



AUDIT INSPECTION UNIT

PUBLIC REPORT ON THE 2010/11 INSPECTION OF KPMG LLP AND KPMG AUDIT PLC

26 JULY 2011

This report is issued by the Audit Inspection Unit of the UK's Professional Oversight Board ("the Oversight Board"), part of the Financial Reporting Council. It has been approved for publication on behalf of the Oversight Board.

Contents		Page
1	Background information and key messages	2
<hr/>		
2	Principal findings	6
<hr/>		
Appendix A	Objectives, scope and basis of reporting	14
<hr/>		
Appendix B	Firm's response	17

1 Background information and key messages

1.1 Introduction

This report sets out the principal findings arising from the inspection of KPMG LLP and KPMG Audit Plc (“KPMG” or “the firm”) carried out by the Audit Inspection Unit (“the AIU”) of the Professional Oversight Board (“the Oversight Board”), part of the Financial Reporting Council (“the FRC”), in respect of the year to 31 March 2011 (“the 2010/11 inspection”). Our inspection was conducted in the period from March 2010 to February 2011 (referred to as “the time of our inspection”). The objectives of our work are set out in Appendix A.

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

We reviewed 14 audit engagements undertaken by the firm in our 2010/11 inspection. These related to FTSE 100, FTSE 250, other listed and other major public interest entities, with financial year ends between September 2009 and February 2010. Our reviews were selected on a risk basis, utilising a risk model, and covered only selected aspects of the audits.

Each year we select a number of areas of particular focus. For 2010/11, these were: the fair value measurement of assets and liabilities, the impairment of assets (including goodwill and other intangible assets), revenue recognition and fraud risks, segmental reporting and the evaluation of going concern. Certain of our reviews were restricted to some or all of these areas.

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

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

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

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU's overall inspection programme for the relevant year. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

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

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

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

The AIU acknowledges the co-operation and assistance received from the partners and staff of KPMG in the conduct of the 2010/11 inspection.

1.2 Background information on the firm

The UK firms of KPMG are owned by KPMG Europe LLP ("ELLP") which is a limited liability partnership created through a merger of the UK and German member firms of KPMG International in October 2007. It has since been enlarged to include a number of other KPMG member firms. The management of ELLP and its operating subsidiaries lies primarily with the Board of the ELLP. The KPMG office in Northern Ireland is part of the Irish member firm which is not part of ELLP.

The UK firm has 22 offices and is organised into three lines of service, being audit, advisory and taxation. All statutory audit work is performed within audit, which is divided into industry and geographical business units for operational purposes.

For the year ended 31 December 2010, the firm's turnover was £1,602 million, of which £458 million related to audit and directly related services. There were a total of 529 partners, of whom 158 were authorised to sign audit reports, and 108 employees (audit directors) who were authorised to sign audit reports.¹

¹ As disclosed in the annual return to the ICAEW as at 31 May 2010.

The AIU estimates that the firm had 413 audit clients within the scope of independent inspection by the AIU as at the 2010/11 reference date of 26 February 2010. Of these audit clients, AIU records show that 171 had securities listed on the main market of the London Stock Exchange, including 22 FTSE 100 audit clients and 49 FTSE 250 audit clients.

1.3 Overview

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

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

Our principal findings, as set out in section 2, largely relate to the application, rather than the design, of the firm's procedures by audit personnel, whose work and judgments ultimately determine the quality of individual audits.

1.4 Key messages

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

- Ensure that audit teams apply appropriate professional scepticism to information prepared by the audited entity's staff that is significant to material amounts included in the financial statements (such as provisions or recognised revenue) and test its reliability.
- Consider the need for further action to improve the overall consistency of work performed on key judgment areas.
- Ensure that the improvements made to the partner appraisal system are also applied to audit managers, particularly in relation to selling non-audit services to entities which are audited by the firm.
- Readdress as a priority our recurring findings in relation to substantive analytical review where there are implications for the sufficiency of substantive testing and as a

result the overall audit evidence obtained. A focused initiative is required to eliminate the recurrence of issues in this area.

