



AUDIT INSPECTION UNIT

PUBLIC REPORT ON THE 2008/9 INSPECTION OF KPMG LLP AND KPMG AUDIT PLC

5 NOVEMBER 2009

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 Scope, objectives and background information

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 2009 (“the 2008/9 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 2008 to January 2009 (referred to as “the time of our inspection”). This is the second year the AIU has reported publicly on individual firms.

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 annually¹. The 2008/9 inspection was the AIU’s fifth inspection of the firm. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU’s 2008/9 report to the ARC, which was finalised in July 2009, recommended that the firm’s registration to conduct audit work should be continued.

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 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.

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.

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 2008/9 cycle of inspections on two dates. 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 2008/9 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.

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 Regulations³. 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.

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 12 individual audit engagements undertaken by the firm in our 2008/9 inspection. These related to FTSE 100, FTSE 250, other full listed and other major public interest entities with financial year ends between June 2007 and March 2008, the majority of which were December 2007 or later. Our reviews covered selected aspects of the audit only. In addition, we undertook two follow-up reviews 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 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

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.

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

KPMG Europe LLP (“ELLP”) is a limited liability partnership which commenced operations following the merger of the UK and German member firms of KPMG International in October 2007. Its registered office is in London but it is headquartered in Frankfurt. The KPMG International member firms in Switzerland, Spain (excluding the audit entity, KPMG Auditores S.L.) and Belgium (excluding the audit entity, KPMG Reviseurs d’Enterprises (SCRL) also joined the merged firms and the businesses became members of ELLP on 30 September, 1 October 2008 and 31 March 2009 respectively. Subsequently, the Dutch Turkish, Russian and CIS and Luxembourg member firms of KPMG International voted to join ELLP with effect from 1 October 2009.

While ELLP is a UK registered audit entity and controls the UK, German and Swiss 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. Both entities share common systems to manage their businesses and to address the requirements of audit regulation. 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 functions, 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 21 offices within the UK.

For the year ended 30 September 2008, the firm’s turnover was £1,619 million, of which £464 million related to the audit function. The total number of partners and staff was

11,265⁴. There were a total of 563 partners, of whom 183 were authorised to sign audit reports, and 108 employees who were also authorised to sign audit reports⁵.

The AIU estimates that the firm had 444 audit clients within the scope of independent inspection by the AIU as at the 2008/9 reference date of 28 February 2008. Of these audit clients, AIU records show that 219 had a full listing or were listed on the AIM market of the London Stock Exchange⁶, including 25 FTSE 100 audit clients and 45 FTSE 250 audit clients.

1.4 Reporting on our reviews of individual audit engagements

The AIU introduced new reporting arrangements in respect of its reviews of individual audit engagements commencing from 2008, with the objective of increasing transparency and meeting the increased expectations of stakeholders. This involved issuing new letter style reports on audits reviewed by the AIU. Although addressed to the relevant audit engagement partner or director, the Oversight Board expects firms to provide copies of these reports to the directors of the relevant clients.

⁴ As disclosed in the firm's annual report for the year ended 30 September 2008. An analysis of Assurance turnover between audit and non-audit fees is not publicly available.

⁵ As disclosed in the annual return to the ICAEW as at 31 May 2008.

⁶ The firm also had other AIM listed audit clients below the threshold for inclusion within the AIU scope.

2 Findings

2.1 Overview

Our review of KPMG's strategy, its business plan for the audit function and the tone and content of key external and internal communications indicated the significance placed by the firm on audit quality.

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, particularly those in relation to the economic downturn, and the monitoring of quarterly mandatory training, as described in section 2.2.3. These procedures are intended to ensure that all significant matters are communicated promptly. In our view, they are likely to make a positive contribution to audit quality. We identified certain areas for improvement, including some matters relating to performance evaluation 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 by reference to significant matters arising on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

We were generally satisfied, subject to our comments in sections 2.4.2 and 2.4.3, with the basis on which significant audit judgments were made on the 12 audits reviewed by us. In our view, audit procedures were generally performed to a good or acceptable standard and, in relation to two listed entities, 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, one of the audits we reviewed, relating to a listed entity, required significant improvements in relation to planning audit work effectively and the adequacy of both controls and substantive testing in the audit of key divisions selected on a rotation basis.

