

May 2016

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# 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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The AQR's objective is to monitor  
and promote improvements in the quality of auditing

## **About the FRC's Audit Quality Review**

### **Our objective**

The FRC's mission is to promote high quality corporate governance and reporting to foster investment. The Audit Quality Review (AQR) contributes to this objective by monitoring and promoting improvements in the quality of auditing

### **What we do**

AQR assesses the quality of the audits of listed and other major public interest UK entities and the policies and procedures supporting audit quality at the major audit firms in the UK. We also review 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. We adopt a risk-based approach to our work and focus our reviews of individual audits on key areas specific to each review.

### **Our team**

AQR consists of approximately 35 professional and support staff. Our inspection teams have extensive expertise with an average of 19 years post-qualification experience. Our audit quality review work is subject to rigorous internal quality control reviews. Independent non-executives oversee our work.

### **Working with Audit Committees (or equivalent bodies)**

Audit Committees play an essential role in reviewing and monitoring the effectiveness of the audit process. We are committed to engaging with Audit Committees to improve the overall effectiveness of our reviews and to support our common objective of promoting audit quality. We speak with Audit Committee Chairs during the year as part of our work. We also send our reports on each individual audit reviewed to the Chair of the relevant Audit Committee (or equivalent body).

### **Priority sectors and areas of focus**

Our priority sectors for inspection in 2015/16 were insurance; food, drink and consumer goods manufacturers and retailers; companies servicing the extractive industries; and business services. We reviewed a number of audits from these sectors at the firms, together with a number of first year audits which were identified as an area of focus given the extent of changes in auditors following increased audit tendering. We also paid particular attention to the audit of revenue recognition and complex supplier arrangements.

### **Thematic reviews**

In addition to our annual programme of audit reviews, we undertake one or more thematic reviews each year. We review firms' policies and procedures in respect of a specific aspect of auditing, and their application in practice, enabling us to make comparisons between firms with a view to identifying both good practice and areas for improvement.

This year we have published reports on "Firms' audit quality monitoring" (January 2016) and "Engagement Quality Control Reviews" (February 2016). We expect all firms to take appropriate action to address the findings from our thematic reviews which apply to them.

### **Developments in Audit Quality 2015/16**

In addition to reports on each of the major firms we have reviewed, the FRC intends to issue later in 2016 (and annually thereafter) a report on the quality of audit in the UK. This will include a report on the overall findings of our AQR activity.



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The AQR assesses the quality of audits and policies and procedures supporting audit quality at major firms



# 1 Overview

This report sets out the principal findings arising from the 2015/16 inspection of KPMG LLP and KPMG Audit Plc (“KPMG” or “the firm”) carried out by the Audit Quality Review team of the Financial Reporting Council (“the FRC”). We conducted this inspection in the period from February 2015 to January 2016 (“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.

Section 2 sets out our key findings requiring action and the firm’s responses to these findings.

Section 3 sets out our overall assessment of the quality of the audits we reviewed in our 2015/16 inspection and how it compares with our assessments for the previous four years.

Appendix A sets out our objectives, scope and basis of reporting.

Appendix B explains how we assess audit quality.

We acknowledge the co-operation and assistance received from the partners and staff of the firm in the conduct of our 2015/16 inspection.

## *Scope of our 2015/16 inspection*

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

The areas covered by our review of the firm’s policies and procedures included:

- Tone at the top;
- Independence and ethics;
- Audit methodology, training and guidance; and
- The firm’s own audit quality monitoring.

We reviewed selected aspects of 22 individual audits in 2015/16. In selecting which aspects of an audit to inspect, we took account of those areas identified to be of higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements.

## *Key findings*

Since our last inspection, the firm has implemented agreed actions and enhanced its procedures in the following areas:

