



Financial Reporting Council

# KPMG LLP

## AUDIT QUALITY INSPECTION

JULY 2020

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# The FRC

Our purpose is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them.

transparency



We have responsibility for the public oversight of statutory auditors.

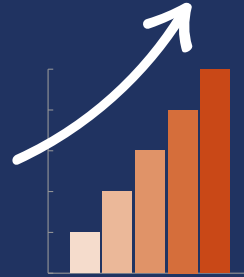
The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.



# AQR

We monitor the quality of UK Public Interest Entity audits.

-155	0.20%	+2.27%	-11.48%	POS	-3.2320
+320	0.21%	+2.83%	-15.93%	NEG	-3.9993
+185	0.14%	+2.42%	-17.67%	POS	-4.2421
+338	0.27%	+2.19%	-18.32%	NEG	-4.2083
+332	0.27%	+2.28%	-14.73%	NEG	-3.5708
+357	0.20%	+2.76%	-20.12%	NEG	-2.8339



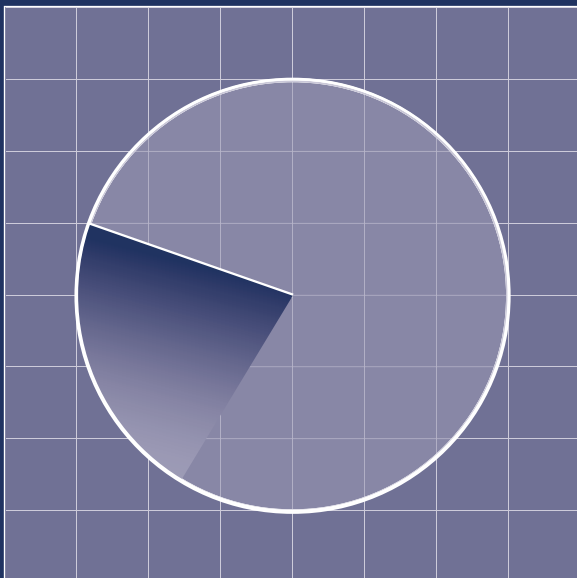
We promote continuous improvement in audit quality.

Our team of over 50 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.



# The Firm

KPMG has 498 audits within the scope of AQR inspection, including 23 FTSE 100 and 49 FTSE 250 audits.



# Our inspection process

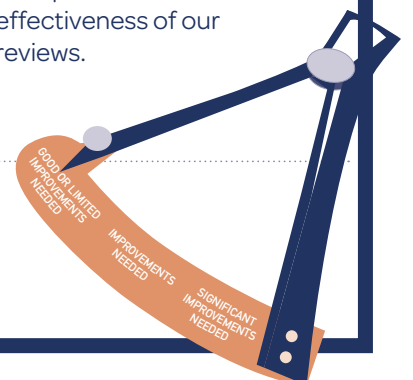


There are around 3,000 audits within the scope of AQR inspection. Of these, we inspected 130 audits in 2019/20, including the 18 KPMG audits covered by this report.



We work closely with audit committee chairs to improve the overall effectiveness of our reviews.

We assess the overall quality of the audit work inspected.



# Financial Reporting Council

## KPMG LLP

### Audit Quality Inspection

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

We consider whether action under the FRC's enforcement procedures is appropriate for all reviews assessed as requiring improvements or significant improvements. In practice, audits assessed as requiring significant improvement, and some of those assessed as requiring improvement, will be referred to the FRC's Case Examiner for consideration of further regulatory action. The Case Examiner will consider the most appropriate action, including Constructive Engagement with the audit firm or referral to the FRC's Conduct Committee for consideration of whether to launch a full investigation. This may result in a sanction being imposed and enforced against a statutory auditor and/or the audit firm in accordance with the FRC Audit Enforcement Procedure.

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This report sets out the principal findings arising from the 2019/20 inspection of KPMG LLP ("KPMG" or "the firm") carried out by the Audit Quality Review team ("AQR") of the Financial Reporting Council ("the FRC"). We conducted this inspection in the period from February 2019 to March 2020 ("the time of our inspection"). We inspect KPMG, and report publicly on our findings, annually.

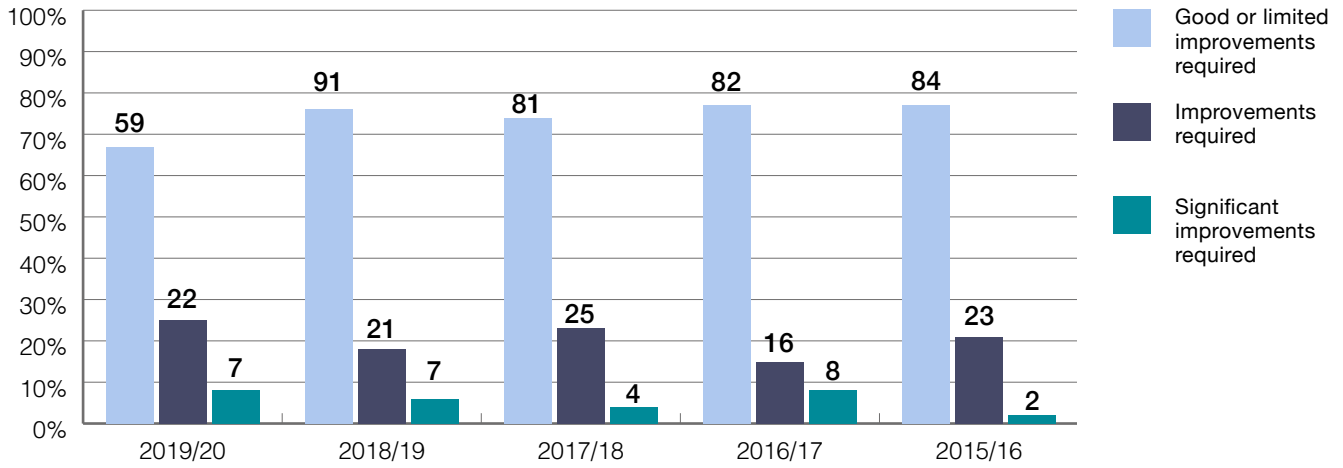
Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm's audit work. Our findings cover matters arising from our reviews of both individual audits and the firm's policies and procedures which support and promote audit quality.

High quality audit is essential to maintain investor confidence by providing an independent, impartial view of a company's financial statements. Poor auditing may fail to alert management, shareholders and other stakeholders to material misstatements (including those arising from fraud) or financial control weaknesses, in those cases where management have not identified or appropriately amended them. The combination of management not meeting their responsibilities in this respect and poor auditing could potentially put businesses and jobs at risk. High quality audit matters and we will drive audit firms to implement the necessary changes to reach the required standards.

Our priority sectors for inspection in 2019/20 were Financial Services, General Retailers, Business Support Services, Construction and Materials, and Retail Property. Of the 108 audits that we reviewed in the year across all firms (excluding Local Audit inspections), the number in priority sectors was: Financial Services – 18, General Retailers – 16, Business Support Services – 6, Construction and Materials – 3, and Retail Property – 8. We also paid particular attention to the following areas of focus: going concern and the viability statement, the other information in the annual report, long-term contracts, the impairment of assets and fraud risk assessment.