The two follow-up reviews we conducted showed that the issues we raised in the previous year had been fully addressed on one of those audits, but that some of the issues had not been fully addressed on the other audit. Although these issues were not significant in nature, we expect all issues raised by us to be addressed appropriately in subsequent years.

KPMG has addressed the overall findings arising from our prior year inspections and its own quality review procedures and has implemented its action plan satisfactorily.

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 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 KPMG 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 audit business plan cites quality, profitability, growth and people as its key priorities. 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 and newsletters. It also publishes an Annual Report and, as of 2008, a Transparency Report. The largest audit firms agreed to publish transparency reports on a voluntary basis in response to the recommendations of the "post-Enron" group, set up by the Government. Quality is a key theme running through KPMG's Transparency Report which includes clear and relevant information on the firm's legal and governance structures, system of quality control and independence policies and procedures.

We met members of the Board, the Executive Committee and other senior partners and reviewed the firm's strategy, 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 are prominent features of the firm's strategy, communications and actions and are 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 the outcome is 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 appropriate emphasis is placed on the delivery of high quality audits.

Appraisal process within the audit function ("audit")

Generic goals relating to audit quality have been developed and are included within the appraisal template. However, these can be de-selected and we have found, in a small minority of cases, that they are not always substituted with appropriate, alternative quality objectives.

We noted in our review of some appraisal forms that the results of AIU reviews had been reflected in an unduly positive manner with insufficient emphasis on areas where a need for improvement had been identified.

Appraisal process outside the audit function

All partners and directors who are based outside the audit function and who are authorised to sign audit opinions are expected to adhere to appraisal procedures followed within audit. As a result of our findings in this area last year, we reviewed the appraisal forms of half the 16 partners based outside the audit function who are authorised to sign audit opinions. We found that there was insufficient input from audit in their performance appraisals and either little or no evidence of input from their appraisers, who were partners based outside audit with no audit responsibilities. We concluded from our review of these appraisal forms that the achievement of audit quality objectives does not have as significant an impact on partners' overall performance assessment as their achievements in other roles. However we found evidence from our work on remuneration that audit quality assessments do have an impact on partners' remuneration regardless of the function in which they are based.

We also noted last year that no formal procedure was 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. An instruction was issued to all partners in charge of audit groups during 2008 to address this matter and we will monitor compliance with its requirements on future inspections.

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 at mandatory courses is monitored monthly and follow-up procedures are in place for non-attendees to attend alternative sessions or complete appropriate self-study courses. The effectiveness of this monitoring process has resulted in close to 100% attendance and we consider it to be a particular strength. 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. We also consider this to be a particular strength.

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 met 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.

Communications and other actions relating to the economic downturn

The firm continued to address the risks associated with adverse conditions in the financial markets and the general economic downturn through regular and frequent communications across the audit practice and by introducing or enhancing a number of audit initiatives. Specific bulletins and briefing papers were issued outlining the causes of continuing adverse market developments and the potential threats, particularly for those clients outside the financial services sectors. They also covered the continually evolving consequences for financial services clients and the ramifications for year-end reporting. In addition, the firm used its established communication processes and dedicated credit crunch intranet site to share relevant intelligence across the practice and raise awareness of the increased level of risk emerging in the conduct of all audits. Within the financial services sector, the weekly conference calls, established in 2007 to facilitate discussion of emerging issues among partners and directors, continued on a monthly basis throughout the year and then increased in frequency to a weekly basis as the December 2008 year-end approached.

