Public Report

Financial Reporting Council

May 2013

# KPMG LLP and KPMG Audit Plc

## Audit Quality Inspection

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.



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## Contents

# 1. Background information and key messages

## 1.1. Introduction

This report sets out the principal findings arising from the inspection of KPMG LLP and KPMG Audit Plc (together referred to in this report as “KPMG” or “the firm”) carried out by the Audit Quality Review Team of the Financial Reporting Council (“the FRC”), during the year to 31 March 2013 (“the 2012/13 inspection”). We inspect KPMG annually. Our inspection was conducted in the period from April 2012 to January 2013 (referred to as “the time of our inspection”). The objectives of our work are set out in Appendix A.

Our inspection comprised reviews of individual audit engagements and a review of the firm’s policies and procedures supporting audit quality.

We reviewed 13 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 2011 and March 2012. Our reviews were selected on a risk basis, utilising a risk model; each review covered only selected aspects of the relevant audit.

Our responsibility is to monitor and assess the quality of the audit work performed by the UK firm. Accordingly, our reviews of group audits covered the planning and control of the audit by the group engagement team, including their evaluation of the adequacy of the work performed by component auditors, and selected aspects of other work performed by the UK firm at group and/or component level.

Each year we select a number of audit areas of particular focus. For 2012/13 these were: the valuation of assets held at fair value; the impairment of goodwill and other intangible assets; the recoverability of deferred tax assets; the assessment of going concern; revenue recognition; and related party relationships and transactions.

In addition, we undertook two follow-up reviews to assess the extent to which our prior year findings on those audits had been addressed in the following year’s audit.

Our review of the firm’s policies and procedures supporting audit quality covered the following areas:

Tone at the top and internal communications
Transparency report
Independence and ethics
Performance evaluation and other human resource matters
Audit methodology, training and guidance
Client risk assessment and acceptance/continuance
Consultation and review
Audit quality monitoring
Other firm-wide matters

We exercise judgment in determining those findings which it is appropriate to include in our 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 our overall inspection programme for the relevant year. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

Further information on the scope of our work and the basis on which we report is set out in Appendix A.

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

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

We acknowledge the co-operation and assistance received from the partners and staff of KPMG in the conduct of our 2012/13 inspection.

## 1.2. Background information on the firm

The UK firm of KPMG is owned by KPMG Europe LLP ("ELLP") which is a limited liability partnership created through a merger of the UK and German member firms of KPMG International in October 2007. It has since been enlarged to include a number of other KPMG member firms. The majority of the partners of KPMG are members of ELLP. The management of ELLP and its operating subsidiaries lies primarily with the Board of ELLP. The UK Board and Executive Management Team have responsibility for the UK firm's general and operational management. The KPMG office in Northern Ireland is part of the Irish member firm, which is not part of ELLP, and does not have any audits within our scope.

The UK firm has 23 offices and 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. For the year ended 30 September 2012, the firm's turnover was £1,774 million, of which £469 million related to audit work and directly related services. There was a total of 602 partners, of whom 156 were authorised to sign audit reports, and 108 employees who were authorised to sign audit reports[1].

We estimate that the firm audited 436 UK entities within the scope of independent inspection as at 29 February 2012. Of these entities, our records show that 170 had securities listed on the main market of the London Stock Exchange, including 21 FTSE 100 companies and 48 FTSE 250 companies. Audits of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area are subject to inspection under arrangements

[1] As disclosed in the annual return to the ICAEW as at May 2013.

agreed with the relevant regulatory bodies. Our records show that the firm has ten such audits, including one FTSE 250 company.

### 1.3. Overview

We focus in this report on matters where we believe improvements are required to safeguard and enhance audit quality. We set out our key messages to the firm in this regard in section 1.4. While this report is not intended to provide a balanced scorecard, we highlight certain matters which we believe contribute to audit quality, including the actions taken by the firm to address findings arising from our prior year inspection.

The firm places considerable emphasis on its overall systems of quality control and, in most areas, has appropriate policies and procedures in place for its size and the nature of its client base. Nevertheless, we have identified certain areas where improvements are required to those policies and procedures. These are set out in this report.