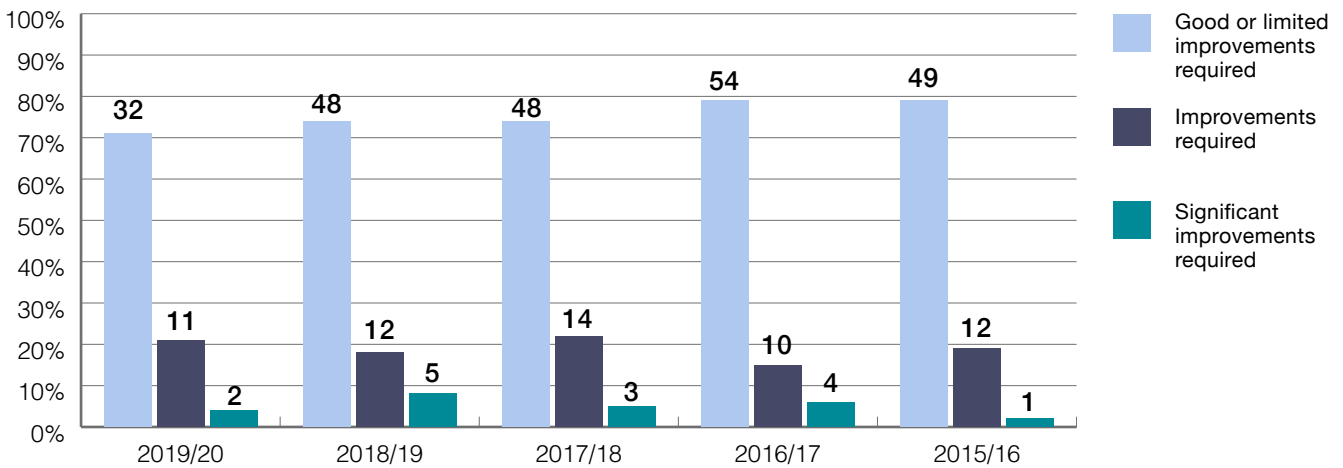
## Our assessment of the quality of audits reviewed

### All reviews – for the seven firms inspected annually



An audit is assessed as good or limited improvements required where we identified either no or only limited concerns to report. Improvements required indicate that more substantive improvements were needed in relation to one or more issues. Significant improvements required indicate we had significant concerns, typically in relation to the sufficiency or quality of audit evidence or the appropriateness of key audit judgements.

### FTSE 350 reviews – for the seven firms inspected annually



Due to resourcing constraints, we reviewed fewer audits overall than in recent years. Across all firms, we completed 130 audit inspections compared to 160 in 2018/19. We did broaden the scope of our reviews to include more aspects of the audit, including the auditor’s response to fraud risk. Changes to the proportion of audits falling within each grading category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. Our inspections are also informed by the priority sectors and areas of focus referred to above. We are also cognisant, when making our selections, of the Competition and Market Authority’s recommendation that FTSE 350 entity audits should be subject to inspection approximately every five years. For these reasons, and given the sample sizes involved, our inspection findings may not be representative of audit quality across a firm’s entire audit portfolio; nor do small year-on-year changes in results necessarily indicate any overall change in audit quality at the firm. Nonetheless, any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

# 1 Overview

## Commentary on our inspection work at the largest audit firms

Overall, 59 (67%) of the 88 audits reviewed in our 2019/20 inspection cycle, across the seven firms inspected annually, required no more than limited improvements. The number of audits requiring more than limited improvements, 29 (33%), remains unacceptable.

Firms have made some improvements and we have observed good practices (for example, better group audit oversight and effective integration of specialists into the audit team at some firms). We acknowledge the steps taken by firms seeking to address the key findings in our 2019 public reports.

However, firms are still not consistently achieving the necessary level of audit quality. They need to make further progress. For example, we continue to find improvements needed in the same three audit areas: impairment of goodwill and intangibles; revenue and contracts; and provisions, including loan loss provisions. Over the past three years, 76 of the 166 (46%) of the findings driving reviews requiring more than limited improvements have been in these areas. These findings often relate to insufficient challenge of, and standing up to, management in areas of complexity and forward-looking judgement. Other audit areas in which we had findings for more than one firm this year include: audit of inventory, group oversight, going concern and investment property valuations.

We take robust action for all reviews assessed as requiring improvements or significant improvements. To date, for the past three inspection cycles, we have referred 28 audits, across all firms inspected, for consideration of possible enforcement action.

We focused this year on key firm-wide procedures to improve audit quality, including firms' audit improvement plans and their processes to analyse the root causes of audit failings. We have raised findings in these areas to help firms build more effective quality improvement processes going forward. We will continue to focus on ensuring that the firms develop their vital root cause analysis processes to identify areas for improvement and implement change on a timely basis.

We have seen some instances of good practice where audit teams have concerns with the most significant audit judgements. Firms' senior management need to be clear that taking difficult decisions is an appropriate response to improving audit quality, even if it might sometimes mean delaying or modifying opinions, and ultimately losing some audit engagements. The tone from the top needs to support a culture of challenge and back auditors making tough decisions.

We are initiating a number of significant changes to improve audit quality, including:

- Increasing our focus on proactive supervision of the large audit firms. We will identify priority areas to improve audit quality, request the firms to implement suitable actions to achieve them and hold the firms accountable for delivery.

- Moving ahead with plans to increase the transparency of our audit quality assessments through publishing the scope and key findings of each of our individual audit inspections. We plan to publish our first set of these reports, where we have obtained the consent of the audit firm and the audited entity, next year alongside these annual reports on each of the largest audit firms.
- Asking the Big 4 firms, beginning from 2021, to implement operational separation of audit practices from the rest of the firm, so that the audit practices are focused above all else on achieving high audit quality.
- Strengthening the AQR team to increase the number of inspections in our 2020/21 cycle. We inspected a limited number of private companies and significant overseas components of groups during 2019/20, in line with the recommendations of the Kingman Review, and we will build on this as part of our overall target of 145-165 inspections for 2020/21.

We wrote to the major audit firms in December 2019<sup>1</sup> setting out elements that we observe consistently on high quality audits, especially on high risk engagements. The hallmarks of such audits include:

- Significant involvement of partner and other senior team members.
- Good use of specialists.
- Consultation on complex areas.
- Challenge of management leading to changes where assumptions are too optimistic.
- Robust quality control procedures.
- Clear and timely communication to Audit Committees.

We recognise the challenges posed currently by the Covid-19 pandemic, both in relation to the level of uncertainty surrounding forward estimates and projections, and inability to carry out physical procedures (for example, stocktakes). We will consider such matters carefully during our 2020/21 inspection cycle.

## Audit selections

In recent years we have selected for inspection an increasing number of 'higher-risk' audits. Reliable reporting and high-quality audit matter most for these companies. This year 42 of the 108 inspections (39%), excluding public sector reviews, were higher risk compared to 32% in the previous year. We define audits as higher risk where the group or entity: is in a high-risk sector or geography; is experiencing financial difficulties; has balances with high estimation uncertainty; or where the auditor has identified governance or internal control weaknesses. Higher-risk engagements frequently require audit teams to assess and conclude on complex judgemental issues, for example:

- Materiality becomes a key factor in determining the significance of audit judgements for entities that have low profitability.

<sup>1</sup> [https://www.frc.org.uk/news/december-2019-\(1\)/letter-to-audit-firms-on-high-quality-audits](https://www.frc.org.uk/news/december-2019-(1)/letter-to-audit-firms-on-high-quality-audits)

- Headroom on impairment assessments may be lower and the entity's balance sheet may be more sensitive to changes in key assumptions.
- Going concern assessments are less clear cut.

Rigorous challenge of management and the application of professional scepticism are therefore especially important.

Perhaps because higher-risk audits are more challenging, we find that their audit quality tends to be lower. Of the audits that required more than limited improvement this year, we had identified almost half as higher risk. This year 40% (47% last year) of the audits that we identified as higher risk were assessed as requiring improvement, compared with 27% (13% last year) of audits not identified as higher risk.