During the course of 2008, going concern issues rapidly became a focus in all sectors and these were discussed and evaluated at each engagement partner's annual risk review. It became a requirement for the audit team of any listed, AIM or public interest entity to consult the firm's technical department in the event of any doubt in relation to going concern matters and arrangements were put in place for special going concern technical panels, drawn from a discrete pool of senior partners. In October 2008 enhanced early stage going concern procedures were introduced including a new requirement for engagement quality review (EQCR) partners to consider going concern matters and their impact on the audit approach earlier than would be the case under normal circumstances.

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 engagement⁷.

⁷ International Standard on Quality Control (UK and Ireland) 1, paragraph 28.

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 UK Head of Audit Risk Management meets with each business unit leader to understand and, where appropriate, challenge the outcome of these discussions, particularly those in relation to higher risk clients. The decision to continue to act as auditors to the highest risk clients must be discussed with and approved by the UK firm's Head of Risk Management and the UK Head of Audit.

In the course of our file reviews we evaluated the acceptance/continuance procedures adopted. We also interviewed a number of business unit leaders and reviewed a sample of CEAC forms. We identified a small number of forms in our sample which had not been fully completed on a timely basis, but nevertheless concluded in each case 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 (EQCR) to be undertaken for all audits of financial statements of listed entities and other audits meeting specified criteria⁸.

An 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 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.

⁸ International Standard on Quality Control (UK and Ireland) 1, paragraph 60.

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.

Pre-issuance technical reviews

In the year under review, a pre-issuance review by the technical department was required for the annual accounts of: all FTSE 500, AIM companies and companies with listed debt that were first time adopters of IFRS or were preparing accounts under IFRS for the second time. 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.

We met partners from the technical department and FS Technical Advisory and we reviewed the output of technical reviews on individual audits. We found the firm's procedures to be appropriate and the output to be of a good standard.

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 annually⁹.

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. Each firm is required to implement this global policy through two distinct reviews. 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.

In the case of QPR, 122 UK audit engagements were reviewed during the spring and summer of 2008. 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. A grading system is used to assess each audit. The grades used are: satisfactory, satisfactory with comments, performance improvement necessary and unsatisfactory.

⁹ International Standard on Quality Control (UK and Ireland) 1, paragraph 74 and the ICAEW's Audit Regulations.

We reviewed these procedures, the results of the 2008 reviews and follow-up actions by the firm. We concluded that the firm had continued to invest 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 LLP's Code of Conduct" which was issued in October 2008 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, but updates have been included to reflect the revised APB Ethical Standards.

The risk management and ethics partner roles are fulfilled by the same person within the UK firm, the UK Head of Risk Management. 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. All partners and managers within client-facing functions are required 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 the completeness of the self-clearance process and any matters arising, and audits every quarter the information held on the database for a sample of individuals, primarily more senior partners and staff.

The 2008 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.

The firm has established an ethics register as a formal disciplinary process to keep track of ethics and independence breaches and to reinforce the importance of compliance to all partners and staff. Individuals will be removed from the register after two years provided no further breaches occur. At the beginning of 2008 there was one ethical standard breach logged in the ethics register for a partner who is an RI. Another two breaches were reported and logged in the register during 2008 for partners who are not RIs. All three cases related to the holding of securities in a UK audit client. None of the individuals provided services to any of the entities in question. We were informed that in each case the breach was inadvertent and rectified as soon as it was identified.

To confirm our understanding of the firm's compliance monitoring procedures we met both the UK Head of Risk Management 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 the level of compliance had improved during 2008 following the delivery of mandatory training to all those required to input data to the firm's independence database.

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 partners (KPs) are required to rotate after seven years¹⁰.

Rotation policies and guidance

Within KPMG the audit engagement partner is primarily responsible for ensuring compliance with rotation requirements. We reviewed the firm's rotation policies and procedures and also confirmed the appropriate application of these policies on the specific audits covered by our file reviews.

