KPMG LLP

Audit Quality Inspection and Supervision

Financial Reporting Council

July 2023

Introduction: FRC's objective of enhancing audit quality

The FRC is the Competent Authority for UK statutory audit, responsible for the regulation of UK statutory auditors and audit firms. We assess, via a fair evidence-based approach, whether firms are enhancing audit quality and are resilient. We adopt a forward-looking supervisory model and hold firms to account for changes needed to improve audit quality.

Auditors' opinions on financial statements play a vital role upholding trust and integrity in business. The FRC's objective is to achieve consistent high quality audits so that users have confidence in financial statements. To support this, we:

- Set ethical, auditing and assurance standards and guidance, as well as influence the development of global standards.
- Inspect the quality of audits performed by, and the systems of quality management of, firms that audit Public Interest Entities (PIEs[1]) and register auditors who carry out PIE audit work.
- Set eligibility criteria for auditors and oversee delegated regulatory tasks carried out by professional bodies such as qualification and the monitoring of non-PIE audits.
- Bring enforcement action against auditors for breaches of relevant requirements.

Since our July 2022 report we have delivered on a reform programme ahead of the Government response to restoring trust in audit and corporate governance, including:

- Taking responsibility for PIE auditor registration allowing us to impose conditions, suspensions and, in the most serious cases, remove registration of PIE auditors.
- Agreeing a memorandum of understanding with the Department for Levelling Up, Housing and Communities (DLUHC) setting out our responsibilities as shadow system leader for local audit.
- Updating Our Approach to Audit Supervision, outlining the work of our supervision teams.
- Publishing a Minimum Standard for Audit Committees and the External Audit and consulting on revisions to the UK Corporate Governance Code.

Our 2023/24 transformation programme will demonstrate our continued commitment to the public interest and restoring trust in the audit profession.

The seven Tier 1 firm[2] reports provide an overview of key messages from our supervision and inspection work during the year ended 31 March 2023 (2022/23) and the firms' responses to our findings.

[1] Public Interest Entity – in the UK, PIEs are defined in Section 494A of the Companies Act 2006 and in Regulation 2 of The Statutory Auditors and Third Country Auditors Regulations 2016.

[2] The seven Tier 1 firms in 2022/23 were: BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP, Mazars LLP, PricewaterhouseCoopers LLP. We have published a separate report for each of these seven firms along with a cross-firm overview report.

Our supervisory approach

The audit supervisory teams in the FRC's Supervision Division work closely together to develop an overall view of the key issues for each firm to improve audit quality. We also collaborate to develop our plans for future supervision work.

The supervisory staff producing our reports

90

The audit supervisory teams comprise 90 experienced professional and support staff assessing the risks to audit quality and resilience at each firm and the actions needed to address those risks.

KPMG LLP

RIs 325

Offices[3] 20

14,019 Professional Staff

Audits within the FRC's inspection scope[4]

Inspection Cycle	FTSE 100 audits	FTSE 250 audits	Total audits in FRC scope
2023-24	20	41	240
2022-23	23	39	284
2021-22	24	48	362

Audit fee income[5] £m

2020	2021	2022
639	646	709

Corporate audits inspected by the FRC[6]

2022-23: 19

2021-22: 19

2020-21: 22

Local audits[7]

2022-23

Major audits **24**
Non-Major audits **25**
Major audits inspected by the FRC **2**

[3] Source - the ICAEW's 2023 QAD report on the firm.
[4] Source - the FRC's analysis of the firm's PIE audits and other audits included within AQR scope as of 31 December 2022.
[5] Source - the FRC's 2021, 2022 and 2023 editions of Key Facts and Trends in the Accountancy Profession.
[6] Excludes the inspection of local audits.
[7] The FRC's inspections of Major Local Audits are published in a separate annual report. The October 2022 report can be found here.

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Appendix

This report sets out the FRC's findings on key matters relevant to audit quality at KPMG LLP (KPMG or the firm). As part of our 2022/23 inspection and supervision work, we reviewed a sample of individual audits and assessed elements of the firm's quality control systems.

The FRC focuses on the audit of PIEs. Our risk-based selection of audits for inspection focuses, for example, on entities: in a high risk sector; experiencing financial difficulties; or having material account balances with high estimation uncertainty. We also inspect a small number of non-PIE audits on a risk-based selection.

Entity management and those charged with governance can make an important contribution to a robust audit. A well-governed company, transparent reporting and effective internal controls all help underpin a high quality audit. While there is some shared responsibility throughout the ecosystem for the quality of audits, we expect firms to achieve high quality audits regardless of any identified risk in relation to management, those charged with governance or the entity's financial reporting systems and controls.