Our file review findings, as set out in section 2, largely relate to the application of the firm's procedures by audit personnel, whose work and judgments ultimately determine the quality of individual audits. While we have seen improvements in audit quality in some areas, a number of findings continue to recur as set out in this report.

In general, the findings arising were diverse in nature and did not fall into common themes. However, we were particularly concerned by the independence and ethical issues arising. The firm's leadership should take responsibility for ensuring that all independence and ethical requirements are complied with.

### 1.4. Key messages

The firm should pay particular attention to the following areas in order to enhance audit quality or safeguard auditor independence:

- Undertake a detailed review of the firm's ethical policies, procedures, guidance and training and ensure that improvements are achieved in the awareness of and attention to ethical matters and in dealing with them in practice.
- Strengthen the testing of general IT controls, particularly for financial services entity audits, for example by undertaking additional work when control deficiencies are identified.
- Reinforce the firm's approach to the audit of specific and collective impairment provisions on financial service entity audits, ensuring that audit work is extended when issues are identified or when further supporting evidence should be sought.
- Provide clarification to audit teams regarding what work may be performed by off-shore staff and enhance the monitoring of their use.
- Review the firm's methodology for sampling for substantive testing purposes, particularly when "specific item testing" is undertaken, and issue further guidance to ensure audit teams undertake appropriate audit procedures over residual balances.
- Strengthen the firm's policies and procedures in relation to Engagement Quality Control Reviews.

## 2. Principal findings

The comments below are based on our reviews of individual audits and the firm's policies and procedures supporting audit quality.

### 2.1. Review of audit engagements

#### Follow-up of audits reviewed in the prior year

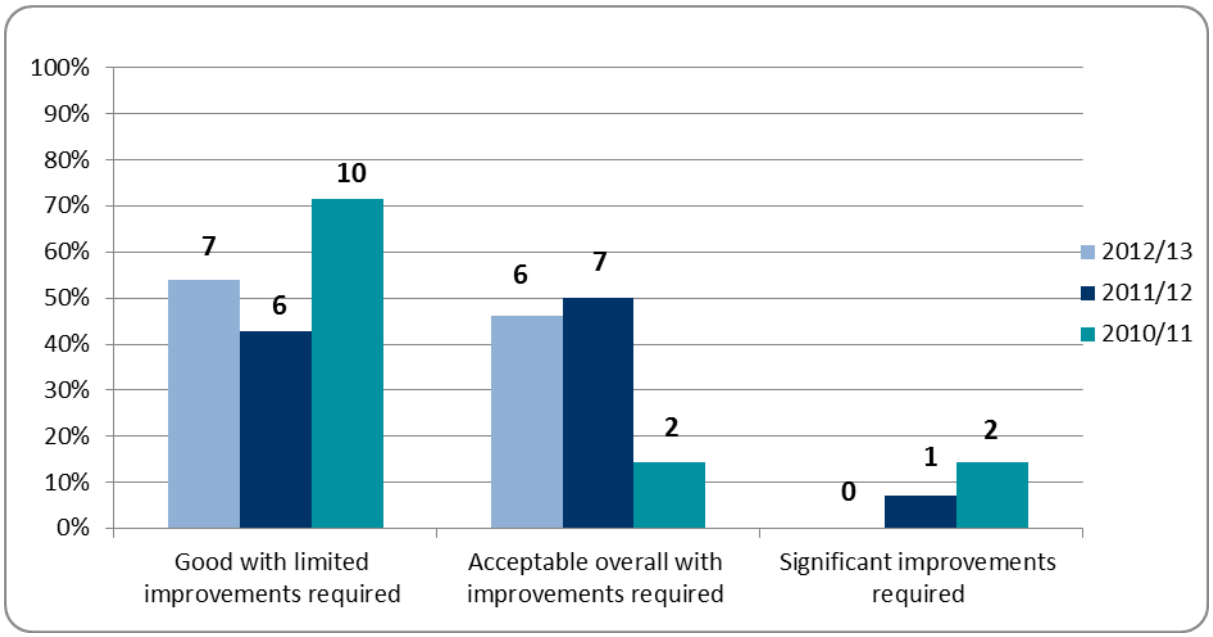
We undertook two follow-up reviews of audits we reviewed in the prior year. The issues arising from our prior year review had been addressed on these audits, resulting in improvements to audit quality in the relevant areas.

