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Audit Inspection Unit

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

8th December 2008

Inspection between April 2007 to December 2007

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

2.2.3 *Other human resource matters*

Audit training and communications

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

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

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

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

Credit crunch communications

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

and specialist skills to perform effective audits exist in all relevant locations. We also considered that the co-ordination of the group audits of multi-location companies reviewed by us was a particular strength. We commented positively on the procedures that had been established to ensure that an appropriate and consistent level of audit quality was achieved across the group. This was a marked improvement on our findings in prior years.

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

2.4.2 *Assessing and responding to risk*

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

Risk assessment

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

Preliminary analytical procedures

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

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

2.4.3 *Audit evidence and related judgments*

Audit judgments

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

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

Reliance on third-parties

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

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

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

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

2.4.4 *Communicating with Audit Committees*

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

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

Communication in the absence of an audit committee

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

2.4.5 *Audit finalisation*

Audit finalisation procedures include a final analytical review of the financial statements as a whole, a review of events occurring after the end of the financial year that may require adjustment of, or disclosure in, the financial statements ("subsequent events") and consideration of the appropriateness of the going concern assumption in preparing the financial statements.

Generally we noted during our file reviews that the audit finalisation procedures adopted were adequate and that the standard of the relevant documentation on file had improved. However, on just over half of the audits reviewed, improvements are required in the relevant procedures to ensure that all inadequate or erroneous disclosures are properly followed up and included in the letter of representation obtained from the Board. In some cases, audit teams should pay greater attention to their assessment on file of the adequacy of disclosures in financial statements.

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