Other factors that may lead both audit quality and our inspection results to vary over time include:

- The economic cycle: audit can be more difficult in an economic downturn when corporate profitability is lower.
- Changes in accounting, auditing and ethical standards: new standards can require more complex and forward-looking estimates which are more difficult to prepare and audit. Examples in recent years include forward-looking provisioning under IFRS 9 and assessing progressive revenue recognition under IFRS 15.

We have increasingly focused on higher-risk audits because they are where reliable reporting and high-quality audit matter most. Firms must perform audits to the same high standards regardless of the risks associated with the audited entity and the difficulty of the audit work.

We accept that our increased focus on higher-risk audits means that the grade profile of our inspection findings may be less representative of audit quality across the whole portfolio of an audit firm. The change in our approach to audit selection over time also means that historical comparisons of results need to be treated with care.

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## KPMG overall assessment

We reviewed a sample of 18 individual audits this year and assessed only 11 (61%) of them as requiring no more than limited improvements. Of the twelve FTSE 350 audits we reviewed this year, we assessed only seven (58%) as achieving this standard.

The firm has taken steps to address the key findings in our 2019 public report, by continuing with and extending the initiatives within its three-year Audit Quality Transformation Plan. We have identified improvements, for example in the audit of goodwill impairment, a key finding last year. We also identified good practice in a number of areas of the audits we reviewed (including the use of internal specialists) and further improvements in the firm-wide procedures (including the introduction of further mandatory work programmes in areas of estimation and judgement and holding related workshops for engagement leaders).

The recurring findings that most contributed to the results were the quality of audit work on banks and building societies and the levels of challenge and professional scepticism.

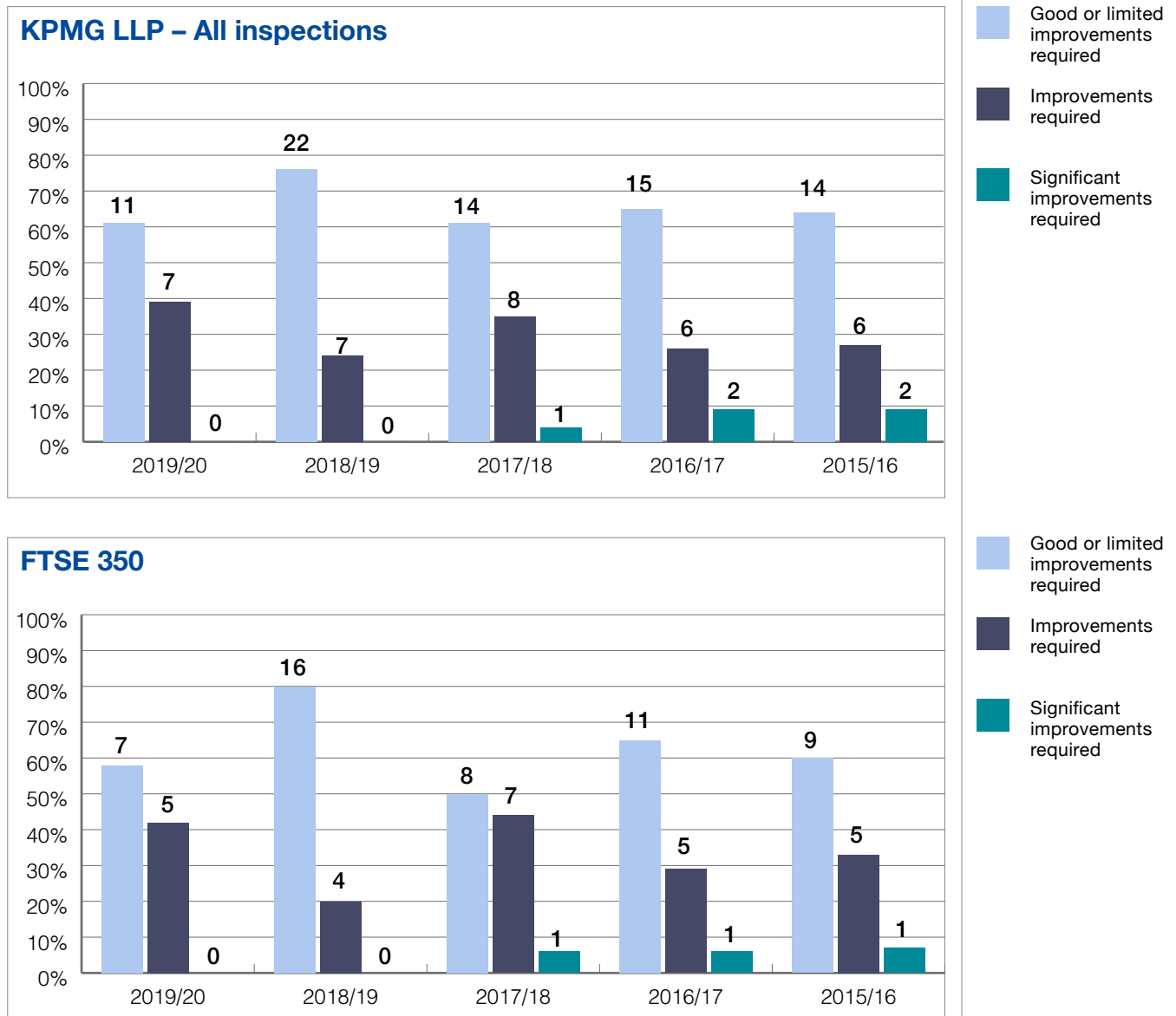
We have highlighted in this report aspects of firm-wide procedures which should be improved, including strengthening the culture of challenge within the firm's audit process. In our previous inspection cycle KPMG was placed under "increased scrutiny" and during this year's inspection we continued to monitor whether the firm's Audit Quality Transformation Plan was sufficient to achieve the necessary improvements in audit quality. In addition, the FRC commissioned an independent review of the firm's audit practice that covered key aspects of leadership and governance, risk management, values and behaviours. We requested that KPMG develop an action plan in response to the recommendations raised, which has now, along with the Audit Quality Transformation Plan, been incorporated into the quality pillar of the firm's three-year Audit Strategy.

We have seen considerable focus on audit quality at the top of the firm and there have been a number of improvements to the audit practice as a result. However, our inspection results show that high audit quality is not being achieved consistently and this report identifies key areas where the firm must make improvements more quickly. The overall inspection results therefore remain unsatisfactory and we expect the firm to take specific action to address this.

We will continue to monitor the response to the independent review as well as the next stages of the firm's Audit Quality Plan including the Banking Audit Quality improvement project. We also plan to inspect a higher number of its audits proportionately in our 2020/21 cycle than at some other firms.



## Our assessment of the quality of audits reviewed



## Reviews of individual audits

Our key findings related principally to the need to:

- Improve, as a matter of urgency, the quality of audit work on banks and building societies, in particular, the audit work on the valuation of financial instruments and the allowance for expected credit losses for loans and advances to customers.
- Take further steps to ensure audit teams apply appropriate levels of challenge and scepticism, particularly on high risk audits.
- Enhance the quality of audit work on certain areas of revenue.

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## Good practice observations

We identified examples of good practice in the audits we reviewed, including the following:

- The use of and interaction with the firm's internal specialists.
- Effective group oversight.
- Assessing the completeness of management's list of litigation and claims.

Further details of our findings on our review of individual audits are set out in section 2, together with the firm's actions to address them, as well as details of the good practices identified in those audits.

## Review of firm-wide procedures

This year, our firm-wide work focused primarily on the following areas:

- Partner and staff matters relating to the FY18 performance year.
- Acceptance and Continuance (A&C) procedures.
- Audit quality initiatives.
- Root cause analysis (RCA) process.