- Monitor more rigorously the application of finalisation policies and file assembly procedures.

2 Principal findings

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

2.1 Review of audit engagements

Follow-up of audits reviewed in the prior year

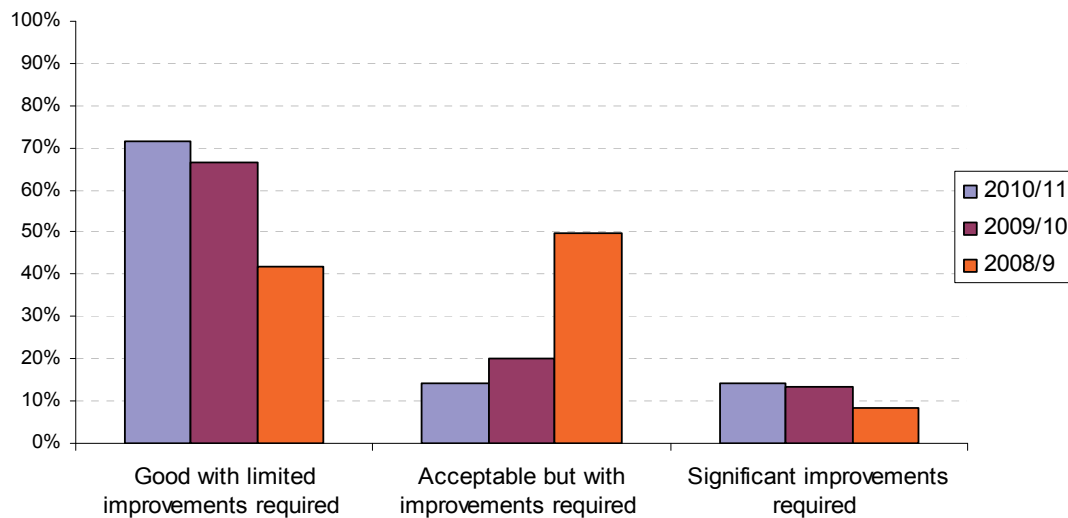
We undertook two follow-up reviews of audits we had reviewed in the prior year. The issues we raised in the prior year had been addressed on both audits which resulted in improvements to audit quality in the relevant areas. However, in one case, while significant improvements had been made, some changes were still required in the finalisation process.

Audits reviewed in the current year

We reviewed selected aspects of 14 audits (2009/10: 15). Ten of those audits were performed to a good standard (2009/10: ten) with limited improvements required and two of those audits were performed to an acceptable standard (2009/10: three) but with improvements required. Two audits required significant improvements (2009/10: two); one in relation to revenue and profit recognition and one in relation to loan impairments and IT general controls.

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

The chart below shows the percentage of the audits we reviewed in 2010/11 by AIU grade with comparative figures for 2009/10 and 2008/9.



Due to the size of the samples involved, changes in performance from one year to the next are not necessarily indicative of an overall change in audit quality.

Findings in relation to audit evidence and judgments

The focus of our reviews has been on the audit evidence and related judgments for material areas of the financial statements and areas of significant risk. We reviewed a number of key audit judgments, paying particular attention to impairment of goodwill and other intangibles, the valuation of assets held at fair value, revenue recognition and fraud risks, segmental reporting and the going concern assessment.

We draw attention to the following findings which the firm should ensure are adequately addressed in future audits.

- Impairment of loans

Improvements were required in the audit of loan impairment in three audits we reviewed. Collective provisions were established in each case for impairments incurred by the end of the year but not yet reported. In each case we raised issues on the sufficiency of audit evidence supporting certain aspects of the techniques adopted by management to assess the level of collective provision required. Also, in one case, there was insufficient review of the work performed by overseas audit teams in relation to significant specific loan impairments incurred during the year.

- Revenue and profit recognition

On one audit significant improvement was required in relation to the sufficiency of audit evidence for revenue and profit recognition. The audit approach adopted in relation to long-term contracts included reviewing management's contract summaries for salient features. We consider this review to be a key component of the audit. However, the process adopted by management for compiling the contract summaries had not been evaluated or tested in the current year and it was not evident when it was last subject to audit testing. On the same audit, the accounting for profit on long term contracts included contingency provisions in respect of future costs. While we were informed that these contingencies were consistent with prior years, there was no evidence that the audit team had assessed whether this remained appropriate.