Higher risk audits are inherently more challenging, requiring audit teams to assess and conclude on complex and often judgemental issues (for example, future cash flows underpinning impairment and going concern assessments). Professional scepticism and rigorous challenge of management are especially important in such audits. Our increasing focus on higher risk audits means that our findings may not be representative of audit quality across a firm's entire audit portfolio or on a year-by-year basis. Our forward-looking supervision work provides a holistic picture of the firm's approach to audit quality and the development of its audit quality initiatives.

The report also considers other, wider measures of audit quality. The Quality Assurance Department (QAD) of the Institute of Chartered Accountants in England and Wales (ICAEW) inspects a sample of the firm's non-PIE audits. The firm also conducts internal quality reviews. A summary of the firm's internal quality review results is included in the Appendix.

1. Overview

Overall assessment

In 2021/22 we reported that 84% of the audits we inspected required no more than limited improvements, placing the firm in the most favourable position across the Big 4 Tier 1 firms. We were encouraged by the inspection results and were pleased to note that the firm's investment in audit quality appeared to be resulting in considerable improvements compared with previous cycles.

This year, the proportion of audits assessed as requiring no more than limited improvements decreased to 74%, with one audit (2021/22: none) requiring significant improvements.

Throughout the year, we have continued to closely engage with the firm over its banking audit quality improvement plan (BAQIP). We have continued to identify findings on our inspections as highlighted in Section 2, although the firm has been able to demonstrate improvements in audit quality in this area as outlined in both Section 2 and Section 3. To address findings identified the firm must now ensure that the changes are sustained and applied consistently across their entire portfolio.

Root cause analysis (RCA) and the subsequent identification of remedial action is a powerful tool to encourage effective continuous improvement. This is key to the elimination of recurring findings and to foster improvements in audit quality and inspection results. For the last three years our audit quality inspections have identified both findings and good practice in respect of the audit of impairment assessments, illustrating inconsistency in audit approach and evidence obtained to support judgements, and the need for further improvement in aspects of this area. The firm must assess the effectiveness of the RCA performed to date and the robustness of remedial actions taken to address these inconsistencies in audit quality.

The results from other measures of audit quality, covering a broader population and larger sample of audits, were positive. The results from the QAD of the ICAEW set out on pages 20 and 21, which are weighted towards higher risk and complex non-PIE audits (within the ICAEW scope), assessed 91% of the audits inspected as good or generally acceptable (75% in the prior year). QAD identified several good practices including: effective use of specialists, clear evidence of appropriate consultation and comprehensive audit documentation in areas of estimation and judgement.

Over a similar period, the results from the firm's internal quality monitoring process (IQM), covering both PIE and non-PIE audits, assessed 87% of audits as being the equivalent of good or limited improvement required, but had

74%

of audits inspected were found to require no more than limited improvements.

One audit inspected in the current cycle required significant improvements.

recurring findings in relation to journals, risk assessment, sampling and estimates as outlined on page 45.

Inspection results only provide a single point in time view of audit quality. The firm must continue to ensure that auditors obtain sufficient and appropriate evidence to support the judgements and conclusions reached and reduce inconsistencies which adversely affect the assessment of quality.

In response to this year's findings, we will take the following action:

- Continue our engagement with the firm on the oversight of its banking audit quality improvement plan, including specific consideration of actions taken and the effectiveness of these in addressing the initial concerns and deficiencies. It is our aim that, when the necessary improvements have been embedded and have proven to be effective, we will transition supervision to business as usual.
- Continue our focus on banking audits in our 2023/24 inspection cycle, increasing the number of audits covered and accelerating the timing of these to enable more timely remediation of any findings.
- Quarterly engagement with the firm to understand the specific changes made to the design and execution of RCA. We will assess the firm's changes and, acknowledging the timing delay between identification of an issue and its remediation, consider the impact of the actions taken.
- Assess the progress and impact of the firm's culture programme as initiatives are launched and embedded, to achieve the firm's desired values-led culture - operating to the highest ethical standards, across the entire firm.
- Continue to review the Single Quality Plan (SQP) and use it to monitor the actions taken to improve audit quality, their effectiveness (over the short and long term) and its use in complying with International Standard on Quality Management (UK) 1 (ISQM (UK) 1).