The reason for the focus on RCA and audit quality initiatives is the importance of ensuring that effective actions are taken to address recurring inspection findings.

Our key firm-wide findings in these areas related principally to the need to:

### *Partner and staff matters relating to the FY18 performance year*

- Reflect all relevant quality metrics (including the results of inspections) in appraisals.

### *A&C procedures*

- We had no significant findings to report.

### *Audit quality initiatives*

- Strengthen the culture of challenge in the audit process.
- Extend the milestone program to improve project management at each stage of the audit.

### *RCA*

- Further improve the RCA process, to consider whether individual engagement findings, that are identified as having a firm-wide application, require stronger actions.

## Good practice observations

We identified examples of good practice in our review of firm-wide areas, including the following:

- Strong monitoring and overall governance of the Audit Quality Transformation Plan by parties outside the audit practice, including an independent non-executive attending monthly Audit Board meetings.
- The high number of in-flight (second line of defence) reviews conducted.
- Reducing the period for archiving audit files to two days after the auditor's report is signed (effective for December 2019 year ends).
- Thorough assessment of the appropriateness and consistency of an entity's brand, values and reputation when taking acceptance and continuance decisions.
- Good root cause analysis of individual findings and clear identification of the extent of firm-wide versus engagement specific application.

Further details of our findings of these firm-wide areas are given in section 3, together with the firm's actions to address them, as well as details of the good practices identified.

### Firm's internal and ICAEW quality monitoring results

This year we have included, in each of our public reports, summary results of the firm's internal inspection results, together with, where performed, those of the ICAEW's latest quality monitoring. We consider that these results provide additional relevant information in relation to the assessment of the firm's audit quality.

The results of the firm's internal inspection results together with those of the ICAEW's latest quality monitoring are set out in Appendix 1.

### Results of RCA and firm's related actions

Thorough and robust RCA is necessary to enable firms to develop effective action plans which are likely to result in improvements in audit quality being achieved.

In section 3 we have commented on the firm's RCA processes, based on our review of them earlier in the inspection cycle. The firm has since performed RCA in respect of our current findings and considered the outcome in developing the actions included in this report. We have reviewed the results (and related processes) of this and set out our key observations below, including whether there have been improvements in the related RCA processes since our review earlier in the year:

- Our key observations on the results of the firm's RCA (including related RCA processes), and the actions to address them, are set out below. They include comments on the extent to which the RCA process findings, included in section 3, have improved since we reviewed them: The firm has a good level of coverage of RCA reviews across internal and external inspection findings, though the firm does not routinely perform RCA reviews over firm-wide findings, unlike some firms.

- The firm uses a clear coding system to classify root causes identified and support the identification of themes across reviews. However, there is not a clear trail to show how the significance of causes has been considered when identifying themes.
- Unlike some other firms, KPMG only reports on their RCA reviews in relation to key AQR and internal findings, not on how the RCA reviews over other inspection findings were considered when identifying themes. The firm's RCA report has less detail on the themes than other firms.
- Unlike some other firms, KPMG does not report on good practice themes and the firm's RCA reviews have less focus on good practice findings.
- The firm's actions have been set out by the firm in reasonable detail and respond appropriately to the identified RCA themes.

We will continue to assess the firm's RCA process and encourage all firms to develop their RCA techniques further.

#### **Firm's overall response and actions:**

We have strengthened the foundations of audit quality as a result of our significant investment over the past three years. Our focus is on achieving consistent application of our new procedures. We recognise that we must continue to invest to ensure that all audits are delivered to the high standards rightly expected by the AQR, and further investment is planned for 2020.

We are disappointed with the results seen in this cycle but note that comparison with year-on-year results is difficult considering the small sample size, and other important variables such as the large percentage of higher risk audits inspected this year. We are pleased that no engagement files were rated as requiring significant improvements and also to see a number of areas of good practice highlighted.

We have completed root cause analysis over all AQR findings in this cycle. This shows that, across our audit practice, the right tools, methodology and guidance are substantially in place, however, our challenge is to achieve consistent application.

We have launched a Culture Change Programme under the leadership of our Audit Head of Culture using support from behavioural specialists and targeted at embedding the behaviours exemplified by our highest performing teams across all teams using the findings of our root cause analysis to identify the areas for most urgent attention. Our 2020 training programme is built around the message of 'Embedding a Culture of Challenge' which will provide individuals with the skills and knowledge needed to meet expectations around scepticism and challenge.

We have launched a full review of our methodology and approach to Banking audits. This review, sponsored by the Head of Audit, and reporting to our Audit Board is addressed in our response to the Banking topic later in this report. Although the findings are based on a small sample, we are dedicating more resource as part of our transformation programme to embed consistent and sustainable good practices in

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Banking Audit. Our primary actions responding to this report (a number of which are already in progress) relate to culture and behaviours to facilitate consistent application of our tools, training and guidance. We had already started a programme of revision and simplification of our Banking workpapers in 2019, some of which were used on one of the files inspected in this cycle. These will continue to be refined and embedded during 2020 for application on 31 December 2020 year ends.

We have continued to increase resourcing across our Audit practice which has grown by 700 people in the year to April 2020, and by over 2,000 people since our transformation programme began in October 2017. This excludes approximately 600 Information Risk Management professionals who transferred into our audit practice in October 2018. We are also continuing to develop our coaching and project management programmes and maintained a focus on reviewing skills to ensure that all auditors have the tools and skills to succeed. Our commitment to audit quality, and the related investment is undiminished.

We will monitor closely the promptness and effectiveness of the firm's actions. Should these not address our concerns adequately, we will consider what further steps we need to take to both safeguard and improve audit quality.

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## 2 Review of individual audits

We set out below the key areas where we believe improvements are required to enhance audit quality. We asked the firm to provide a response setting out the actions it has taken or will be taking in each of these areas.

### **Improve, as a matter of urgency, the quality of audit work on banks and building societies, in particular, audit work on the valuation of financial instruments and the allowance for expected credit losses for loans and advances to customers.**

Last year we reported that the firm needed to:

- Improve the quality of the audit of the valuation of financial instruments in financial services entities; and
- Strengthen the audit of loan loss provisions in financial services entities.

These are key issues for financial services audits as they involve significant management judgement and estimation uncertainty. Management's calculations often involve complex models containing a number of assumptions and other inputs. Auditors should perform sufficient procedures to test the reliability of the models and to corroborate the key inputs and assumptions, in order to support their conclusions.

#### *Key findings*

We continued to identify weaknesses in the audit procedures performed.

- On one audit we identified insufficient testing of management's methodologies and assumptions relating to the fair value of derivative financial instruments, including: insufficient evidence of the nature and extent of testing on certain key controls relating to valuation models; and inadequate evidence obtained from independent repricing procedures.
- On the same audit we identified a number of issues with the audit of key aspects of the entity's allowance for expected credit losses for loans and advances to customers under IFRS 9, a new accounting standard implemented in the year. Irrespective of the change in accounting standard, the underlying audit issues continued to relate to the testing of management's models and assessment of key assumptions.
- On the other audit, there was insufficient evidence that individual provisions on impaired loans had been appropriately assessed, including limited evidence to confirm the reliability of the property valuations used.

The firm should take urgent action to improve the quality of its audit work, including revising aspects of its audit methodology particularly in relation to IFRS 9. Given certain findings are similar to last year, the firm should closely monitor the progress of its audit quality initiatives to ensure the required improvements are implemented quickly.

## Firm's actions:

The findings above are drawn from a small number of engagement reviews including one at the very start of the inspection cycle which had not fully benefitted from actions implemented in relation to the previous review cycle. Our root cause on this engagement confirmed that actions subsequently taken would have mitigated some of the findings on this audit. In relation to IFRS9, as noted in the comments, this is a new and highly complex area and we appreciate the challenge from the AQR on the approach we have taken.