#### Audits reviewed in the current year

We reviewed and assessed the quality of selected aspects of 13 audits.

In our view, seven of the audits we reviewed (2011/12: six) were performed to a good standard with limited improvements required, six audits (2011/12: seven) were performed to an acceptable overall standard with improvements required and none (2011/12: one) required significant improvements.

The bar chart below shows the percentage of the audits we reviewed in 2012/13 falling within each grade, with comparatives for 2011/12 and 2010/11.



An audit is assessed as requiring significant improvement if we had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of audit judgments in one or more key audit areas or the implications of concerns relating to other areas are considered to be individually or collectively significant. This assessment does not necessarily imply that an inappropriate audit opinion was issued.

Changes to the proportion of audits reviewed falling within each grade from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review, changes to our areas of particular focus and the scope of the individual reviews. For this reason, and given the small sample sizes involved, changes in gradings from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

## Findings in relation to audit evidence and judgments

Our reviews focused on the audit evidence and related judgments for material areas of the financial statements and areas of significant risk. We draw attention to the findings below which the firm should ensure are addressed appropriately in future audits.

The implication of such findings for our grading of an audit depends on their significance in the context of the individual audit. Even where our overall assessment of an audit was that the improvements required were limited in nature, we consider the relevant findings for inclusion in this report if we consider them important in the broader context of improving audit quality at the firm.

### *Recurring findings*

In response to our prior year findings, the firm has taken steps to achieve improvements.

We have seen developments in the audit of goodwill impairment assessments and the planning of group audits, particularly risk assessment procedures and two-way communications between the group auditors and other auditors. We also observed a general improvement in the identification of significant risks.

Some of the actions taken by the firm were not in place until after the audits reviewed by us in the current year had been undertaken. Issues continued to arise in the areas noted below and the firm should, therefore, review the effectiveness of its actions in these areas.

*Loan impairment provisions*

We reviewed three audits of financial services entities and, in each case had concerns in relation to the audit of loan loss provisioning.

For example, in one case, the audit of impairment provisions relating to UK retail and corporate loans required improvement in the areas set out below.

In calculating the collective impairment provision, management segmented corporate loans by industry sector. Whilst information was also available which assessed loans on a credit risk scale,

management's collective provision did not take this assessment of the probability of default into account. The audit team should have specifically evaluated whether it was appropriate for commercial loans to be segmented only by industry sector for this purpose, without using the other credit risk characteristics available to management.

In relation to specific impairment provisions, the audit team tested the valuation of loans and evaluated the effectiveness of management's annual review control to ensure that the credit risk ratings were appropriate. However, in concluding on the adequacy of specific provisions, for a number of the loans tested the audit team did not adequately test certain of the key inputs and assumptions used in the annual review process.

Furthermore, insufficient audit evidence was obtained that all forbearance arrangements in place for commercial and retail loans had been identified for disclosure and provisioning purposes.

Given the findings on the relevant audits reviewed, the firm should take further action to improve the consistency of its audit approach, including: ensuring adequate audit evidence is obtained to support key assumptions used and judgments made; and demonstrating appropriate challenge of management and exercise of professional scepticism in relation to responses received from management.

*Group audit considerations*

We assessed the quality of the firm's audit work in this area on all the relevant audits we reviewed. We identified a lack of evidence of certain group audit procedures on four audits. For example, in one case it was unclear whether all issues raised by component auditors had been resolved satisfactorily at a group level. In a second case there was insufficient evidence of adequate procedures to ensure the accuracy of subsidiary trial balance figures reported on by component auditors and used within the consolidation process.

*Audit of goodwill and other intangible assets*

We reviewed the firm's audit of goodwill and other intangible assets in eight audits, including six FTSE 350 entities. In one audit, there was insufficient evidence of the auditor's assessment of the revenue and operating expense growth rates and the long-term growth rate assumed in the terminal value. In a second audit, the auditors had not identified deficiencies in the disclosure of growth rate assumptions in the goodwill note in the financial statements.