¹⁰ APB Ethical Standard 3 (Revised), paragraphs 5, 6, 12 and 18. "Key partners" are partners other than the audit engagement partner responsible for key audit decisions or judgments.

The central rotation monitoring database (the CMS database) is not a real-time system, but is updated from the financial system on a monthly basis. The database holds inter alia, basic client data and details of the length of service of relevant partners whose roles are subject to rotation rules, and a number of reports can be produced for monitoring purposes. 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.

The partners in charge of business units are responsible for ensuring that the data held on the CMS database is accurate and are required to sign off monthly to this effect for listed clients and annually for unlisted clients. Any issues identified by the audit team or 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 UK Head of Audit Risk Management as appropriate.

Last year we identified inaccuracies in the data held on the CMS database. We were informed that during 2008 the data held had been subject to a more rigorous checking procedure than in prior years and that the firm's QPR and RCP reviews in the current year had found no errors, concluding that the system was being operated and controlled in a satisfactory manner.

We requested access to the CMS database during our inspection to check whether the quality of data had improved. We tested the information held for a number of audit clients and found that all data critical to rotation was accurate. As reported last year the CMS system is due to be replaced by a new system during 2009.

Long association and key partners (KPs)

It is the responsibility of the audit engagement partner to consider whether any other partners on the audit should be classified as KPs. During 2008, KPMG's audit methodology was updated to reflect changes to the definition of KPs in the revised Ethical Standards and the requirements for rotation. At the time of completing our inspection, the number of internal specialists identified as KPs on the firm's major audits was small. At this stage the firm had not fully implemented the revised requirements across the audit practice since they apply for financial years ending on or after 5 April 2009. In view of the revisions to the Ethical Standards, however, we expected to see more evidence on the audits reviewed by us that audit engagement partners had considered whether any other partners involved in the audit were responsible for key judgments and should be designated KPs for the following year.

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 a further instance this year where the independence

threats and safeguards required in relation to an extended period of service had not been properly considered or assessed.

In our view some improvements to the firm's rotation policy and procedures are required in the area 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 is currently being piloted in the UK and will be implemented in 2010 and 2011. We believe that the introduction of automated audit software will improve the quality of audit files by assisting audit teams in linking audit planning with work steps executed and conclusions reached.

In prior years we have reviewed the firm's mapping of Auditing Standards to its audit methodology. This year we reviewed any updated material 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, KPMG's firm-wide approach to financial services audits continued to be a strength; 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 believe that KPMG's audit methodology 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")¹¹. 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.

Response to economic downturn

As part of our firm-wide procedures this year we reviewed the audit teams' approach to the risks arising from increasing market turmoil and the procedures adopted to address these risks. In our view, the audit teams were able to demonstrate that they had applied the guidance issued by the firm in response to adverse market conditions. There was also evidence on file that they had both identified and addressed the significant risks arising in an appropriate manner. Of particular note were: the early briefing meetings held with client management; the insistence on the preparation of a rigorous assessment of going concern risks by boards and management and the use of technical panels at appropriate stages of the audit.

Risk assessment, planning and controls

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. However, on a minority of files reviewed, we identified issues relating to either the adequacy or timeliness of planning procedures. In particular we expressed concerns in relation to the audit of one listed entity and concluded that improvements were required in relation to planning audit work effectively and the adequacy of both controls and substantive testing in the audit of key divisions selected on a rotation basis.

¹¹ International Standard on Auditing (UK and Ireland) 315, paragraphs 100 and 108.

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. Continued efforts by the firm to provide guidance and coaching in this area resulted in an improved approach compared with last year.

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 valuation of financial instruments, loan loss provisions, work-in-progress, goodwill, property valuations and bad debt provisions, we were generally satisfied that the judgments were appropriate and had been given due consideration. We found that the quality of audit evidence on file supporting key audit judgments had improved overall this year and, in the majority of audit files we reviewed, appropriate audit partner involvement in the resolution of key audit issues was apparent.