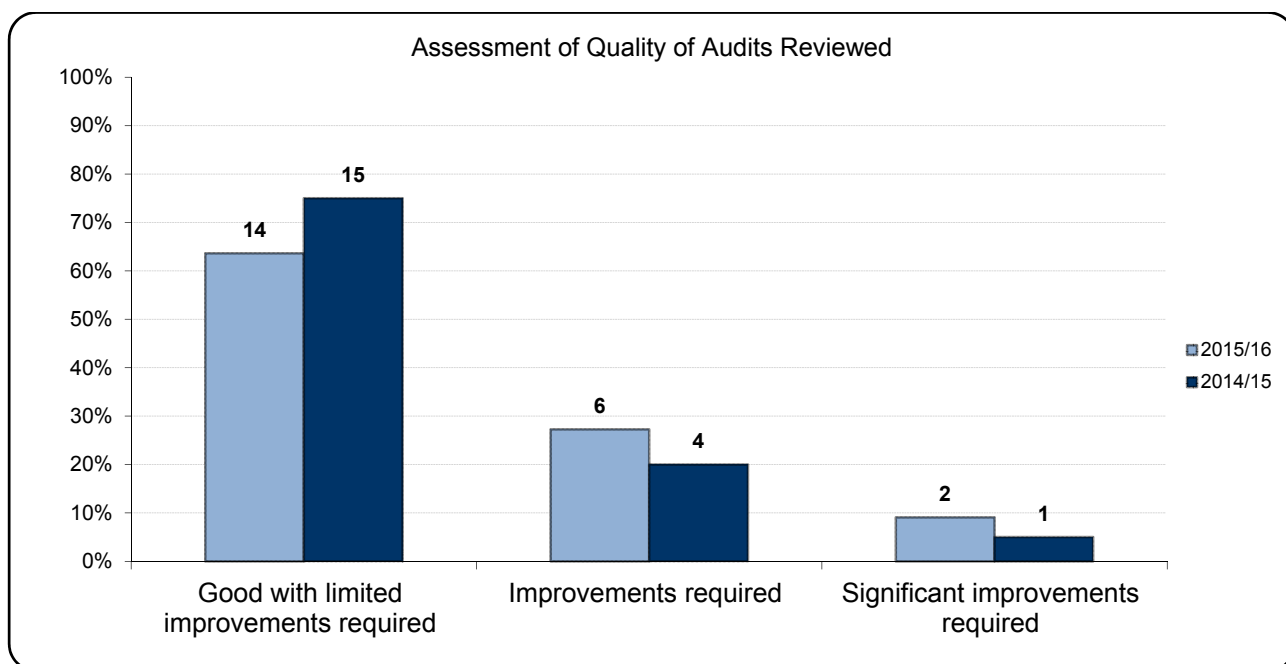
- Audit quality monitoring processes:
  - The firm enhanced its process for monitoring completed audits. In particular, for certain higher risk entities, a team of core reviewers was used to improve consistency of the process. This builds on the firm's revised review approach which targets a more focused and challenging review of the audit with more helpful findings and recommendations to audit teams.
  - The firm has revised its approach to reviewing firm-wide quality control processes. We have seen improvements in the level of testing, the attention paid to findings by senior leadership within the firm and the actions taken by the firm to address issues identified.
- Partner Independence – Financial interests: KPMG has continued to improve the central processes relating to partners holding financial interests in an audited entity and expand its Partner Independence Team. As a consequence, the number of instances identified of prohibited investments being held in audited entities has decreased.
- Pre-issuance reviews (PIR) of financial statements: A requirement for the firm's central team to review the clearance of any significant matters arising from PIRs prior to the audit report being signed has been introduced.

Our key findings in the current year requiring action by the firm, which are elaborated further in section 2 together with the firm's actions to address them, are that the firm should:

- Take further actions to address recurring findings from internal and external quality reviews and monitor their effectiveness.
- Improve the consultation and approval processes for non-audit services.
- Improve the audit procedures performed to test controls, including IT controls, and the testing of reports relied upon.
- Improve the scope and depth of the audit work performed by certain of the firm's specialists.
- Improve the extent of challenge of management in relation to areas of judgment, in particular valuations, impairment reviews and provisions.
- Review its methodology and training for the audit of revenue.



The following chart shows our assessment of the quality of the firm’s audits which we reviewed in 2015/16 with comparative information for 2014/15. Further details are provided in section 3.



There was a significant increase in the number of audits reviewed in 2015/16 which were assessed at our highest level compared with the assessments achieved for audits reviewed in 2014/15. However, two audits were assessed as requiring significant improvement in 2015/16.

Section 3 sets out examples of good practice which contributed to audits being assessed as requiring no more than limited improvements. It also sets out the principal issues resulting in two audits being assessed as requiring significant improvements.

We expect all the firms we inspect to make continuous improvements such that, by 2019, at least 90% of FTSE 350 audits reviewed will be assessed as requiring no more than limited improvements<sup>1</sup>.

*Root cause analysis*

Thorough and robust root cause analysis is necessary to enable firms to develop effective action plans which are likely to result in real improvements in audit quality being achieved. At our request, the firm has performed root cause analysis in respect of our key findings in this report.

<sup>1</sup> FRC Plan and Budget 2016/17

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

We welcome the external perspective provided by the AQR's feedback and seek to use this, together with the findings from our own internal quality reviews, as we strive for continued improvement. Whilst we are pleased with the comments recognising positive developments, including some good practice observations in complex challenging areas, we are disappointed to have two engagements rated as requiring significant improvement.