We also identified cases of insufficient challenge of the useful economic lives of other intangible assets on three audits. On a further audit, there was insufficient work performed to support the valuation attributed to acquired intangible assets.

*Revenue recognition*

We identified weaknesses in relation to the audit of revenue on four audits.

On one of these audits, while enquiries were made into the appropriateness of the revenues recognised on long-term contracts, appropriate corroboration of management's explanations should have been obtained. On the same audit, insufficient substantive procedures were performed in respect of non-contract revenues.

Weaknesses identified on the other three audits included insufficient evidence to support the deferral of revenue to cover incomplete installation services; insufficient substantive testing of the revenue recognised during the year at three of the four major sites visited; and inadequate justification of the rebuttal of the presumption required by Auditing Standards that revenue recognition is an area involving significant fraud risks.

*Substantive analytical review*

In three audits, we found weaknesses in the substantive analytical procedures performed. On one of these audits the expectations set did not take account of all relevant information. On the other two audits the work performed was only a high level analysis and therefore limited audit evidence was obtained.

### *New findings*

*General IT controls*

We found deficiencies in the testing of general IT controls on two audits.

On one audit, there was insufficient evaluation of the implications of three controls being found to be ineffective and the auditors had not tested certain authorisation controls.

On a second audit, we identified a number of concerns over the testing of general IT controls. This included insufficient assessment and testing of the effectiveness of new controls intended to address significant control weaknesses identified in the prior year and instances where the audit team concluded that there were no control deficiencies when deficiencies had in fact been identified by their IT specialist. Inadequate audit procedures were, therefore, performed to conclude on the effectiveness of general IT controls. As a result, the testing of automated application controls using a sample of one item was not sufficient.

*Inventories*

On three audits, we identified weaknesses in the audit of inventory balances. In the first case, the levels of audit testing relating to physical verification, cost analysis and provisioning were insufficient. On the second audit, the teams did not review the coverage and results of the company's own perpetual inventory counting and confirm that any material differences had been investigated and

corrected. In the last case, they also did not consider the implications of the inventory count control weaknesses to determine whether additional audit procedures were required.

*Substantive tests of detail*

We have observed an increase in the use of "specific item testing", the selection of items to test based on certain risk criteria, by audit teams. When performed, the firm's guidance permits no further testing over material residual balances where the risk of a material misstatement in that balance is assessed as 'acceptably low'. Based on our reviews, audit teams frequently conclude that the risk is acceptably low without sufficient justification. Further guidance is needed to ensure audit teams are required to undertake sufficient appropriate audit procedures over residual balances.

On three audits, we raised concerns regarding the level of substantive audit evidence obtained or the level of corroboration of evidence provided by management. In one case, reliance was placed for provisioning purposes on reports prepared by management but the auditors did not test the reliability of these reports. In the same audit, substantive testing of assets under construction was performed at a high level only with insufficient corroboration of management explanations. In the second audit, we considered that insufficient work had been performed in relation to the completeness and existence of derivatives. In the third case, we found insufficient challenge of the appropriateness of a 100% provision raised against a fixed asset investment.

## Findings in relation to independence and ethics

On three audits, there was insufficient evidence that the audit team had given appropriate consideration to the threats and safeguards relating to the provision of non-audit services. On one of these audits, the firm's Ethics Partner should have been notified of a contingent fee arrangement for certain tax services and asked to confirm whether, in the circumstances, this was permissible under Ethical Standards.

## Findings in relation to quality control and audit finalisation

*Engagement quality control reviews*

There was insufficient evidence of the appropriate involvement of the engagement quality control reviewer ('EQCR') on five audits, including considering those areas involving significant judgment.

On two audits for which an EQCR had not been appointed, we considered that this was inappropriate given the level of public interest involved and the firm's policies should be reconsidered in this area.

## Other Findings

*Reporting to Audit Committees*

We considered the sufficiency, quality and timeliness of the firm's reporting to Audit Committees on all the audits we reviewed and identified three aspects requiring improvement.

On four audits, independence threats and related safeguards adopted, particularly in regard to the provision of non-audit services, were not adequately reported to the Audit Committee.

