to sign audit reports, and 113 employees who were also authorised to sign audit reports[5].

The AIU estimates that the firm had 440 audit clients within the scope of independent inspection by the AIU as at the 2007/8 reference date of 27 February 2007. Of these audit clients AIU records show that 224 had a full listing or were listed on the AIM market of the London Stock Exchange[6], including 23 FTSE 100 audit clients and 53 FTSE 250 audit clients.

[4] As disclosed in the annual return to the ICAEW as at 31 May 2007. An analysis of Audit fee income between audit and non-audit fees is not publicly available.
[5] As disclosed in the annual return to the ICAEW as at 31 May 2007.
[6] The firm also had other AIM listed audit clients below the threshold for inclusion within scope.

2 Findings

2.1 Overview

KPMG has demonstrated its commitment to audit quality in the implementation of its business strategy, the continued enhancement of procedures and controls and the tone and content of external and internal communications.

In our view, the firm has appropriate policies and procedures in place for its size and the nature of its client base in the relevant areas which are subject to our review. Of particular note are the quality and regularity of technical briefings and updates, as described in sections 2.2.1 and 2.2.3, which ensure that audit quality is high on the agenda for partners and staff throughout the firm and that all significant matters are communicated promptly. In addition, we believe that the firm's co-ordination of its financial services audits within a separate business unit, as set out in section 2.4.1, enhances the quality of work in that sector. We identified certain areas for improvement, including some matters relating to rotation procedures, as set out in sections 2.2 to 2.4 of this report

In relation to reviews of individual audits, we have generally reported our findings on the basis of themes arising or issues of a similar nature identified across a number of audits. We believe that the number of individual audits reviewed by us makes it appropriate to report on this basis.

We were generally satisfied, subject to our comments in section 2.4.3, with the basis on which significant audit judgments were made on the fourteen audits reviewed by us. In our view, audit work was generally performed to a good or acceptable standard and, in relation to one FTSE 100 entity and one other listed entity, to a very good standard. The overall findings arising from our review of individual audits are set out in section 2.4; these include areas where improvements are, in our view, needed in order to enhance audit quality. In our view, two of the audits we reviewed, relating to entities which were not listed on a regulated market[7], required significant improvements in certain areas.

The follow-up review we conducted showed that the issues we raised in the previous year had been addressed on that audit.

KPMG has made significant efforts to implement recommendations arising from both our inspections and its own quality review procedures, especially in the area of risk assessment. However, certain issues continue to recur; while some audits reviewed by us may have been undertaken before the relevant training or briefing was provided, we

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[7] Within the meaning of Part VI of the Financial Services and Markets Act 2000.

believe that these areas should remain on the firm's agenda for future communications to the audit practice until the required improvements are achieved.

The principal findings arising from our review of the firm's policies and procedures supporting audit quality and the quality of the individual audits selected by us for review are set out below under three broad headings: quality control (section 2.2); independence and ethics (section 2.3); and audit performance (section 2.4).

2.2 Quality control

This section covers our review of the following aspects of the firm's system of quality control for audit engagements:

- 2.2.1 Leadership, strategy and communications
- 2.2.2 Performance evaluation, promotions and remuneration
- 2.2.3 Other human resource matters
- 2.2.4 Client risk assessment and acceptance/continuance
- 2.2.5 Consultation and review
- 2.2.6 Audit quality monitoring

2.2.1 Leadership, strategy and communications

The management of ELLP and its operating subsidiaries, which includes the UK firm, lies primarily with the Board of ELLP. It is responsible for setting strategy and overseeing its implementation. The Board has two joint chairmen. The Executive Committee, in conjunction with other executive teams, has day-to-day responsibility for implementing the strategic objectives and policies of the entire ELLP group.

The firm has stated that its key priorities are to turn "knowledge into value for the benefit of clients, people and the capital markets" and "to be the best employer among the accounting firms in the UK". The audit business plan cites quality, profitability, growth and people as its key priorities and the Head of Audit regularly confirms that his prime responsibility is to drive the firm's quality agenda. The firm communicates matters relevant to audit quality on a regular and frequent basis using meetings, office visits, training, conference calls, the intranet, quarterly updates available electronically, newsletters and its audited Annual Report.

We held meetings with members of the Board, the Executive Committee and other senior partners and reviewed the firm's audit business plan and key communications, to assess the emphasis placed by the firm on audit quality. We found that the commitment to quality generally and high quality audits in particular is a prominent feature of the firm's strategy, communications and actions and is particularly well supported by the quality and regularity of the firm's technical briefings and updates.