However, on the files of one audit there was, in our view, insufficient evidence of the team's consideration and assessment of the appropriateness of a change in a key assumption used in determining loan loss provisioning levels. This had a material impact on the ultimate level of provisions which decreased compared with the prior year.

Reliance on third-parties

A recurring issue in prior years has been the quality of audit evidence on file to support the decision to rely on the work of third parties. In the current year we did not review any audits where reliance had been placed on service organisations or internal audit. However, the majority of audits we reviewed included one or more specialist areas where the audit team relied on the work of experts and we noted an overall improvement in this area.

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 Board¹². 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 noted that one or more of the following matters had not been reported to the Audit Committee: certain planning issues, control weaknesses, material disclosure errors and omissions, instances of non-compliance with accounting policies and inadequate reporting by subsidiary auditors.

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.

We noted an overall improvement in the audit finalisation procedures adopted and the standard of the relevant documentation on file compared with the previous year. However, we noted some instances of unexplained erroneous disclosures and/or insufficient consideration of the adequacy of accounts disclosures on half the audits reviewed.

Going concern

At the commencement of this year’s inspection visit, there was evidence of significant market turmoil and a threat of an economic downturn. As a result, going concern was a key area of focus in this year’s file reviews. The firm had enhanced its procedures in relation to going concern and these were appropriately adopted by audit teams on all the audits we reviewed. Nevertheless, we identified some aspects of going concern work, on a minority of audits, where we believe the procedures should have been further enhanced given the prevailing and anticipated market conditions.

5 November 2009

END OF REPORT

¹² International Standard on Auditing (UK and Ireland) 260, paragraph 11.

Appendix A – Firm’s response

The firm’s response is on the following page.



KPMG LLP
Audit
8 Salisbury Square
London EC4Y 8BB
United Kingdom

Tel +44 (0) 20 7311 1000
Fax +44 (0) 20 7311 3311
DX 38050 Blackfriars

Private & confidential.
Audit Inspection Unit
Aldwych House
71-91 Aldwych
LONDON
WC2 4HN

28 October 2009

Dear Sirs,

AIU Public Report 2008/9

We are pleased that the AIU has again applauded our commitment to audit quality and note specifically the various references highlighting our continuous improvement. This is further demonstrated by their review nine months ago of the subsequent year's audit in the one instance where they believed that significant improvement was required – this confirmed that all the matters raised had been appropriately dealt with. As in prior years we are also glad to note that the AIU has not questioned the appropriateness of any audit opinion that the firm has issued.

We do not believe that we are ever far apart from the AIU's considered opinion on the various topics. However the degree of emphasis is necessarily occasionally different as we have to achieve a careful balance of effectiveness and efficiency. Also, it is sometimes difficult for the AIU inspectors to "re live" an audit in a cold file review many months later. The following comments should be viewed in this context.

The FRC's overall aim is to promote confidence in corporate reporting and governance. We fully accept such confidence needs to be well founded, but we would question whether starting to include in the public report certain very minor single instances is commensurate with that objective. Such blemishes should not be permitted to taint the profession merely because there are insufficient comments of substance to be made.

In addition we are pleased that the AIU has commended us for our reactions to the crisis. As regards the application of policies to specific going concern considerations it is difficult to ignore subsequent events. In that context however we believe that the circumstances following the collapse of Lehman in September 2008 led to market conditions that we do not consider it was reasonable to fully anticipate in early 2008.

Lastly, we would like to take this opportunity to thank the AIU for the open and professional manner in which the review was conducted.

Yours faithfully

KPMG LLP



FINANCIAL REPORTING COUNCIL

5TH FLOOR

ALDWYCH HOUSE

71-91 ALDWYCH

LONDON WC2B 4HN

TEL: +44 (0)20 7492 2300

FAX: +44 (0)20 7492 2301

WEBSITE: www.frc.org.uk

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Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.