- Segmental reporting

On five audits we identified areas for improvements in the audit of segmental reporting disclosures. In one of these cases, we noted an apparent inconsistency between the identification of reporting segments in the financial statements and the disclosures provided elsewhere in the Annual Report. The audit team had not explained the basis for their judgment that this apparent inconsistency was acceptable.

Recurring findings from one year to the next

Areas where there has been no improvement compared with last year

At the time of the relevant audits, the action taken by the firm did not appear to have been sufficiently effective in addressing the recurring findings related to substantive analytical review procedures and the long involvement of Other Partners and Staff in Senior roles as detailed below. Both areas continue to be covered in the firm's training programmes. We will continue to monitor these areas and expect the firm to have dealt with our recurring findings effectively.

- Substantive analytical review

On four audits we identified weaknesses in the substantive analytical review procedures performed in respect of the income statement. In three cases the analytical review procedures were not, in our view, performed in sufficient depth. In addition, in one case, the majority of the audit evidence relating to supplier incentives, rebates and discounts was obtained from substantive analytical procedures which involved discussions with buyers. While there was evidence that these discussions had taken place, notes of these discussions were not retained. Since these audits took place the firm has required both the use of the firm's substantive

analytical review template and enhanced review of all analytical procedures conducted to obtain substantive audit evidence.

- Long involvement of Other Partners and Staff in Senior roles

On four audits the audit teams did not evidence the identification and consideration of threats to independence for all Other Partners and Staff involved in the audit in Senior roles. In one of these cases the IT specialist partner had been involved for nine to ten years and, in our view, his role constituted a senior position as envisaged under the Ethical Standards. In the three other cases we identified shortcomings in the audit teams' records of Other Partners and Staff involved in Senior roles but none of them had been involved in the audit for longer than seven years.

Areas with an improvement compared with last year

While we have seen some improvement in relation to the following matters, following a number of positive steps by the firm, continued effort is required to achieve further improvements:

- Communicating with Audit Committees

We continue to note good examples of reporting to Audit Committees and a number of the issues in prior years have been addressed and have not recurred. However, on two audits issues arising were not adequately reported and on three audits the audit approach and/or the basis on which conclusions were reached on significant areas of judgment were not adequately reported.

- Dating of working papers and assembly of audit files

We identified various issues on four audits regarding the assembly of audit files and instances in two cases where a few key work papers had been backdated. Audit file assembly issues have also occurred in prior years. All audits from 31 December 2010 onwards will be completed using KPMG's new audit software which the firm believes should help prevent the recurrence of these issues.

- Signing and dating of audit reports

As a result of our prior year findings the firm revised and reissued its policy and mandatory guidance in relation to the signing and dating of audit reports and we observed an overall improvement in this area. However, on two audits reviewed, including one follow-up review, we continued to identify some issues in this area, albeit of a more minor nature. Once these issues had been identified in the current inspection cycle, the firm further enhanced its mandatory guidance in this area. Application of this guidance should continue to be closely monitored.

Other findings in the current year

Extended assurance services

In the light of the prior year publicity surrounding the provision of “extended assurance” services, we reviewed the audit of two entities where such services had been provided. We did not identify any relevant requirements of the Ethical Standards applicable at the time that had not been met or any adverse impact on audit quality.

IT general controls

On one audit where the control environment had a significant impact on the audit approach there was insufficient consideration of weaknesses identified in relation to IT general controls. In our view, there was insufficient evidence to support the conclusion that the weaknesses had no impact on the planned audit approach. The audit team should have explicitly evidenced their assessment of the cumulative effect of weaknesses in relation to interrelated or complementary controls on the level of audit risk.