We have expanded our "root cause analysis" (detailed investigation of the underlying causes of the issues identified) to cover findings in relation to our firm wide procedures in addition to those arising from engagement level reviews. We apply this approach, which includes independent interviews of the teams, to findings from both internal and external reviews. A significant focus is around engagements with adverse findings but we also consider other engagements reviewed to contribute to our understanding.

Underlying causes are often linked to the specific circumstances of the engagement, but we also identified behavioural and environmental factors that contributed to recurrent findings. We have developed a comprehensive action plan built up from this better understanding. Whilst ensuring guidance is constantly enhanced to keep pace with the changing world we recognise training and guidance cannot address every issue. The practical workshops we run, where our experts collaborate with audit teams to work on tangible challenges, are proving to be particularly effective in addressing behavioural factors.

In our responses to the key messages we summarise the actions already taken and in progress, which are supported by detailed work programmes and timetables. As we identify areas for remediation early in the review cycle we perform our "root cause analysis" on a rolling basis, incrementally building our understanding and allowing us to accelerate deployment of carefully considered actions. As a result, many of the actions we describe are now implemented. We have also developed monitoring to give us earlier visibility of the impact of these actions to allow us to intervene if required.

We are fully committed to continuous improvement in audit quality and will work constructively with the FRC to achieve this. Our aspiration is go beyond the FRC's published aim that at least 90% of FTSE350 audits reviewed should require no more than limited improvements by achieving this standard for 100% of our public interest entity audits.

We seek to be open and transparent with investors and current and prospective audit clients and ensure that all of our engagement leaders can discuss these findings and how our actions are responsively designed.

## 2 Key findings requiring action and the firm's response

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

### ***Take further actions to address recurring findings from internal and external quality reviews and monitor their effectiveness***

Appropriate and effective actions to address findings arising on both internal and external reviews should minimise the number of recurring issues. There is an increased risk of recurring issues where the root cause of a problem has not been fully identified and understood or where the firm's action is inappropriate.

We identified a number of recurring issues where actions taken since our last inspection have not significantly changed our findings:

- Weaknesses in the testing of journals were again identified in the majority of audits reviewed. These included insufficient evidence supporting the journals selected for testing, insufficient procedures to ensure the completeness of the population of journals and insufficient testing in relation to certain fraud risk characteristics.
- In half of the reviews undertaken, communications with Audit Committees could still be improved in areas such as presentation of significant risks identified, the involvement of the group audit team in the component audits and specific independence threats identified and related safeguards applied.
- We continued to identify cases where the audit report did not accurately describe certain procedures performed by the audit team, although there has been an improvement in the nature and extent of the matters identified.
- Ineffective use of substantive analytical review procedures was again identified in relation to the testing of revenue.

#### **Firm's actions:**

We are dissatisfied when actions taken do not eliminate the issue targeted. In general, we are pleased that the frequency and severity of these issues has reduced but are not content with the pace of improvement. Whilst there is inevitably a time delay between a matter being identified as recurring, root causes being determined and actions implemented, we recognise this time lag is not the sole cause of recurring issues. Where recurring issues have arisen we analyse why previous actions have not been fully successful and modify, augment or replace these actions as necessary. Often there is no single root cause and we use a package of initiatives. Whilst these areas previously had been the subject of guidance or training, we have refreshed relevant sections of these to address specific practical application issues identified. We have also identified and addressed areas where relevant guidance was not being accessed or used through a targeted communications plan.

To mitigate the inherent risk of time delays, we identified recurring issues earlier and we have already introduced updated measures in relation to each of these matters. We also amended the timing of

our internal quality review cycle to give us earlier visibility of the impact of these actions, and added additional, quality focussed, briefings for all auditors earlier in the year than previously provided.

Feedback from teams in the root cause process has been positive about the steps taken on increasing awareness of issues and understanding behavioural and environmental impacts in these areas, in particular the focus on practical application issues.

### ***Improve the consultation and approval processes for non-audit services***

Ethical Standards require the audit engagement partner to identify and assess circumstances which could adversely affect the auditor's objectivity ('threats'), including any perceived loss of independence, and to apply safeguards which will either eliminate the threat or reduce the threat to an acceptable level. Ethical Standard 5 ("ES5") deals specifically with the threats arising from the provision of non-audit services to an audited entity. Both the principles underlying the standards, as well as the specific prohibitions on providing certain services, are important in the consideration of actual and perceived threats to independence.