We took a series of enhancement actions in relation to the standardisation of our approach to auditing banks at both a national and international level during 2019 as findings emerged from this review and other monitoring actions which will be tested in our 2019/20 inspection cycle. However, recognising the need to respond to the specific challenges raised by the AQR and more generally to rapidly embed all of our enhancement activities we have created a Banking Audit Quality improvement project, sponsored by the Head of Audit, and reporting to our Audit Board. The project team lead by the Head of Banking Audit is responsible for developing and implementing an Audit Quality improvement project that will be implemented effective for 31 December 2020 year end audits. This plan will respond to all aspects of quality findings relevant to the audit of banks and will be informed by the AQR findings as well as our root cause analysis and wider cultural network within audit. The plan will be integrated with the actions being taken more widely in relation to the findings in this report.

## Take further steps to ensure audit teams apply appropriate levels of challenge and scepticism, particularly on high risk audits

Audit teams can identify engagements as high risk for a number of reasons, including the entity:

- Being in a high risk sector or location;
- Experiencing financial difficulties;
- Accounting for balances with significant estimation uncertainty; or
- Having governance and internal control weaknesses.

On all audits, and in particular those that are high risk, audit teams should assess whether management's judgements and estimates, and related disclosures, are reasonable. This requires the audit firm to instil a mindset of professional scepticism and challenging management.

## Key findings

Each finding relates to a separate audit:

- The audit procedures performed on the sales forecasts used in management's going concern assessment, were insufficient to adequately assess whether a material uncertainty existed. In addition, we found there was insufficient audit evidence to support the appropriateness of additions to product development costs due to weaknesses in both the sample testing and substantive analytical review procedures performed.
- There was insufficient evidence of the assessment of the accounting treatment and adequacy of disclosures relating to a material contingent consideration payment and, in particular, whether or not there should have been a restatement of the prior year financial statements.
- There was insufficient evidence of the audit team having adequately considered the potential audit implications of an identified risk of non-compliance with laws and regulations.

### Firm's actions:

We recognise that the need to evidence the challenge and scepticism we deliver on our audits is a critical requirement. For 2020, the Covid-19 pandemic means that we will not be holding our classroom based KPMG Audit University this year but will be moving it to a series of virtual classrooms. The thread running through these materials, and the rest of our 2020 development programme, is 'Embedding a Culture of Challenge'. This will be re-enforcing key elements such as how to avoid potential confirmation bias, assessing alternative scenarios and conflicting evidence, recording and reporting the impact of audit challenge, obtaining relevant evidence remotely, having challenging conversations, seeking corroborating evidence to support management responses, and how to do 'stand-back' and 'top-down' assessments. It will also focus on the public interest obligations of an audit and the vital importance of the auditors view especially in today's challenging environment.

We have analysed each of the findings raised in this report and the underlying conclusions reached by the audit engagement team and concluded that the judgements made by the teams were appropriate. However we accept that the evidence of our challenge and the basis for the conclusions reached was insufficient and our root cause analysis has focussed on this area. We have achieved significant cultural change since the start of our audit quality transformation plan but acknowledge that we must continue to reinforce the importance of delivering consistently in these critical areas.

Our root cause analysis also identified that the behavioural areas discussed in our response to the revenue findings are also relevant here. Effective risk assessment and planning, coaching and project management are vital ingredients to ensuring that audit work is produced on a timely basis to allow effective review procedures to take place. It is these review processes that are critical to ensuring the audit file consistently tells the story of the challenge we apply on our audits.



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## Enhance the quality of audit work on certain areas of revenue

Revenue is usually a key driver of an entity's operating results. We reviewed the relevant audit work on the majority of the audits we inspected. Audit teams should design and perform procedures that obtain sufficient and appropriate evidence for revenue. The nature of the audit procedures performed may vary considerably depending on the type of business being audited.

### Key findings

- Accounting for long-term contracts, including revenue recognition, is highly judgemental and can be susceptible to management bias. Audit teams should apply an appropriate level of challenge and obtain sufficient and appropriate audit evidence in relation to the significant judgements in these areas. On one audit, where long-term contract accounting was being applied, the audit team did not sufficiently assess or challenge the level of contingency applied within the contract accounting.
- Using data analytics to audit revenue is becoming increasingly common and can be a highly effective technique to test large volumes of transactions. On one audit, insufficient audit procedures were performed on the revenue transactions that could not be matched to cash receipts by the analytic tool. The data analytic and cut-off testing were the main substantive procedures on revenue and there was no reliance on internal controls.
- The risk of fraud in revenue recognition is a presumed significant risk. On one audit, there was insufficient evidence that the audit team's procedures had adequately addressed the fraud risk identified in relation to bill and hold sales.
- We raised findings on three other audits, one of which related to a key input to the expectation set in a substantive analytical review not being adequately supported, and two related to inadequate justification for aspects of the audit team's risk assessment.

### Firm's actions:

We have analysed the findings summarised above and compared them with the issues arising from our internal monitoring processes to identify any recurring or pervasive matters. We are pleased to note this has highlighted limited recurring matters indicating that our core methodology and tools are appropriate and generally well executed by engagement teams. This conclusion is re-enforced by the results of our root cause analysis into each of the findings which indicates that the key challenge was at the practical application level in these individual engagements with largely specific circumstances contributing to each item. Accordingly we have taken actions at the engagement level to support these individual teams but also considered the environment in which these audits were delivered. This has confirmed that actions previously taken ahead of the timing of these audits in the areas of acceleration of planning activities, greater coaching and support to teams, enhancing reviewing skills and project management, have started to deliver positive results and we must continue to work to achieve consistency.

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In our previous responses to AQR findings, we had noted that these actions will be delivered progressively and derive benefits over time. As part of this programme, we have already delivered, throughout 2019, further enhancements in each of these areas and will continue to do so in 2020 using the results of these reviews, our other monitoring activities and our root cause analysis to continue to shape these programmes to be responsive to developments. For example, we are looking at how we need to modify our coaching programme to respond to today's ways of remote and virtual working. We believe these actions will support the continued reduction in the frequency and severity of individual findings.

### *Good practice*

We identified examples of good practice in the audits we reviewed, including:

- **The use of and interaction with the firm's internal specialists:** On three audits of insurance entities, we identified the KPMG actuaries' work, and integration into the audit team, to be examples of good practice. We also identified examples on audits not in the insurance practice relating to acquisition accounting and leasing.
- **Effective group oversight:** On one audit, we identified the group team's instruction and oversight of the component auditors to be of a high standard, particularly in relation to the audit of revenue.
- **Assessing the completeness of management's list of litigation and claims:** On one audit, we identified good use of audit tools to search for contradictory evidence, including relevant media articles.

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### 3 Review of firm-wide procedures

We reviewed firm-wide procedures, based on those areas set out in International Standard on Quality Control (UK) 1 (“ISQC1”), as well as certain other key audit initiatives. We review some areas on an annual basis, and others on a three-year rotational basis.

This year, our firm-wide work primarily focused on the following areas:

- Partner and staff matters relating to the FY18 performance year.
- Acceptance and Continuance (A&C) procedures.
- Audit quality initiatives.
- Root cause analysis (RCA) process.

#### Partner and staff matters

##### *Background*

Human resources processes are a key element of a firm’s overall System of Quality Control and are integral to supporting and appropriately incentivising audit quality. Our inspection included an evaluation of the firm’s policies and procedures and their application to a sample of partners and staff for the FY18 appraisal year, across the following areas: Appraisals and remuneration; Promotions; Recruitment; and Portfolio and resource management.