Quality control

On six audits there was inadequate evidence of the timely review of certain working papers by the engagement partner and engagement quality control reviewer (EQCR). In two cases there was no evidence of the engagement partner’s review of a key area of judgment prior to the date of the audit report. In five of the six cases, planning and/or certain completion documentation appeared to have been signed late or not to have been signed at all by the EQCR. The firm should reinforce its policy regarding the timely review of work papers.

2.2 *Review of the firm’s policies and procedures*

The firm generally has appropriate policies and procedures in place for its size and the nature of its client base in those areas which are subject to our review. The policies and procedures are largely developed either globally or at a European (ELLP) level and the UK firm puts significant resources into the global, ELLP and its own central support functions, such as risk management, audit and accounting technical, independence compliance and human resources.

During the year we have noted enhancements and improvements that have been made to the firm’s policies and procedures. We have also identified certain areas for improvement in their application in practice which need to be addressed.

Progress on dealing with prior year findings

Overall the firm has made significant progress in enhancing its systems and procedures and in addressing issues in their application. The firm has made a number of improvements to its procedures in response to our prior year findings including the following:

- Enhancements to the partner appraisal process to ensure that appraisals are completed on a timely basis and that there is a record of audit quality considerations. No issues were raised in the current year in relation to partner appraisals.
- Greater scrutiny of the timely completion of client acceptance and continuance forms.
- Improvements to the vetting of tender documents. In response to our prior year findings, Audit Quality & Risk Management is now required to review the appropriateness of the content of all FTSE 350 audit tenders.

We have in past years raised issues on certain audit files regarding insufficient follow-through from planning to work done and conclusions drawn. These issues have also been raised by the firm's internal quality monitoring processes (QPR). In 2010 the firm completed the roll-out of a fully automated audit system, 'eAudIT', which was in place for 31 December 2010 year-ends. On the basis of our review of some of the pilot audits conducted using the new software, it has the necessary facilities to prevent the above issues and other file assembly problems from recurring.

The firm has formalised its practice whereby, in the event of an audit regulator concluding that an audit engagement requires significant improvement, the Audit Quality & Risk Management Partner will consider whether a further independent review within the firm is required. The objective of such a review is to understand more fully the points being raised by the regulator and to ensure that any learning points are identified and appropriately addressed.

One prior year finding had not been fully addressed during the year. This related to responses to weaknesses identified by internal quality reviews in the performance of substantive analytical review procedures. The firm has subsequently taken further action intended to address this matter.

Other findings in the current year

Through the Quality Forum established by the UK Head of Audit in the prior year, KPMG has continued to implement a number of initiatives with the objective of raising the profile and awareness of the importance of audit quality across the UK firm. These include the launch of its own Audit Quality Framework focusing on the skills and behaviours required to deliver an appropriate and independent audit opinion.

In response to the need to maintain and enhance professional scepticism at all levels, the firm included professional scepticism as a focal point of its training on Clarified ISAs and its training on auditing management forecasts. We have also seen evidence of the emphasis placed on professional scepticism in the briefings and training related to the audit of going concern. In addition a tool was rolled out during the year to help audit teams achieve the firm's objective of consistently applying good professional judgment.

Findings where improvements are required are set out below.

Performance appraisal process for audit managers

Three audit manager appraisal forms included goals that implied objectives had been set to sell non-audit services to audit clients. The firm should ensure that managers and their appraisers are in no doubt that such objectives must not be set as such sales are not to be taken into account in performance assessments or remuneration decisions.

The results of one AIU file review conducted in the year where significant improvements were required were not fully reflected in two of the relevant audit manager appraisals. We expect the outcome of relevant aspects of all internal and external quality reviews to be addressed in manager appraisals.

Guidance on the provision of tax services

Certain supplementary ethical guidance issued by the firm (in 2004 and still available for use) on the provision of tax services to listed audit clients and significant affiliates was not, in our view, consistent with relevant Ethical Standard requirements. The APB has subsequently revised the relevant Ethical Standard to preclude the interpretation of the particular requirement that gave rise to our concern as this was inconsistent with its original intent. The clarification removes any doubt that the services concerned are

prohibited. We were informed that KPMG has revised its policy and related guidance accordingly and will review the application of this policy in future inspections.