There should be evidence that the auditor has given proper consideration to the appropriateness of providing non-audit services to an audited entity, having assessed the significance of related independence threats and the effectiveness of available safeguards.

We reviewed the consideration of independence threats on fourteen audits, eight where non-audit fees exceeded the audit fee and six to understand further the non-audit services disclosed to the Audit Committee. Significant findings included:

- In three cases there was insufficient evidence that the audit team and the firm's Ethics Partner had adequately considered all matters relevant to assessing the appropriateness of non-audit services, in particular the significance of any related threats to the auditor's objectivity and whether the specific prohibitions in ES5 applied. The non-audit services involved:
  - The firm acting as an expert witness for a listed audited entity; and
  - Two instances of tax services provided on a contingent fee basis to listed audited entities.
- In another case the audit team used the firm's 'investor relations specialist'/'equity advisor' to provide advisory services to an audited entity. The services included "assistance with the definition and refinement of [the] message to institutional shareholders and general investor relations advice and assistance". There was insufficient evidence that the audit team had properly understood the precise nature of the services and adequately assessed whether the safeguards applied were sufficient to reduce to an acceptable level the identified advocacy, self-review and management threats.

We are concerned about the nature and appropriateness of the services provided by the 'investor relations specialist'/'equity advisor' to current audited entities. While the firm initially considered the nature of the services and limited their application in respect of audit clients, it should continue to monitor closely the nature of the services being provided to audited entities and offered in audit tender documents. In particular, it should consider the appropriateness of such services in light of the changes to Ethical Standards which take effect in June 2016. We will review these services further during our 2016/17 inspection.

Other findings in this area, on a further four audits, included applying insufficient safeguards to mitigate threats to independence; and ineffective or unclear consultations with the Ethics Partner.

We are concerned about the number and significance of the above findings, and any wider implications for the firm as a whole. The firm should therefore undertake a thorough review of its consultation and approval processes for the provision of non-audit services.

**Firm's actions:**

We recognise the importance of auditor independence and seek to apply the spirit, as well as the detailed provisions, of the Ethical Standards. All professional staff, regardless of function, receive annual training on ethics and independence, including in relation to the provision of non-audit services to audit clients.

We believe that the non-audit services we provide to audit clients are consistent with prevailing requirements, although we do recognise that the application of principles requires the exercise of professional judgement (which we aim to apply diligently) which may differ between individuals.

We recognise the importance of evidencing our consideration of the appropriateness of any non-audit service and note that in each of the significant findings cited the initial consideration predates the introduction of our RiskConnect system in April 2015. We believe that the introduction of RiskConnect already provides a more systematic and detailed approach to evidencing our consideration of certain independence consultations. In particular, all contingent fee approvals are now managed through this system.

We are currently reviewing our approach to consultations by professional staff in relation to non-audit services, including who is consulted, how consultations should be evidenced and how RiskConnect might facilitate this.

We also recognise changing expectations and requirements and at this time are preparing for the implementation of the revised Ethical Standard (including the consideration of the implications of the revised Ethical Standard to services provided by our investor relations specialists). In addition, we are preparing mandatory training and guidance to ensure that both audit and non-audit staff are aware of changes in requirements.

***Improve the audit procedures performed to test controls, including IT controls and the testing of reports relied upon***

Testing the operational effectiveness of controls is necessary to provide the auditor with a proper basis on which to place reliance on them. This includes testing controls over IT systems including general IT controls, which relate to the IT environment such as the integrity and security of data, and application controls, which relate to the processing of transactions.

Tests of controls were performed on a number of the audits we inspected and the following issues were identified:

- In some cases we identified weaknesses in the testing of IT system controls and/ or general IT environment on which audit teams had placed reliance.

- Insufficient follow-up work once deficiencies in controls had been identified and a lack of testing of certain controls which were relied upon (including controls at service organisations).
- In some cases reliance was placed on system outputs where audit teams had not tested those systems.
- On one audit there was a change of systems and third party IT provider and on another there was a system upgrade. The audit teams did not design and perform procedures to obtain sufficient appropriate audit evidence in response to the migration risk or the system upgrade.
- On two retailer audits, where controls over inventory counts were relied upon, too few stores were visited to provide evidence that the controls were operating effectively.

#### **Firm's actions:**

The findings raised under this heading are broad and have many different root causes.