2.2.2 *Performance evaluation, promotions and remuneration*

Audit partners and staff are appraised annually in relation to their overall performance and against agreed objectives. Each partner and member of staff is appraised by a more senior partner or manager who reviews all evidence of performance gathered, such as assignment feedback, 360 degree feedback and the individual's overall self-appraisal for the year. Following a discussion with the individual being appraised a performance rating is proposed which is subject to a moderation process before approval at the appropriate level.

There are separate processes for the key stages of promotion to director and partner which include the submission of business cases from the appropriate practice area, independent panels to assess a candidate's suitability for the proposed role and interviews with members of the firm's management.

Remuneration is determined according to a model on the basis of position in the firm and performance rating and is also subject to a moderation process. Proposed partner remuneration levels are considered by the Remuneration Committee and approved by the Board.

We reviewed the performance evaluation, promotion and remuneration procedures and noted that the firm has invested considerable effort and resource into these areas in recent years. We also reviewed a sample of partner and staff appraisals, a sample of partner and director promotion nomination files and remuneration models. Our review of this material indicated that the key focus of the audit practice is the ability to deliver high quality audits, although exceptions were noted as highlighted in the findings below.

Appraisal process within non-audit functions

All partners and directors who are based outside the audit function and who are authorised to sign audit opinions are expected to adhere to those procedures followed within Audit. The objectives set in one partner appraisal form reviewed by us did not refer to audit quality, but concentrated instead on generating advisory fees from clients including one of the partner's audit clients. The Ethical Standards prohibit partners from being rewarded for gaining non-audit work at their own audit clients because this could threaten their independence. Following an investigation by the firm, we were informed that the non-audit work referred to was in fact gained by others and did not influence the partner's remuneration. We were also informed that no further occurrences of a similar nature had been identified.

We also noted that no formal procedure is in place to ensure that appropriate feedback from the audit function is included within the appraisal process for non-audit partners and staff involved in audits, such as those from tax and IT. It is left to the discretion of audit engagement partners to provide feedback for all partners and staff as appropriate.

2.2.3 *Other human resource matters*

Audit training and communications

Audit training for junior staff prior to qualification is incorporated into the mandatory annual core training courses. Attendance at the firm's annual summer audit training is mandatory for all audit partners and professional staff. Attendance is monitored and follow-up procedures are in place for non-attendees to attend alternative sessions or complete appropriate self-study courses. Partners and staff responsible for the audits of companies within complex business sectors also receive regular specialist training.

All audit partners and professional staff receive a quarterly "Audit Professional and Technical Update" electronically. Each update includes a test which must be passed and re-taken if necessary. Completion is monitored to ensure that all recipients read and understand the material.

The firm provides some specific audit-related training for non-audit staff who are involved in audit work. Many of these staff also attend the summer audit training referred to above.

We held meetings with partners and staff from the firm's technical department and reviewed a sample of training material. We concluded that the firm has a comprehensive range of training courses covering, inter alia, audit methodology, accounting and specific business sectors. These courses address both new requirements and development needs which have been identified by internal quality reviews and external regulatory processes.

Credit crunch communications

In the autumn of 2007, KPMG responded to global liquidity problems by issuing bulletins outlining the causes of the adverse market developments, the potential consequences for both financial services and non-financial services sectors and the ramifications for year-end reporting. A "credit crunch" intranet site was established so that all matters arising could be logged and easily shared across the practice. In early December, a series of weekly meetings was established within financial services, with conference call facilities, to discuss emerging issues. Following each call a summary of the issues discussed, the agreed response and/ or actions going forward were posted on the intranet site. In our view the firm responded in an appropriate and timely manner to the audit risks arising from global liquidity problems.

2.2.4 *Client risk assessment and acceptance/ continuance*

Firms are required to have policies and procedures in place to provide them with assurance that client integrity, compliance with ethical requirements and their competence, capabilities and resources are considered before they decide whether to accept or continue an audit engagement[8].

Each audit engagement partner is required to complete an annual review of the threats to the firm posed by each audit engagement; this culminates in the determination of a risk rating. Company specific data is input to the firm's client engagement acceptance and continuance (CEAC) system which prompts the audit team to consider a number of potential issues within specific areas.