##### *Key findings*

We identified the following key findings, where the firm needs to improve the consideration of audit quality in relation to:

- Reflect all relevant quality metrics (including the results of inspections) in appraisals: The firm introduced a formal process to consider quality metrics in performance management for partners and directors in 2018. However, we identified examples at a partner level, where there was insufficient evidence of how adverse quality findings had been considered in appraisals, objective setting and, in one case, promotion decisions. The firm did not have a formal process in place for managers and senior managers to ensure that all relevant quality metrics (including the results of internal or external inspections) were appropriately considered and reflected in 2018 appraisals.

#### **Firm’s response and actions:**

We implemented a formal process to record quality metrics for Managers and Senior Managers in FY19, consistent with that deployed for Partners and Directors in FY18. We will continue to reinforce throughout our goal setting, performance assessment and promotion that we expect that quality considerations are explicitly evidenced.

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## Acceptance and Continuance (A&C) procedures

### Background

Audit quality control processes incorporate risk management procedures and are undertaken at various stages of the engagement. In accordance with the requirements of ISQC1, the firm has detailed policies and procedures relating to acceptance and continuance decisions for audited entities. We have reviewed these processes and their application within our firm-wide inspection activity this year.

Given the greater number of audit tenders in recent years, we assessed firms' acceptance and continuance processes as at October 2019. We also discussed with senior leadership any proposed changes to these processes together with each firm's strategic decisions. In addition, we considered firms' policies relating to withdrawal/dismissal from audits and, for a sample of audits, the statements provided to the public, successor auditors and the regulatory authority in connection with withdrawal/dismissal.

### Key findings

We had no significant findings to report.

### Good practice

We identified the following areas of good practice:

- **Thorough assessment of the appropriateness and consistency of an entity's brand, values and reputation when taking acceptance and continuance decisions:** The firm introduced a new acceptance and continuance form at the end of January 2019. We reviewed a sample of the acceptance and continuance decisions made using the new form and consider it to be a robust control to help audit teams address the risks facing the firm. The firm goes further than its peers to reiterate to teams the importance of potential damage to values, reputation and brand when making acceptance and continuance decisions, including asking teams to consider explicitly how their decisions would be perceived by third parties.

#### Firm's response and actions:

We are pleased that there are no findings relating to this section but continually review A&C procedures to ensure that these are appropriately responsive to emerging issues.

## Audit quality initiatives

### AQR procedures

We reviewed key aspects of the firm's Audit Quality Transformation Plan ("the plan"), including the firm's monitoring of the progress of the plan and other key audit quality initiatives. This included the consideration of recurring themes identified in the RCA of past inspection findings, in the following areas: Culture of the firm, including challenge of management; In-flight reviews (internal reviews undertaken during the audit)/central support; and Project management/milestone programs (monitoring the phases of completion of audits).

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### *Background to firm's audit quality transformation plan*

KPMG started its plan at the end of 2017. We reviewed the plan in detail as part of last year's inspection and considered that the actions taken had demonstrated the firm's commitment to improving audit quality. We required the plan to focus more going forward on improving the quality of financial services audits and the robust challenge of management. During 2018, the firm undertook key initiatives in time to affect 17 out of the 18 audits inspected in this year's cycle, including:

- For financial services audits, increasing the strength of the firm's central support/hot review team (2nd line of defence), issuing structured work-programmes and improving guidance.
- Issuing mandatory work programmes for auditing estimates and judgements and holding mandatory workshops for engagement leaders.

The results of our 2019/20 inspections cycle indicate that these initiatives were not always effective.

During our inspection period we continued to monitor whether the firm's Audit Quality Plan was sufficient to achieve the necessary improvements in audit quality. This was done in part by some benchmarking across the firms that we inspect annually. Fresh initiatives in 2019 included improving the project management and coaching skills of audit teams. Our inspection findings next year will indicate whether these initiatives, in combination with those already implemented, have been more effective.

In addition, the FRC commissioned an independent review of the audit practice which covered key aspects of leadership and governance, risk management, values and behaviours. The report was delivered to the FRC in November 2019 and contained 12 recommendations, including the need for KPMG to:

- Fully implement and embed recent and planned enhancements to governance structures, including further refinements to address sustainability and independence;
- Enhance audit monitoring through high quality and transparent management information; and
- Clearly align vision, values and audit quality to effect long-term cultural change.

We requested that KPMG develop an action plan in response to all recommendations, which was submitted to us in February 2020 and has already been incorporated into the quality pillar of the firm's three-year Audit Strategy. Examples of actions already taken by the firm include reconfirming the risk ratings and associated quality control measures assigned to audits with a particular focus on significant audits that sit outside the high risk category and piloting new controls to further strengthen the audit finalisation process. The FRC will continue to monitor the design and implementation of the firm's response to the independent review and the progress and effectiveness of the next stages of the Audit Quality Transformation Plan.

## Key findings

We identified the following key findings, where the firm needs to improve the consideration of audit quality to:

- Strengthen the culture of challenge in the audit process: KPMG has been implementing a firm-wide culture plan. As the next step, the firm has recently appointed a Head of Audit Culture to develop a plan to strengthen the firm's audit culture. In light of this year's inspection results, and when compared to initiatives already underway at certain other firms, we consider this to be a key initiative. The audit culture plan should include more emphasis on scepticism and challenge of management in the values and behaviours of audit teams.
- Extend the milestone program to improve project management at each stage of the audit: One of the key themes from last year's RCA related to ineffective project management on audits. The firm has taken a number of actions to address this, including hiring project management specialists to support audit teams and using its in-flight review team to monitor the progress of certain audits. KPMG has also adopted milestones at the planning phase which focus on both the timing of the work and ensuring that the work is completed to a high quality. The milestone programme should be extended to cover all phases of the audit with a continued focus on driving the right behaviours to ensure high quality work.

## Good practice

We identified the following areas of good practice:

- Strong monitoring and overall governance of the Audit Quality Transformation Plan by parties outside the audit practice, including an independent non-executive attending monthly Audit Board meetings.
- The high number of in-flight (second line of defence) reviews conducted.
- Reducing the period for audit files to be archived to two days after the auditor's report is signed (effective for December 2019 year ends).

### Firm's response and actions:

We are pleased that some of the steps we have taken in our audit quality transformation plan have been recognised as good practice. Our root cause analysis has identified that achieving consistent execution of our audit procedures requires greater focus on cultural change. We have launched a Culture Change Programme under the leadership of our Audit Head of Culture using support from behavioural specialists and targeted at embedding the behaviours exemplified by our highest performing teams across all teams. Our 2020 training programme is built around the message of 'Embedding a Culture of Challenge' providing individuals with the skills and knowledge needed to meet expectations around scepticism and challenge. The actions being developed in response to the review of bank audits are fully aligned with this culture programme.

We are also continuing to develop our coaching and project management programmes and focus on reviewing skills to ensure that all auditors have the tools and skills to consistently execute high quality audits.

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## The Firm's RCA process

### Background

The RCA process should be designed to identify the causes of inspection findings, in order to aim to prevent them from recurring. It is part of a continuous improvement cycle of inspecting audits, investigating the root causes for inspection results and improving the firms' ability to act on them through implementing effective actions.

The firm has been performing RCA for a number of years and follows methodology and guidance issued to it by the global firm, supplemented by additional UK specific procedures.

This year, we have reviewed the firm's 2018/19 process for undertaking its RCA, including resources and timing.

### Key findings

The firm should further improve the RCA process, in particular:

- Further improve the RCA process, to consider whether individual engagement findings, that are identified as having a firm-wide application, require stronger actions.