The sophistication of technology used by clients has accelerated significantly in recent years and auditors are responding by a significantly increased focus on auditing the clients' IT environment and using data analysis audit techniques. As this change occurs, the expectations of audit evidence continue to evolve rapidly. We have invested significantly in developing our audit teams and the specialist support available to them. However, this is a fast moving area and ensuring that outside of the classroom all auditors achieve, at all times, the necessary standard of evidence is challenging as the broad body of practical experience on which to draw is developed. We continue to invest, using practical examples, to share our responses to areas identified for improvement. Feedback from our specialist support network is that awareness of the evidence requirements has risen significantly over the last year. Assessing 'Information prepared by the entity', where the requirements in existing auditing standards are unclear, has been identified as an area requiring incremental training in the current training cycle.

In the cases of IT system changes/upgrades, two teams did not provide a sufficiently clear assessment of the migration risk and accordingly design a suite of fully effective procedures. We have developed guidance in this area to support teams with this specific topic.

In the case of inventory count procedures, the root cause was a lack of guidance addressing practical scenarios which resulted in certain teams not adequately demonstrating the sufficiency of their procedures. We are developing specific practical application guidance to address areas of confusion. The audit teams with whom we have discussed the new guidance with are keen to adopt it at the earliest opportunity.

#### ***Improve the scope and depth of the audit work performed by certain of the firm's specialists***

Where industry or other expertise is required, audit teams may use internal specialists, integrating their work into the audit process. Where a specialist carries out or contributes to the audit work performed, or is consulted by the audit team, the audit engagement partner remains responsible for the work undertaken and conclusions reached.

In our previous inspection report we noted that internal specialists were not being used as extensively as we expected and, where they were used, the work was not sufficiently integrated into

the audit process. During this inspection, we noted that specialists had been used more extensively, but we continued to identify some concerns where they were integrated into the audit as a whole. The firm's actuaries were used on two insurance audits reviewed:

- On one of these audits the actuarial team did not sufficiently test the completeness and accuracy of data, key controls and reports used for substantive procedures, in relation to policyholder liabilities.
- On the other, there was insufficient evidence of the specific procedures performed by the firm's actuaries in relation to key balances and disclosures in the financial statements.

**Firm's actions:**

We believe we have made good progress in further integrating the work of specialists and are pleased the AQR acknowledges that specialists have been used more extensively. However these reviews identified a specific gap in our training of insurance actuarial specialists. Historically this specialist group had provided deep technical knowledge and industry insight which relied predominantly on their actuarial expertise. In recent years, as we integrated our specialists more fully, the scope of their involvement at the engagement level broadened into performing certain audit test work. These reviews highlighted that we had not identified this development and we have therefore responded with appropriate incremental training.

We are now formalising a sustainable training programme for these specialists equivalent to that in place for IT and tax professionals who support audit delivery. We have also completed an exercise to confirm there are no other specialists requiring specific training, and undertaken a full review of current training for specialists to ensure it remains appropriate.

***Improve the extent of challenge of management in relation to areas of judgment, in particular valuations, impairment reviews and provisions***

The audit of valuations, impairment reviews and provisions requires appropriate use of professional judgment. The auditor reaches an independent and informed view of the reasonableness of management's key judgments and assertions through effective challenge of management based on the auditor's knowledge of the business, other audit evidence obtained and an understanding of the wider business environment.

We identified a number of concerns in relation to the audit of valuations, impairment reviews of goodwill and other intangibles, tax provisions and loan loss provisions. For example:

- Insufficient challenge of management regarding, in one case, the consistency of the financial projections which formed the basis for the recognition of deferred tax assets.
- For an audit where business combinations were identified as a significant risk, there was insufficient testing relating to key estimates and judgements used in the valuation of acquired intangible assets.
- On two retailer audits, there was insufficient evidence of challenge of management's judgments relating to impairment of stores. In one case the audit team did not sufficiently challenge management's identification of cash generating units. In the other audit there was



insufficient evidence of challenge of management as to whether certain stores should have been assessed for impairment.

**Firm's actions:**

This is another area where there is little commonality in either the specific findings or the underlying root cause of issues identified.

We have reviewed again our critical thinking framework that provides teams with the structure to effectively audit key judgements and estimates and remain confident that it provides an appropriate base for such considerations. We found teams had an understanding of our approach and auditing requirements and developed audit work papers using their professional judgement and industry knowledge. However, in these cases, the teams had not provided the level of precision and detail needed to demonstrate fully an appropriate consideration of all aspects of the issue. This was an awareness issue and we had already started to use real examples to provide practical evidence of the standards expected. We are continuing to roll this out making it easier for teams to access practical examples to allow individuals to more effectively and critically self-review their work. We will continue using such examples in our quality workshops.

***Review the firm's audit methodology and training for the audit of revenue***

Revenue is an important driver of a company's operating results and auditors typically need to evaluate and address fraud risks in relation to revenue recognition.