The audit team's deliberations on the level of risk inherent in the audit engagement and the output from the CEAC system, together with any risk mitigation measures deemed necessary, are discussed at the time by the engagement partner with the appropriate business unit leader and during the partner's annual risk review. The Head of Audit Risk Management meets with each business unit leader to understand and where appropriate challenge the outcome of these discussions. The decision to continue to act as auditors to the highest risk clients must be discussed with and approved by the firm's Head of Risk Management and the Head of Audit.

In the course of our file reviews we evaluated the acceptance/ continuance procedures adopted. We interviewed a number of business unit leaders to confirm that annual risk reviews were appropriately conducted. We reviewed a sample of CEAC forms and concluded that the firm appeared to have rated each audit engagement in accordance with the firm's policies and guidance and to have implemented appropriate risk mitigation measures in relation to those audits regarded as higher risk.

2.2.5 *Consultation and review*

Engagement quality control review

Firms are required to have policies and procedures in place requiring an engagement quality control review to be undertaken for all audits of financial statements of listed entities and other audits meeting specified criteria[9].

An engagement quality control review (EQCR) partner is required by KPMG for all listed entities (including those listed on AIM), public interest entities, engagements where there is modified reporting and engagements considered to be higher risk. EQCR partners must

[8] International Standard on Quality Control (UK and Ireland) 1, paragraph 28
[9] International Standard on Quality Control (UK and Ireland) 1, paragraph 60

have the appropriate technical expertise, experience and authority to carry out the review objectively and will normally have at least five years' experience as engagement partners on listed or public interest clients. EQCR partners are also required to have relevant industry experience to identify audit risks and understand the major issues on audits within complex business sectors.

We reviewed the application of the firm's EQCR procedures as part of our review of individual audits and found that they were being appropriately applied in practice.

Pre-issuance technical reviews

In the year under review, a mandatory pre-issuance review by the technical department was required for IFRS consolidated accounts of all the firm's listed clients, annual accounts of any unlisted higher risk clients and subsidiaries with listed debt if the parent's consolidated accounts were not subject to review. Building societies, banking institutions and insurance clients requiring a mandatory review had also to be reviewed by the firm's Financial Services (FS) Technical Advisory department.

Certain changes were made from December 2007 including the requirement, in response to the credit crunch, that all financial services entities should have both a review by FS Technical Advisory and a pre-issuance review.

We held meetings with partners from the technical department and the FS Technical Advisory department and we reviewed the output of technical reviews on individual audits. We found the firm's procedures to be comprehensive in this area.

2.2.6 *Audit quality monitoring*

Firms are required to have monitoring procedures in place, including reviews of a selection of completed audit engagements, to provide them with assurance that their system of quality control is adequate, operating effectively and complied with in practice. Such monitoring is required to be undertaken at least annually[10].

KPMG's international Quality Review and Compliance Program (QRCP) is an annual global programme covering all KPMG member firms and all functions within the firms. It is conducted in two distinct parts. The Quality Performance Review (QPR) covers the quality of individual audits and comprises a review of a sample of engagements. The Risk Compliance Program (RCP) comprises an examination of the firm's processes against a series of objectives including those related to risk management.

[10] International Standard on Quality Control (UK and Ireland) 1, paragraph 74 and the ICAEW's Audit Regulations

In the case of QPR, 102 UK audit engagements were reviewed during the spring and summer of 2007. The UK firm's policy is to carry out a review, on a business unit basis, of all partners and directors authorised to sign audit opinions within each three year period. Reviews are also conducted using risk based criteria to ensure that a broad cross-section of partners and engagements is covered.

We reviewed these procedures, the results of the 2007 reviews and follow-up actions by the firm. We concluded that the firm had invested significant resource and effort to develop and implement comprehensive and effective audit quality monitoring procedures.

2.3 Independence and ethics

2.3.1 Ethical policies and consultation

Firms are required to have policies and procedures in place designed to achieve compliance with the Ethical Standards issued by the Auditing Practices Board together with relevant ethical pronouncements issued by the professional body with which the firm is registered.

The firm's ethical policies are set out in the "UK Ethics and Independence Manual-Incorporating the KPMG Europe Code of Conduct" which was issued in October 2007 and distributed to all partners and staff. The firm had already, in prior years, mapped the requirements of the Ethical Standards to its policies and procedures.

The Risk Management Partner and Ethics Partner roles are fulfilled by the same person within the UK firm. Within Risk Management there is a separate team, led by the Head of Independence and Regulatory Compliance, with specific responsibility for independence and ethics.

