Financial Reporting Council

# KPMG LLP
# KPMG AUDIT PLC

## AUDIT QUALITY INSPECTION

JUNE 2017

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

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

### Improve the extent of challenge of management in relation to areas of judgment, in particular for impairment reviews, loan loss provisions and other valuations

The audit of valuations, loan loss provisions and impairment reviews requires appropriate use of professional judgment. Effective audit teams will consider management's assumptions and compare these to available audit evidence and, where appropriate, challenge management in relation to the basis of those assumptions. We continue to identify a number of concerns in relation to the audit of valuations, loan loss provisions and impairment reviews of goodwill and other intangibles. The issues largely related to the extent of audit teams' challenge of management, including:

- Audit teams not adequately demonstrating their critical assessment of valuation assumptions or methodology relating to investments and inventory.

- Insufficient challenge of management's assumptions in relation to the impairment of goodwill and other intangibles, with undue reliance placed on evidence which supported management's assumptions/ position.

- In relation to loan loss provisions our concerns, on both audits where this was relevant, related to there being insufficient procedures performed to corroborate certain of the inputs used. The work performed did not demonstrate sufficient scepticism and challenge of management regarding the appropriateness of the provisions.

Other concerns arose in relation to the identification of intangibles, the challenge of sensitivities considered by management and the compliance of impairment models with Accounting Standards.

**Firm's actions:**

This is a broad topic and one where we have always left a great deal to the judgment of individual engagement leaders. Their experience and judgment has been central to the audit approaches they tailored for each client.

The primary root cause identified where our work has been identified as requiring improvement is the failure to adequately evidence all elements of the thought process and the basis for the decisions made.

Going forward, we will drive more consistent approaches from our teams and ensure their findings are evidenced using mandatory templates. Where practical, consistency will be achieved using data analysis tools which we have already developed.

These solutions will be followed up by the Second Line of Defence teams to ensure adoption and check consistency of application.

### Re-assess the firm's approach to the audit of revenue and the related training provided

Revenue is an important driver of a company's operating results and is often identified as a key performance indicator on which investors and other users of financial statements focus. It may be open to manipulation as a result, and auditors, therefore, 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 a number of issues:

- Analytical review procedures were often 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 to corroborate management explanations adequately.

- Insufficient revenue testing was performed on certain audits. One audit team did not perform the planned procedures over customer contracts or substantive analytical procedures for two components. On two audits we identified insufficient understanding and testing of system-generated interest income, in particular regarding the associated IT controls.

Our concerns in relation to the ineffective use of substantive analytical review procedures have recurred over a number of our annual inspections, with similar findings in the firm's own internal quality reviews. The firm's actions to address the quality of work through increased training and guidance have, to date, not proved sufficiently effective. The firm should therefore re-assess its overall approach to the audit of revenue.

FRC – AUDIT INSPECTION UNIT

# Appendix C – 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 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.

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, assessing an audit as requiring significant improvements does not necessarily imply that the conduct of the relevant audit firm, or one or more individuals within the firm, may warrant investigation and/or enforcement action by the FRC.