We reviewed the audit of revenue on the majority of audits that we inspected and identified the following issues:

- On a number of audits analytical review procedures were used to obtain substantive audit evidence in relation to revenue. These procedures were sometimes ineffective due to a failure either to set sufficiently precise expectations formed from independent sources or inadequate corroboration of management explanations.
- Insufficient revenue testing was performed on three audits. On one audit the analytical procedures and controls testing performed did not provide sufficient audit evidence. On the other two audits, only the recognition of revenue in the correct period was tested in detail without testing the underlying revenue itself.

**Firm's actions:**

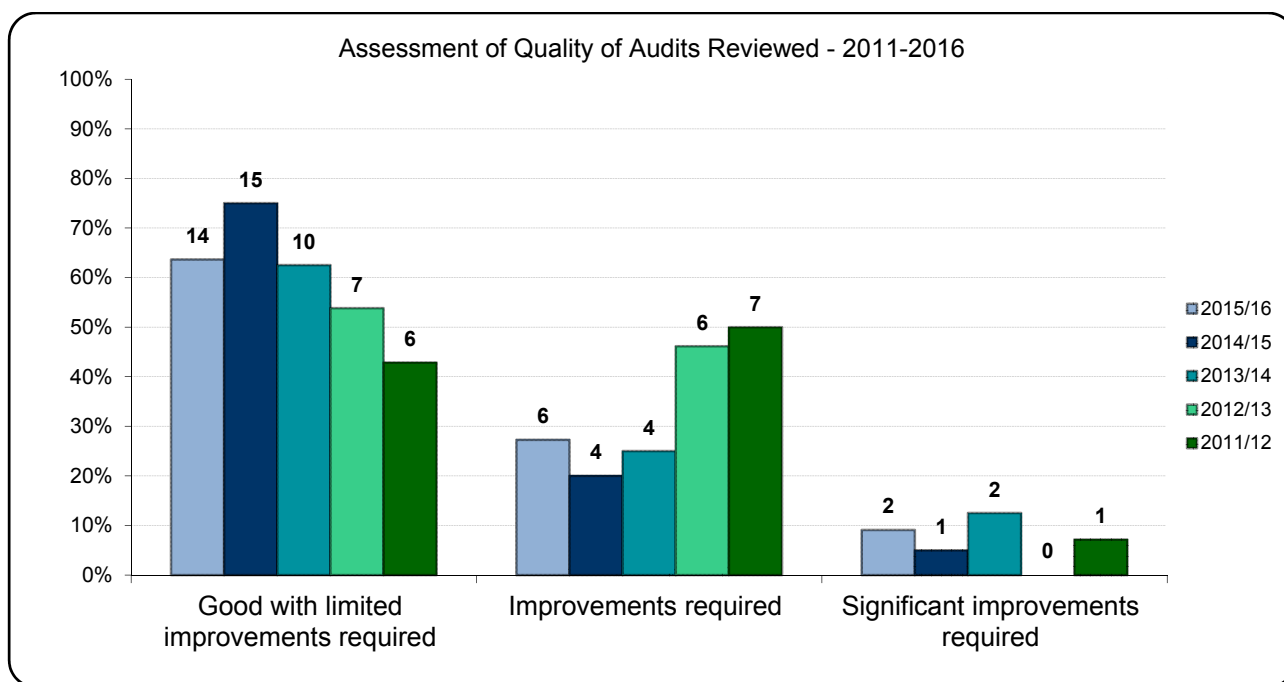
In relation to the effective execution of substantive analytical procedures, our root cause work has identified a generally good understanding of the technical requirements but issues with their practical application. The other findings related to a more diverse mix of largely engagement specific findings in the audit of revenue. Here again the root causes were more aligned to practical application issues rather than the underlying audit methodology. These included a failure to either articulate the overall evidence obtained from revenue and related testing or to evidence accurate performance of specific tests to suitably demonstrate the sufficiency of evidence obtained. These teams requested more practical guidance specifically related to the challenges of auditing revenue which we have now developed. In this area, as with all of the others, we will use both our internal quality monitoring processes and focused central support and challenge processes to provide early insight into the impact of our actions taken.



### 3 Assessment of the quality of audits reviewed

We reviewed selected aspects of 22 individual audits in 2015/16, none of which were first year engagements.

The bar chart below shows the results of our assessment of the quality of the audits we reviewed in 2015/16, with comparatives for the previous four years<sup>2</sup>. The number of audits within each category in each year is shown at the top of each bar.