On eight audits there were inconsistencies and/or omissions in the reporting of significant risks to the Audit Committee.

In two audits, there was no evidence that the audit team had asked the Audit Committee to correct unadjusted audit differences close to the level of materiality, as required by Auditing Standards. The firm's Audit Committee report template did not include any wording requesting that unadjusted misstatements be adjusted in finalising the financial statements.

## 2.2. Review of the firm's policies and procedures

The firm's policies and procedures have been developed either globally or at an ELLP level and the UK firm puts significant resources into the global, ELLP and its own central support functions, such as risk management, audit and accounting technical, independence compliance and HR.

The strategy of the audit practice emphasises the importance of audit quality. The audit practice also continues to focus on revenue growth and audit efficiency, partly to address continuing audit fee pressures.

### Improvements in the year

The firm took action to address a number of our prior year findings and enhanced its procedures in certain areas, including those referred to in section 2.1 above in relation to the performance of audits.

Of particular note was the full use of audit quality metrics (used in the prior year for partner appraisals) in manager appraisals and further enhancements to the partner performance evaluation system itself to improve consideration of audit quality matters. Enhancements were also made to the firm's electronic audit software.

In addition, in response to matters raised by us in the prior year, the firm introduced a new independence compliance process which, inter alia, is intended to more easily identify and monitor business relationships with audit clients. We will review this new process during our next inspection.

### Prior year finding not addressed

*Pre-issuance reviews of financial statements*

We reported in the prior year that, in our view, there should be a requirement for the firm's Department of Professional Practice to review the clearance of any significant matters raised by them in a pre-issuance technical review prior to the audit report being signed. The firm takes the view that the engagement partner retains responsibility for the audit report and does not need to seek such clearance. Nevertheless, we recommend that the firm reconsiders this point in the light of increased complexity of reporting and the practice of its peers in this area.

## Findings in the current year

We identified certain areas where improvements to the firm's policies and procedures are required, as set out below, which need to be addressed.

### *Independence and ethics*

*Ethical issues arising in relation to partner appointments and departures*

Financial interest in an audited entity

On re-joining the firm as a partner a former executive of an audited entity had a significant shareholding in that entity. Ethical Standards do not permit partners of the firm to hold any direct financial interest in an audited entity. The individual did not dispose of the shareholding upon joining the firm and it was some months before this was done. We were informed that senior personnel with responsibility for the firm's ethical compliance arrangements were not aware of this issue until it was drawn to their attention as a result of our inspection. We were advised that the firm has subsequently penalised the relevant partner and established that no financial benefit was obtained from the delay in disposal.

Appointment to senior management role

The individual referred to above was subsequently promoted to a senior management role within the firm. This appointment occurred prior to the completion of the audit of the relevant company but after the audit findings report had been issued to the Audit Committee.

The seniority of this role could indicate that the individual was in the chain of command of the firm. Ethical Standards do not permit the appointment of such an individual to a role in which he or she is able to influence the conduct and outcome of the audit within two years of their departure from the relevant audited entity.

Former partner joining an audited entity

Another ethical matter has come to our attention, concerning the firm's consideration of whether a former partner who joined an audited entity as a Director was, prior to his retirement as a partner in 2010, in the chain of command for audit. If the former partner was in the chain of command, Ethical Standards require the firm to resign as auditor in such a situation.

We have drawn the matters above to the attention of the Conduct Committee, the part of the Financial Reporting Council responsible for professional discipline.

*Personal independence compliance*

The firm maintains separate databases for business and personal ethical consultations and has differing review and assessment processes depending on whether the matter relates to business or personal independence. Panels are held in respect of certain business matters but no such panels

have been held regarding personal independence matters. An issue is elevated to the Ethics Partner if the UK firm's Head of Ethics and Independence believes this to be appropriate.

Personal independence issues do not appear to receive the same degree of scrutiny and attention as business related matters. The firm should review its processes and monitoring procedures in this area and enhance its guidance.