All personnel have a responsibility to undertake training on ethical requirements that is appropriate for their role. All partners and staff, including long-term secondees, are required to complete relevant training as directed periodically.

We reviewed the firm's ethical policies and procedures and found them to be comprehensive and, based on our testing, appropriately applied in practice.

2.3.2 Compliance monitoring procedures

The firm performs an annual independence confirmation exercise which requires all partners and staff to answer a series of questions on their personal independence. Last year the system was improved by extending to all partners and managers within client-facing functions the requirement to input all data on financial interests to a specifically designed database which flags investments as they become "restricted". The Independence and Regulatory Compliance team monitors any matters arising from this process and audits every quarter the information held on the database for a sample of individuals, primarily more senior partners and staff.

The 2007 process commenced in October and within two months was substantially complete. There is an efficient follow-up system in place both to resolve any potential issues that arise and to chase non-replies. Disciplinary action may be taken if breaches of regulatory requirements are identified.

To confirm our understanding of the firm's compliance monitoring procedures we held meetings with both the Risk Management and Ethics Partner and the Head of Independence and Regulatory Compliance. We also reviewed a sample of annual independence declaration forms and examined the results of the follow-up exercise.

It was evident from our review that the firm's annual independence confirmation exercise was comprehensive and that KPMG had invested significant resources into upgrading its system and procedures in recent years.

2.3.3 Rotation policies and monitoring

Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. This reflects the need to avoid auditor independence being compromised by the familiarity threat arising from a long period of service in a senior role. For listed company audits, the engagement partner and engagement quality control reviewer are required to rotate after having served for a maximum period of five years and key audit partners (KAPs) are required to rotate after seven years.[11]

Rotation policies and guidance

Within KPMG the audit engagement partner is primarily responsible for ensuring compliance with rotation requirements. Historically, compliance with rotation policies and procedures was monitored through a system maintained at a business unit level. Two years ago a rotation database ("the database") was implemented across the practice and the system was populated with data during 2006. It holds, inter alia, basic client data and details of the length of service of relevant partners whose roles are subject to rotation rules.

[11] APB Ethical Standard 3, paragraphs 5, 6, 12 and 16. "Key audit partners" are partners other than the audit engagement partner responsible for key audit decisions or judgments.

The database is not used to monitor the length of service of other partners and staff in senior positions; this is the responsibility of the engagement partner.

Any issues flagged by the database together with rotation matters generally are discussed and resolved with the relevant business unit leader during the audit engagement partner's annual risk review. Input is sought from the Head of Audit Risk Management as appropriate.

We reviewed the quality of the database as well as updates to the firm's rotation policies and procedures. We also held meetings with a number of business unit leaders to discuss the implementation of rotation requirements and the effectiveness of the database.

Both our review of a sample of entries in the database and the firm's own RCP review (described in Section 2.2.6) identified some inaccuracies in the data held. The firm is aware of the occurrence of a number of inaccuracies in the data held but is satisfied that any discrepancies are largely timing differences and that these would not remain undetected as a consequence of the monthly review process conducted by the business unit leader and periodic audit by the Central Risk Management Team. While our sample review confirmed some discrepancies, we did not find any breaches of the rotation rules.

Long association and key audit partners

While the firm's rotation policy requires audit teams to consider whether "advisory" partners such as those who provide tax and IT support should be classified as KAPs, it is rare for such a partner to be so classified since the firm's view is that the audit engagement partner would normally make the key audit judgments in those areas. However we saw little evidence on the files we reviewed that audit engagement partners had considered whether the relevant advisory partners or partners responsible for key subsidiaries or divisions should be identified as KAPs or, if not, whether they should be classified as other partners and staff in senior positions.

In relation to the role of lead relationship partner, where this is assumed by a partner other than the audit engagement partner, we found inconsistencies within KPMG's documentation. The definition within one of the firm's sources of reference had been updated to comply with the rotation principles set out in the Ethical Standards, whereas another source had not been similarly updated.

As already noted, other partners and staff in senior positions are not consistently identified and monitored across the firm, which increases the risk of independence threats arising and not being appropriately addressed. We found some instances where the independence threats and safeguards required in relation to extended periods of service had not been properly considered or assessed.

In our view the firm has comprehensive rotation policies and procedures but some improvements are required in the areas outlined above.

2.4 Audit performance

This section covers findings arising from our review of the firm's audit methodology and our review of individual audits. Our findings are set out under the following headings:

- 2.4.1 Audit methodology
- 2.4.2 Assessing and responding to risk
- 2.4.3 Audit evidence and related judgments
- 2.4.4 Communicating with Audit Committees
- 2.4.5 Audit finalisation

Any findings relating to quality control and independence are covered in sections 2.2 and 2.3 respectively.