We identified the following examples of good practice in 2015/16 on certain audits assessed as requiring no more than limited improvements:

- A high quality substantive analytical review of revenue for the UK subsidiary of a multinational group. In this case the analytical review was detailed, using a precise expectation that had been adjusted appropriately for reasonable anticipated changes from the prior year.
- Effective strategies and procedures for the audit of complex supplier or customer relationships, on all relevant audits that we reviewed.
- Effective procedures for the audit of contract revenue for two multinational groups.

<sup>2</sup> Changes to the proportion of audits falling within each category 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 and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

The principal issues resulting in two audits being assessed as requiring significant improvements in 2015/16 were as follows:

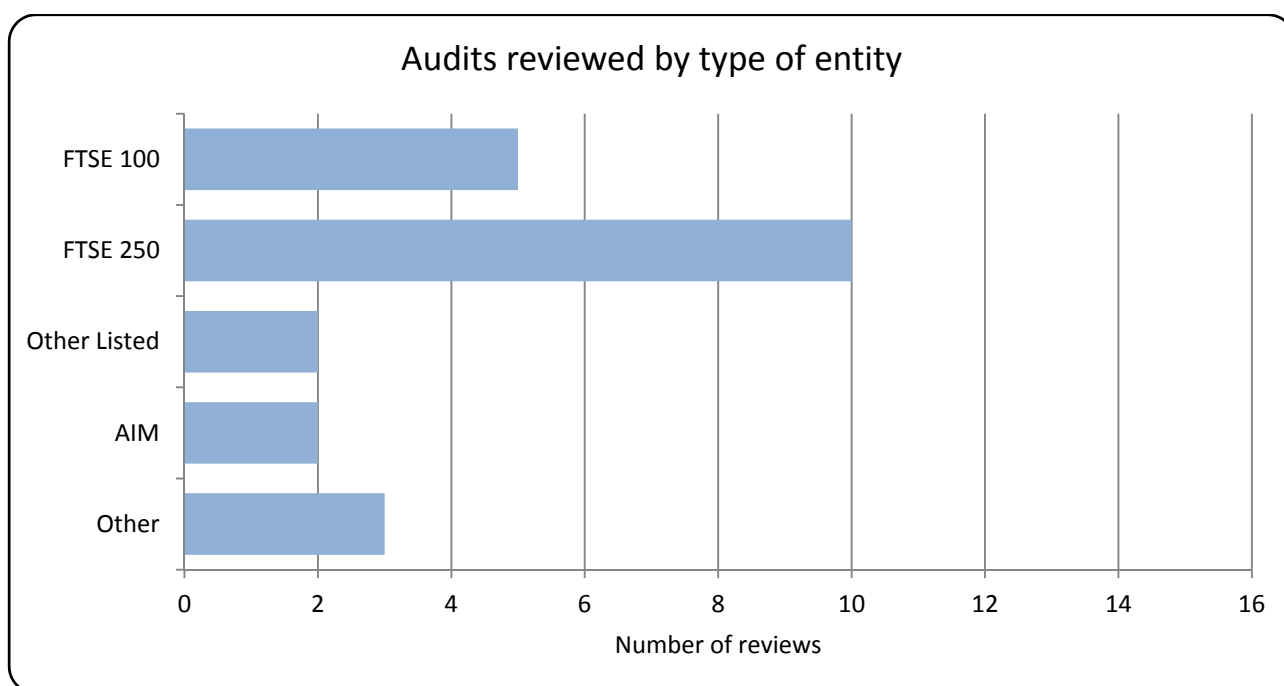
- On one audit, there was a change of systems and third party IT provider. The audit team did not design and perform procedures to obtain sufficient audit evidence in response to the migration risk.
- On the second audit, insufficient audit work was performed in relation to revenue and inventory. Furthermore, materiality had been set at too high a level for a profit-oriented entity.

Other issues arising from our reviews of audits assessed as requiring more than limited improvements are included in section 2.

#### *Audits inspected in 2015/16*

We estimate that the firm audited 504 UK entities within the scope of independent inspection as at 31 December 2014. Of these entities, our records show that 196 had securities listed on the main market of the London Stock Exchange, including 23 FTSE 100 companies and 61 FTSE 250 companies.

The following chart provides a breakdown of the audits inspected in 2015/16 by type of entity<sup>3</sup>:



<sup>3</sup> The listed entities whose audits we reviewed include two investment trusts or similar entities.

### *Audit Quality Indicators*

The firm's transparency report for the year ended 30 September 2015 includes certain Audit Quality Indicators (AQIs) which the six largest audit firms are using. We believe that such AQIs provide useful additional information to those wishing to understand firms' approaches to monitoring and improving audit quality.