### Good practice

The firm has continued to develop its RCA process. We identified examples of good practice in the RCA process:

- **Analysis of findings:** There is good analysis of individual findings and the RCA analysis clearly identifies the extent of firm-wide versus engagement specific application.
- **Team wide interviews:** The interviews cover a wide selection of engagement team members and, where relevant, both the 2nd line of defence reviewer and supporting specialists.

### Firm's response and actions:

We recognise the importance of effective root cause analysis and continue to invest in our root cause programme. Over the last twelve months we have broadened its scope and further increased the number and seniority of our cohort of trained and accredited individuals supporting the programme. This investment is continuing and we will build on the areas of good practice identified and address those areas of our process where refinements have been suggested by the AQR. We believe that the results of our analysis provide a good understanding of the root causes to be addressed. We also consider that the remedial actions we are taking, as summarised in our responses in this report, are appropriately responsive to the findings.

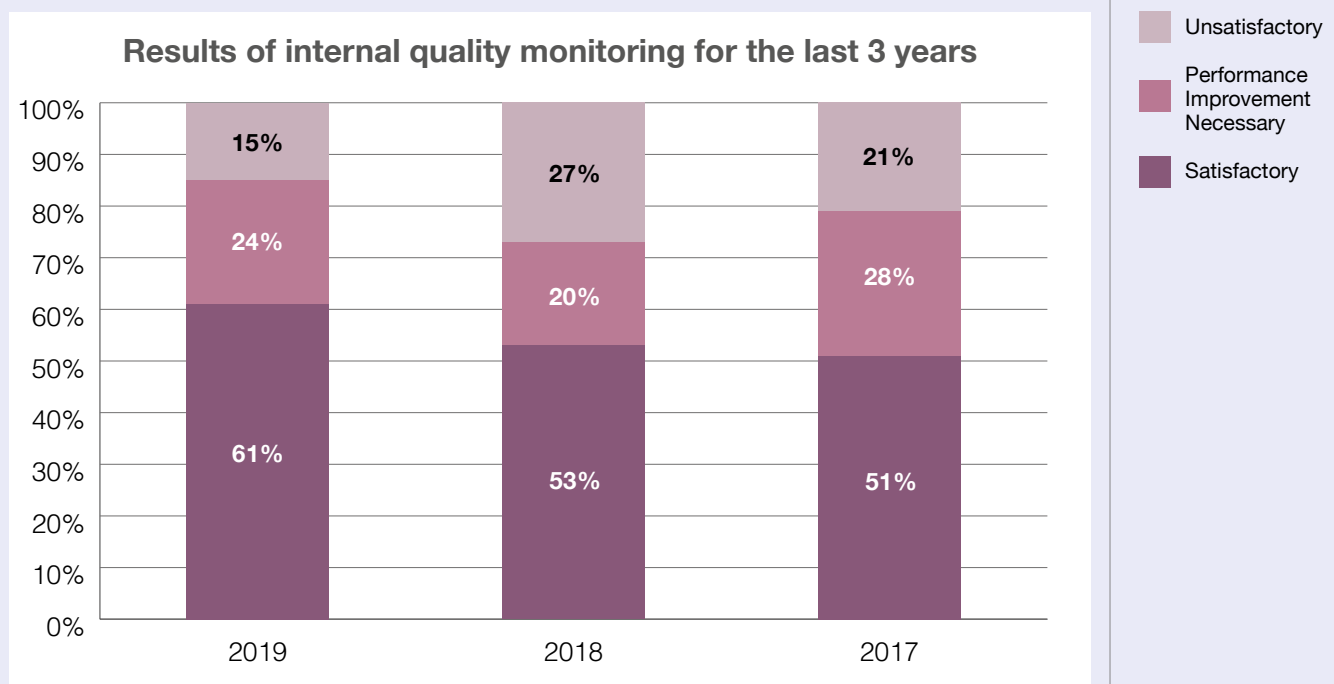
## Appendix 1: Firm’s internal quality monitoring and ICAEW results

This appendix sets out information relating to the firm’s internal quality monitoring for individual audit engagements. It should be read in conjunction with the firm’s transparency report for 2019, which provides further detail of the firm’s internal quality monitoring approach and results, and the firm’s wider system of quality control. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified the accuracy or appropriateness of these results.

Due to differences in how inspections are performed and rated, the results of the firm’s internal quality monitoring may differ from those of external regulatory inspections and should not be treated as being directly comparable to the results of other firms.

### Results of internal quality monitoring

The results of the firm’s most recent Quality Performance Review (“QPR”), which comprised internal inspections of 124 engagements including (108 individual audits with periods ending up to 31 March 2019), are set out below along with the results for the previous two years.



Inspections are graded as performance improvement necessary where the auditor’s report is supported by evidence, but the independent reviewer required additional information to reach the same conclusion as the auditor; or where supplementary evidence obtained as part of the audit was not sufficiently documented; or specific requirements of the firm’s audit methodology were not followed. Inspections are graded as being unsatisfactory where the audit was not performed in line with KPMG’s professional standards and policies in a more significant area, or where there are deficiencies in the related financial statements.



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## Firm's approach to internal quality monitoring

The firm's QPR program considers the full population of audits performed. All engagement leaders are subject to selection for review at least once in a three-year cycle. Engagements for review are selected by the QPR inspection team after review of individual engagement leader portfolios to ensure an appropriate mix of engagements are selected taking account of size, risk and profile. Each QPR inspection is overseen by an Independent Lead Reviewer from outside KPMG UK and the program is monitored globally. The Independent Lead Reviewer participates in a moderation process at both national and regional level, designed to achieve consistency of results both between engagement findings in the UK and other KPMG member firms. Where the QPR identifies significant deficiencies, a remedial action plan is prepared, applicable at both an engagement and firm level. Remedial action is generally in respect of future periods unless the review highlights evidence of an inappropriate opinion.

The firm undertakes root cause analysis ("RCA") on Unsatisfactory engagements and other findings considered to be more pervasive, including some arising on engagements assessed as Satisfactory and PIN, which informs further remedial actions at a firm level incremental to the team level actions described above. Engagement teams also undertake specific incremental or remedial training based on the QPR.

### Firm's response and actions:

We are pleased that our internal inspection results have improved year on year. The scope of a review under our internal QPR is broad and normally considers elements of the audit that are not assessed by an external inspection. Our QPR programme is designed to hold audit teams to quality levels that assess not only compliance with auditing standards but also adherence to internal requirements such as the performance of specified procedures or completion of specific mandated consultations. As such teams that perform audits that are very substantially compliant with auditing standards may receive a rating other than satisfactory in our internal reviews. Accordingly it is difficult to make direct comparisons between the results of our internal and external inspection processes.

Our internal review cycle is aligned with our annual performance review cycle and completes in the Autumn each year. The 2019 internal QPR programme described above covered audits with year ends of 31 March 2019 and earlier, which is contemporaneous with those reviewed by the AQR in this report.

As noted above, in order to learn from the inspections process we perform root cause analysis to consider the details of findings from across the full spectrum of reviews to identify remedial actions. We conducted 125 interviews with team members and other individuals and considered 12 audit areas with potentially pervasive findings. This process happens progressively throughout the review cycle which means we take some remedial actions identified on individual inspections as soon as their need is identified accelerating their impact on audit delivery across the audit practice. We also consider findings from a range of inspections to ensure that we develop robust remedial actions. Areas that contributed most significantly to unsatisfactory ratings were insufficient clarity or evidence on the audit file to allow an independent reviewer

to understand the basis for individual conclusions, weaknesses in the execution of KPMG mandated procedures in the audit of journals and in the performance or documented explanation of specific substantive audit procedures. We did not identify any engagements where we concluded the underlying financial statements were inappropriate or that the audit opinion was not appropriately delivered.