*Ethics Partner role*

Whilst the Ethics Partner has overall responsibility for ethical matters, day to day operational responsibility is delegated to the UK firm's Head of Ethics and Independence and in some cases to the Quality and Risk Management partners in each function. Matters delegated by the Ethics Partner include consideration of contingent fees, consideration of any extension of audit engagement partner tenure and review of cases where non-audit fees exceed audit fees. Regular update meetings are held between the Ethics Partner and those reporting to him.

On one file review, non-audit fees exceeded audit fees but it was not clear to what extent the matter had been discussed with the Ethics Partner. Issues relating to the financial interest in an audited entity noted above should have been identified and reported to the Ethics Partner on a timely basis.

In our view, the extent of delegation of the Ethics Partner's responsibilities should be reconsidered by the firm to ensure that he can properly discharge the role as envisaged by Ethical Standards.

Having regard to the ethical matters arising from our inspection, the firm should undertake a detailed review of its ethical policies, procedures, guidance and training to ensure that there is an awareness of, and attention to, ethical matters at all levels of the firm, and that they are always dealt with appropriately in practice. The ultimate responsibility for this review, and compliance with independence and ethical requirements generally, should rest with the firm's senior leadership.

### *Performance evaluation and other human resource matters*

*Partner performance evaluation*

We reported in the prior year that the existing appraisal system did not ensure the specific consideration or assessment of audit quality matters as an objective against which partners and staff should be appraised. In the current year, the firm extended the scope of comprehensive 'Quality and Risk Metrics' forms as part of the appraisal documentation. These show whether an individual complied with the firm's policies and procedures in respect of a number of quality and risk parameters.

On five out of a sample of partner appraisals reviewed, there was insufficient evidence that adverse audit quality metrics had been taken into account in arriving at the partner's year end grading.

In three cases, the final grade for the partner was altered subsequent to completion of the formal appraisal process but there was no supporting evidence for these changes.

Our review also noted a lack of evidence on partner appraisal forms as to whether all planned ‘quality goals' and ‘balanced scorecard’ requirements had been achieved and assessed during the appraisal process. Whilst we acknowledge that discussions form an important part of the appraisal process, completion of the appraisal documents should be improved to reflect a more comprehensive record of discussions held.

### *Audit methodology, training and guidance*

*Off-shoring of audit work*

During the year the firm continued to develop its off-shoring capability using a “department extension” model whereby audit work performed off-shore is completed under the direction and review of the UK audit engagement team and included within the UK audit files. In 2012, work performed by these centres accounted for less than 5% of the firm’s audit hours. This is planned to increase significantly in future years.

We are continuing to see an expansion in the type of work performed by the off-shore team. Additional guidance containing examples of procedures that are considered appropriate to be performed off-shore was issued by the firm in the year. This guidance included the off-shore team being permitted to summarise, inter-alia, board minutes and certain third party reports. We also identified that in an audit of a financial services entity the off-shore team performed certain work over loan impairments.

In our view, the firm should ensure that audit work, such as reviewing board minutes and certain third party reports, is undertaken by staff with a sufficiently detailed working knowledge of the audited entity in order to be able to identify significant matters.

Furthermore, audit engagement teams have sole responsibility for determining the extent of use of off-shore staff. The firm does not centrally monitor what or how much is requested to be performed by the off-shore team, either operationally to ensure appropriate use or through reviews of the quality of audit work performed off-shore.

*Use of other auditors*

The firm’s audit methodology includes “signing partner arrangements” guidance for use where the firm is the appointed auditor but another KPMG network firm performs a full audit of the relevant financial statements and provides an opinion to the firm on the work performed. The guidance also applies to group audits where the preparation of the group financial statements, including the group consolidation, is performed in the country of the other auditor. The guidance requires further revision to reflect the proper application of current Auditing Standards.

When used for single component audits, this guidance does not appropriately reflect the requirements of Auditing Standards regarding the responsibility of the audit engagement partner for the direction, supervision and performance of the audit. In relation to group audits, or single entity audits where there is more than one component, the guidance does not reflect the need for the group engagement

team, headed by the UK engagement partner, to comply fully with the requirements of ISA 600 in all such cases.

*Audit proposals*

We reviewed a sample of FTSE 350 audit proposal documents.