We are pleased that firms have made a good start in identifying and monitoring AQIs. We would, however, encourage them to gather the relevant data on a more consistent basis and follow-up the results more effectively.

Audit Quality Review

FRC Audit Division

May 2016

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

Matter	Explanation
Objectives of our inspection	<p>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.</p>
Audits in the scope of our inspection	<p>In addition to the UK audits in scope, as stated in section 3 of our report, the UK firm audits a number of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area. These audits are inspected by us under separate arrangements agreed with the relevant regulatory bodies in those jurisdictions. The results of these reviews are included in this report. Our records show that, at the time of our inspection, the firm had 11 such audits.</p> <p>KPMG LLP and KPMG Audit Plc also supplies audit services to local authorities and the NHS (Local Public Audits - LPAs). Whilst we review LPAs undertaken by firms, this is done under separate arrangements agreed with the Public Sector Audit Appointments Limited (PSAA), previously the Audit Commission. The results of these reviews are not included in this report because the LPA inspections fulfil a different purpose to those considered in this report. These reviews of LPAs form part of the PSAA's assessment of the quality of contracted-out audits. The PSAA publishes its assessment both in overall terms and individually by firm. The most recent reports can be found on its website.</p>
Impact of our risk-based inspection approach	<p>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 for review and cannot be relied upon for this purpose.</p>
Key audit areas inspected	<p>In selecting which aspects of an audit to inspect, we take account of those areas considered to be higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The rationale for including each area of audit work (or excluding any area of focus listed in the auditors' report) is documented as part of the planning process for each audit inspected.</p>
Our reports on individual audits	<p>We issue a report on each individual audit reviewed during an inspection to the relevant audit engagement partner or director and the chair of the relevant entity's Audit Committee (or equivalent body).</p>

Matter	Explanation
Our emphasis on improvements to audit quality	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.
Basis of our public reporting	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 is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.
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.
Inspection findings included in our public report	We exercise judgment in determining those findings to include in our public report on each inspection, taking into account their relative significance in relation to audit quality, in the context of both the individual inspection and any areas of particular focus in our overall inspection programme for the year. Where appropriate, we have commented on themes arising or issues of a similar nature identified across more than one audit.
Inspection of audits outside our scope	<p>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 our work 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 are not otherwise defined as being within the scope of our work.</p> <p>All matters raised in this report are based solely on the work which we carried out for the purposes of our inspection.</p>

## **Appendix B – How we assess audit quality**

We assess the quality of the audit work we inspect using the following four categories:

- Good (category 1);
- Limited improvements required (category 2A);
- Improvements required (category 2B); and
- Significant improvements required (category 3).

The assessments of the quality of the audits we reviewed in our public reports on individual firms combine audits assessed as falling within categories 1 and 2A.

These four categories have been used consistently since 2008, although there have been some minor refinements to the category descriptions over the years. They reflect our assessment of the overall significance of the areas requiring improvement that we have reported to the Audit Committee and the auditor. We expect the auditor to make appropriate changes to its audit approach for subsequent years to address all issues raised.

An audit is assessed as good where we identified no areas for improvement of sufficient significance to include in our formal report. Category 2A indicates that we had only limited concerns to report. Category 2B indicates that more substantive improvements were needed in relation to one or more issues reported.

An audit is assessed as requiring significant improvements (category 3) if we have significant concerns in relation to the sufficiency or quality of audit evidence, the appropriateness of key audit judgments or other matters identified. In such circumstances we may request some remedial action by the firm to address our concerns and to confirm that the audit opinion remains appropriate. We will generally review a subsequent year's audit to confirm that appropriate action has been taken.

We exercise judgment in assessing the significance of issues identified and reported. Relevant factors in assessing significance include the materiality of the area or matter concerned, the extent of concerns regarding the sufficiency or quality of audit evidence, whether appropriate professional scepticism appears to have been exercised, and the extent of non-compliance with Standards or a firm's methodology.

Our inspections focus on how selected aspects of a particular audit were performed. They are not designed to assess whether the information being audited was correctly reported. An assessment that an audit required significant improvements, therefore, does not necessarily mean that an inappropriate audit opinion was issued, the financial statements failed to show a true and fair view or that any elements of the financial statements were not properly prepared.

Equally, where we have assessed an audit as requiring significant improvements, this does not necessarily imply potential misconduct on the part of an individual or audit firm which may warrant investigation and/or enforcement action by the FRC.





**Financial Reporting Council**

8th Floor  
125 London Wall  
London  
EC2Y 5AS

+44 (0)20 7492 2300

[www.frc.org.uk](http://www.frc.org.uk)