Andrew Jones
AIU Director
26 July 2011

Appendix A – Objectives, scope and basis of reporting

Scope and objectives

The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC's Auditing Practices Board and other requirements under the Audit Regulations issued by the relevant professional bodies. The standards referred to in this report are those effective at the time of our inspection or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.

Our reviews of individual audit engagements and the firm's policies and procedures cover, but are not restricted to, the firm's compliance with the requirements of relevant standards and other aspects of the regulatory framework. Our reviews of individual audit engagements place emphasis on the appropriateness of key audit judgments made in reaching the audit opinion together with the sufficiency and appropriateness of the audit evidence obtained.

We 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 requiring action by the firm than areas of strength and are not intended to be a balanced scorecard or rating tool. We also assess the extent to which the firm has addressed the findings arising from its last AIU inspection.

Our inspection was not designed to identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by us for review and cannot be relied upon for this purpose.

The monitoring units of the professional accountancy bodies in the UK which register firms to conduct audit work are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection by the AIU but within the scope of audit regulation in the UK. Their work, which is overseen by the Oversight Board, covers audits of UK incorporated companies and certain other entities which do not have any securities listed on the main market of the London Stock Exchange and whose financial condition is not otherwise considered to be of major public interest. All matters raised in this report are based solely on work carried out by the AIU.

Basis of reporting

This report is based on the AIU's more detailed private report on its inspection of the firm to the Audit Registration Committee ("the ARC") of the Institute of Chartered Accountants in England and Wales ("the ICAEW") with which the firm is registered for audit purposes. The AIU currently inspects the largest audit firms including KPMG annually. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU's 2010/11 report to the ARC, which was finalised in May 2011, recommended that the firm's registration to conduct audit work should be continued.

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU's overall inspection programme for the relevant year. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

While the AIU's 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 by the AIU 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 the AIU's inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits are selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied before the AIU's private and public reports are finalised. As a result, there may be a significant period of elapsed time between completion of the AIU's inspection fieldwork at firms and the publication of reports on the inspection findings.

The AIU also issues confidential reports on the individual audits reviewed by it during an inspection. These reports are addressed to the relevant audit engagement partner or director but firms are expected to provide copies of the reports to the directors of the relevant clients.

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, the Oversight Board, the AIU and their employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.

Appendix B – Firm’s response

The firm’s response is on the following page.



KPMG LLP
15 Canada Square
Canary Wharf
London E14 5GL
United Kingdom

Tel +44 (0) 20 7311 1000
Fax +44 (0) 20 7311 3311
DX157460

Audit Inspection Unit
Aldwych House
71-91 Aldwych
LONDON
WC2 4HN

5 July 2011

Dear Sirs

AIU Public Report 2010/11

We welcome the recommendations made in the report which will contribute to our continuous improvement process. We have already taken action to address the specific matters raised. Whilst we may not always have exactly the same view as the AIU on the significance of individual matters, we share the objective of avoiding any “significant improvement required” assessments in future.

The AIU has commented on our emphasis on professional scepticism within our training programme and notes our significant progress in enhancing our systems and procedures and addressing issues in their application. We accept that our efforts with regard to substantive analytical review have not been sufficiently effective and as noted in the report we have taken further action this year. The effectiveness of this action will be a focus of our 2011 Quality Performance Review process and we will take further steps where necessary.

This is the second Public Report on KPMG since the economic crisis and once again the AIU has raised no issues in respect of going concern assessments or impairment of fixed assets (including goodwill and other intangibles).

We also note that the AIU has not questioned the appropriateness of any of the non-audit services we have delivered, including extended assurance.

We would like to take this opportunity to thank the AIU for the open and professional manner in which the review was conducted.

Yours faithfully

KPMG LLP



FINANCIAL REPORTING COUNCIL
5TH FLOOR
ALDWYCH HOUSE
71-91 ALDWYCH
LONDON WC2B 4HN
TEL: +44 (0)20 7492 2300
FAX: +44 (0)20 7492 2301
WEBSITE: www.frc.org.uk

© The Financial Reporting Council Limited 2011

The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368.
Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.