In one case, the audit proposal included contact details for a Non-Audit Relationship Partner ("NARP"). The NARP is only responsible for the provision of non-audit services to the entity and is not permitted to have any involvement in or influence on the conduct of the audit. In this case the NARP was the former audit engagement partner and was pictured with the current audit team throughout the audit proposal document. There was insufficient distinction between him and the audit team, contrary to the firm's policy and Ethical Standards.

The same audit proposal referred to the potential provision of certain non-audit services which may not be permissible under Ethical Standards (we were informed that these services were not, in fact, provided).

A further audit proposal document included a misleading reference relating to the firm's internal quality control procedures while another proposal document named the EQCR. Whilst the role of the EQCR should be explained in an audit proposal document, the objectivity of the EQCR could be affected by communications with management or the Audit Committee.

All FTSE 350 audit proposals are sent to the Audit Quality and Risk Management team for an informal high level review. In our view, a more detailed formal audit proposal review process should be undertaken for major listed and public interest entities in order to minimise errors, ensure appropriate matters are included and enhance quality control around the proposal process.

*Audit quality monitoring*

The firm's programme for monitoring its policies and procedures and their compliance with Auditing Standards is determined globally and includes a sampling approach and suggested sample sizes for substantive testing in order to ensure a degree of consistency across network firms.

We reviewed the testing performed by the firm relating to the operation of certain aspects of its quality control procedures. In our view, insufficient testing was performed in certain areas, including business relationships and the rotation of EQCRs and key partners involved in the audit.

## *Other matters*

*Transparency report*

We reviewed the firm's transparency report for the year to 30 September 2012, which was published in December 2012, to assess whether the information in the report was consistent with our understanding of the firm's quality control and independence procedures. We did not identify any such inconsistencies.

Andrew Jones
Director
Audit Quality Review
FRC Conduct Division
31 May 2013

## Appendix A – Objectives, scope and basis of reporting

### Scope and objectives

The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC and other requirements under the Audit Regulations issued by the relevant professional bodies. 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.

Our reviews of individual audit engagements and the firm's policies and procedures cover, but are not restricted to, the firm's compliance with the requirements of relevant standards and other aspects of the regulatory framework. Our reviews of individual audit engagements place emphasis on the appropriateness of key audit judgments made in reaching the audit opinion together with the sufficiency and appropriateness of the audit evidence obtained. We also assess the extent to which the firm has addressed the findings arising from its previous inspection.

We seek to identify areas where improvements are, in our view, needed in order to safeguard audit quality and/or comply with regulatory requirements and to agree an action plan with the firm designed to achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified which require action by the firm than areas of strength and are not intended to be a balanced scorecard or rating tool.

Our inspection was not designed 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.

The professional accountancy bodies in the UK register firms to conduct audit work. Their monitoring units are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection but within the scope of audit regulation in the UK. Their work, which is overseen by the FRC, 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 and whose financial condition is not otherwise considered to be of major public interest. All matters raised in this report are based solely on the work which we carried out for the purposes of our inspection.

### Basis of reporting

We exercise 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 our overall inspection programme for the relevant year. In relation to reviews of individual audits, we have

generally reported our findings by reference to important matters arising. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

While our 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. 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 which, in turn, reflects the firm's client base. An issue reported in relation to a particular firm may therefore apply equally to other firms without having arisen in the course of our inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits are selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied. As a result, there may be a significant period of elapsed time between the completion of our inspection fieldwork at a firm and the publication of a report on the inspection findings.

We also issue confidential reports on individual audits reviewed during an inspection. These reports are addressed to the relevant audit engagement partner or director but firms are expected to provide copies to the directors or equivalent of the relevant audited entities.

## Purpose of this report

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 and its 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.

## Appendix B – Firm's response

The Firm's response is on the following page.

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16 May 2013

Dear Sirs

**Audit Quality Inspection Report 2013**

We are committed to achieving high levels of audit quality and the highest ethical standards, and to continuous improvement in both areas. We therefore consider carefully all of the AQRT's recommendations, and where we consider it appropriate we have taken action to address the specific matters raised.

Yours faithfully

Tony Cates
Head of Audit

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