The root causes identified varied across engagements. There were limited findings related to our audit approach and methodology and the tools and guidance provided to engagement teams which we believe reflects the significant investment made since 2017 on standardising our audit approach and developing our toolkit available to audit teams. Any identified gaps have been or are being addressed. There were also only a small number of areas where training gaps were identified, reflecting the investment in our KPMG Audit University quality programme. The majority of the findings identified related to how we applied our tools and methodology in practice and here the root causes related to more cultural and behavioural issues including:

- how we on-boarded and then supported individuals as they joined our audit practice;
- how we project manage our audits; and
- how we ensure we allocate and schedule work appropriately to enable better coaching and more timely reviews.

We have a series of actions in place focussed on enhancing our coaching, reviewing and project management capabilities. We have also continued to expand our Second Line of Defence team.

We monitor review outcomes over time and a key data point for us is that the later audits within this QPR cycle (measured as 31 December 2018 and later year ends) achieved significantly improved results compared with the audits performed earlier in this cycle. There was a meaningful reduction in the proportion of engagements rated Unsatisfactory and a corresponding increase in the level of engagements rated as Satisfactory.

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## Results of ICAEW monitoring

### Background

The firm is subject to annual independent monitoring by ICAEW. ICAEW undertakes its reviews under delegation from the FRC as the Competent Authority. ICAEW reviews audits outside the FRC's population of retained audits, and accordingly its work covers private companies, smaller AIM listed companies, charities and pension schemes. ICAEW does not undertake work on the firm's firm-wide controls as it places reliance on the work performed by the FRC.

### Scope

Reviews of audits are either standard-scope or focused. Standard-scope reviews are designed to form an overall view of the quality of the audit. ICAEW assesses the audits it reviews as either 'satisfactory/acceptable', 'improvement required' or 'significant improvement required'. Where appropriate, ICAEW also carries out focused reviews to follow up on significant issues highlighted in the previous year's file reviews or other specific risks. These reviews are limited in scope. Visit [icaew.com/auditguidance](https://www.icaew.com/auditguidance) for further information about ICAEW's audit monitoring process including its approach to assessing audits.

ICAEW has completed its 2019 monitoring review and the report summarising its audit file review findings and any follow-up action proposed by the firm will be considered by ICAEW's audit registration committee in September 2020.

### Results

In 2019, nine of the ten standard-scope reviews were satisfactory/acceptable, with one requiring improvement.

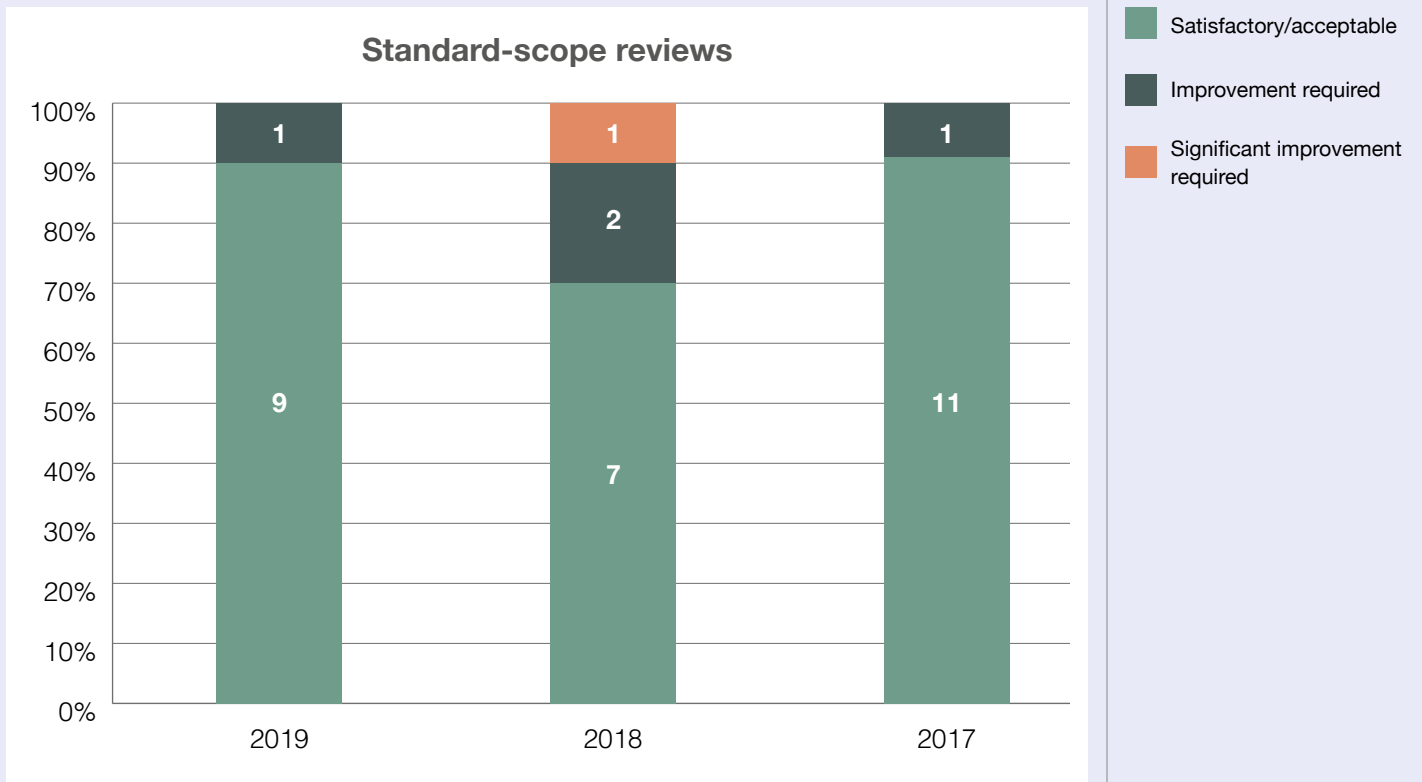
ICAEW also carried out three focused reviews and raised some significant findings on two of these. The audit teams had taken steps to address the specific issues reported on these files in 2018, but ICAEW's review of two of the subsequent year's audits found additional issues. On one of these focused reviews, ICAEW had significant concerns over the accounting treatment of a major contract and the recoverability of related balances.

ICAEW considered that most of the key findings were linked to insufficient challenge of management and weaknesses in quality control. Other significant issues indicating weaknesses in quality control were:

- incorrect accounting treatment of foreign exchange contracts not identified by the audit team.
- on a focused review, a flaw in a substantive analytical review test on revenue and a gap on the same audit file relating to a change in presentation of key audit matters in the audit report.

Other findings related mainly to isolated aspects of audit evidence and documentation, with no particular themes. ICAEW identified and shared a number of examples of good practice, including effective use of templates recently introduced as part of the firm's Audit Quality Transformation Programme.

Results of ICAEW’s standard-scope reviews for the last three years are set out below.



Given the sample size, changes from one year to the next in the proportion of audits falling within each category cannot be relied upon to provide a complete picture of a firm’s performance or overall change in audit quality.

### Response from the firm

We are pleased that a higher proportion of this year’s standard reviews were satisfactory or generally acceptable being 90% of the files reviewed. We are disappointed in the results of the follow-up reviews. As noted elsewhere within this report, following root cause analysis, we have implemented or are implementing actions to improve evidence of challenge of management. In respect of the point raised in relation to quality control we have implemented a coaching course for all audit RIs and managers and placed a focus on effective reviewing practices. For the poorest graded engagements we have allocated in-flight review to the subsequent period audit to provide an additional level of challenge and oversight in respect of the grade driving findings.

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