2.4.1 Audit methodology

KPMG's audit methodology is based on Auditing Standards and is developed at an international level with significant participation by the UK firm. Its application is mandatory for all audit engagements within the KPMG global network. In the UK, the firm develops procedures to meet the additional requirements under UK standards.

While KPMG's audit methodology is supported by an IT tool which, to a degree, automates the preparation of work programmes and audit documentation, it is not a fully integrated work-flow system and the final audit files are paper files. The global firm is developing an electronic work-flow approach which will be piloted in the UK in 2009 and implemented in 2010 and 2011. We believe that the introduction of automated audit software will assist audit teams in linking audit planning with work steps executed and conclusions reached; this has been raised by us as an issue on some audits.

In prior years we have reviewed the firm's mapping of Auditing Standards to its audit methodology. This year we reviewed any updated material resulting from, for example, any changes in the requirements of standards, as well as audit technical alerts issued in the year. We reviewed the application of the firm's audit methodology on those audits selected by us for review.

In our view, audit work in the financial services sector was enhanced by the firm's overall approach to financial services audits; they are co-ordinated and conducted within a separate national business unit which is responsible for ensuring that appropriate expertise and specialist skills to perform effective audits exist in all relevant locations. We also considered that the co-ordination of the group audits of multi-location companies reviewed by us was a particular strength. We commented positively on the procedures that had been established to ensure that an appropriate and consistent level of audit quality was achieved across the group. This was a marked improvement on our findings in prior years.

We believe that KPMG's audit methodology comprehensively covers the requirements of Auditing Standards, although its application by audit teams should be improved by the implementation of fully integrated automated computer software. There are also a number of specific areas in its application that require attention. These are discussed under the headings below.

2.4.2 *Assessing and responding to risk*

Auditing Standards require the identification and assessment of the risks of the financial statements being materially mis-stated, including which of these risks require special audit consideration (such risks are termed "significant risks") [12]. A proper assessment of the significance of identified risks is important to ensure that audit work planned and undertaken is sufficiently focused on higher risk areas of the audit.

Risk assessment

The firm's audit methodology contains relevant guidance on the identification of significant risks and requires those risks to be addressed and documented in the planning process. It also sets out the work to be performed on the controls over assertions affected by significant risks. In the majority of files reviewed the audit team had applied and followed the firm's guidance and requirements. We concluded that the compulsory training and briefing organised by the firm in response to our findings last year had resulted in improved audit quality in these areas.

Preliminary analytical procedures

Auditors are required to conduct analytical procedures as part of their overall risk assessment process, to enhance their understanding of the entity and its environment. Appropriate guidance on preliminary analytical procedures is included in the firm's audit methodology and the additional guidance provided by the firm during the year resulted in an improved approach. However, on nearly half of the files reviewed there was a lack of evidence that appropriate preliminary analytical procedures had been performed.

[12] International Standard on Auditing (UK and Ireland) 315, paragraphs 100 and 108

2.4.3 *Audit evidence and related judgments*

Audit judgments

We reviewed a number of significant audit judgments, including the rationale for accounting treatments, the reasonableness of assumptions in valuations and estimates and the judgments relating to the extent of audit work performed. Following discussions with the relevant audit teams in relation to audit areas such as stock, goodwill, property valuations, provisions, fixed asset impairments and deferred income, we were generally satisfied that the judgments were appropriate and had been given due consideration.

However, one of the main recurring themes continued to be the lack of evidence on files that all relevant data, procedures and thought processes underpinning key audit judgments had been effectively analysed and evaluated and appropriate conclusions reached. The quality of audit evidence on file did not always reflect the extent of partner involvement in the resolution of key audit issues or the thoroughness with which these matters were addressed.

Reliance on third-parties

A recurring issue on just over half the audits reviewed was the quality of audit evidence on file to support the decision to rely on the work of third-parties. This was particularly significant in relation to a small minority of audits.

- *Use of experts:* The majority of audits we reviewed covered one or more specialist areas where the audit team decided to use the work of experts. We identified examples of the use of experts in relation to the audit of pension assets and liabilities, IT controls, billing systems and stock. On nearly half of the audits reviewed we found that the requirements of Auditing Standards had not been fully complied with in relation to the competence and independence of the experts and/ or the scope of their work, the verification of source data and/ or follow-up of the results of the experts' work.

- *Service organisations:* On a minority of files reviewed by us where audit reliance had been placed on service organisations there was a lack of evidence to support that reliance and the quality of monitoring and control procedures in place.

- *Internal audit:* We noted only two instances of reliance on the work of internal audit but the relevant audit teams had not complied fully with certain requirements of Auditing Standards. In particular, they had not conducted an annual assessment of the competence and reliability of internal audit including re-performing a sample of their work.

2.4.4 *Communicating with Audit Committees*

Auditing Standards require the auditor to communicate matters of governance interest arising from the audit with those charged with governance of the entity. Such communications will usually take place with an Audit Committee or similar body acting on behalf of the Board[13]. Appropriate communication with the Audit Committee or other relevant governance body contributes to the quality of the audit and assists both parties to discharge their responsibilities effectively.

In relation to the majority of audits reviewed, we found communications with audit committees to be timely, thorough and clear. However, on a minority of audits reviewed we identified disclosure errors and instances of non-compliance with accounting policies that had not been reported to the Audit Committee.

Communication in the absence of an audit committee

In situations where an entity's governance structure is not well defined, the auditor is required to determine with the entity the persons to whom audit matters of governance interest are to be communicated. This situation could potentially arise in relation to a large number of subsidiaries of foreign parents and some private companies. We found two instances where, in the absence of an audit committee, the audit team had treated the finance director (who was a board member) as the representative of those charged with governance without confirming these arrangements with the board. We noted that there was no firm-wide guidance in this area.

2.4.5 *Audit finalisation*

Audit finalisation procedures include a final analytical review of the financial statements as a whole, a review of events occurring after the end of the financial year that may require adjustment of, or disclosure in, the financial statements ("subsequent events") and consideration of the appropriateness of the going concern assumption in preparing the financial statements.
Generally we noted during our file reviews that the audit finalisation procedures adopted were adequate and that the standard of the relevant documentation on file had improved. However, on just over half of the audits reviewed, improvements are required in the relevant procedures to ensure that all inadequate or erroneous disclosures are properly followed up and included in the letter of representation obtained from the Board. In some cases, audit teams should pay greater attention to their assessment on file of the adequacy of disclosures in financial statements.

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[13] International Standard on Auditing (UK and Ireland) 260, paragraph 11

8 December 2008 END OF REPORT

Appendix A – Firm’s response

The firm’s response is on the following page.

KPMG

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24 November 2008

Dear Sirs

AIU Public Report

We refer to the report issued by the Audit Inspection Unit ("AIU") on its 2007/08 inspection of this firm to which this letter is appended.

We welcome the AIU's recognition of many positive ways in which we put quality in audit at the forefront of what we do, including our response to the global credit crunch. We are also pleased that the high quality of our audits of listed entities is recognised by the AIU.

We are firmly committed to ensuring all our audits are of the highest quality. We continually seek to make improvements, and this includes the timely implementation of actions arising from the work performed by the AIU. We continue to develop and enhance our professional and business training programmes and our extensive internal review processes continue to underpin our commitment to audit quality.

Fundamental to our view of audit quality is a carefully balanced focus on effectiveness and efficiency. Just as auditors use their judgment to determine the auditing procedures to be performed, the AIU's observations are based upon their assessment of audit risk and financial statement materiality. We may on occasions have differing views as to the nature and extent of necessary auditing procedures, resulting conclusions, and/or required documentation in specific circumstances, but we recognise that judgments are involved in both the performance of an audit and the subsequent inspection process.

Part of the balance to be achieved requires that our teams spend the majority of their time assessing audit risks on individual engagements and then performing the appropriate audit test work. Whilst we acknowledge that audit documentation can always be improved, and we will continue to strive to do so, this is a key area where judgment is required. It is vital that the public reporting in this area remains balanced – too much emphasis on excessive levels of documentation will result in a "tick box" approach which, in our view, will undermine the very objective we are striving for – ever increasing audit quality.

With regard to the detail of the AIU's observations we note that the sample used for review is necessarily very small and therefore care should be taken in drawing conclusions about any themes arising. Furthermore, we are pleased that the AIU has not questioned the appropriateness of any audit opinion that the firm has issued and has not found any matters to report to the Financial Reporting Review Panel, in either this or in prior years.

Finally, we would like to thank the AIU for the open and constructive manner in which its review was conducted.

Yours faithfully

KPMG LLP

KPMG LLP

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