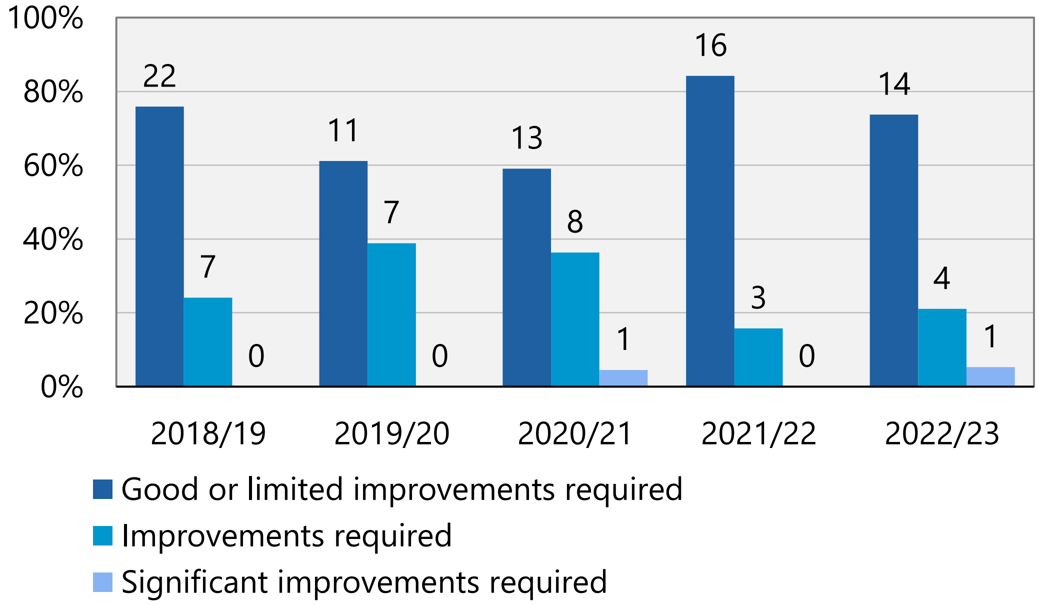
These actions are designed to hold the firm's leadership to account for delivering improvement and change in the areas that we regard as most important to the continuous improvement in audit quality that is required.

All firms are required to include actions within a Single Quality Plan, subject to formal reporting and regular review by the FRC.

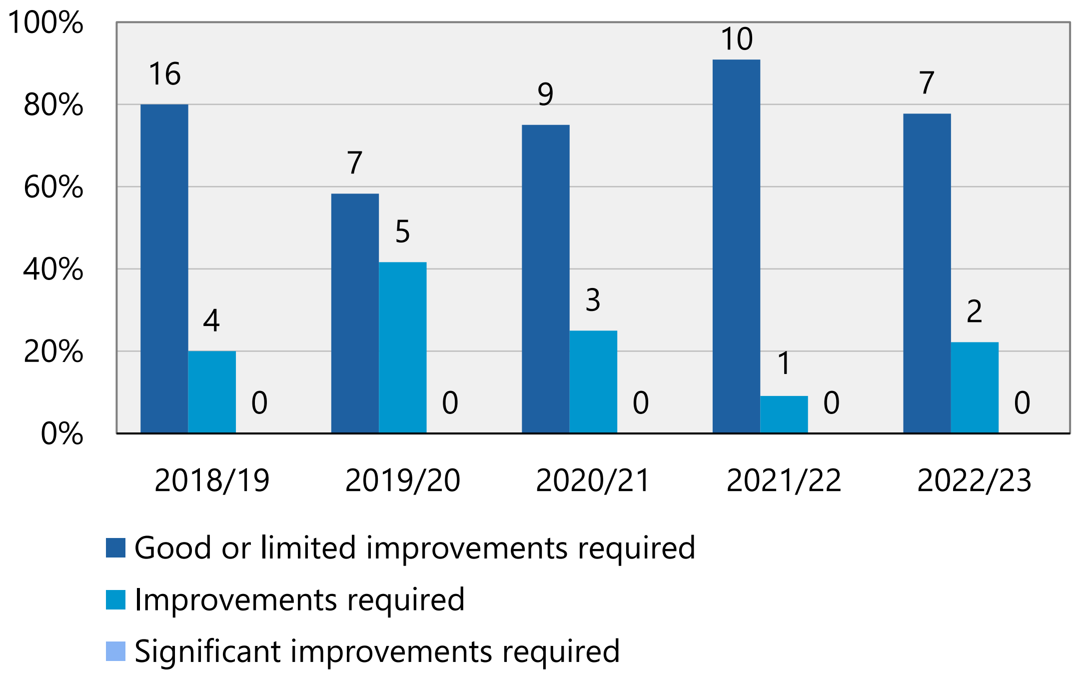
Inspection results: arising from our review of individual audits

We inspected 19 individual audits this year and assessed 14 (74%) as requiring no more than limited improvements. Of the audits inspected, nine were of entities in the FTSE 350. We assessed seven (78%) of these as achieving this standard.

Our assessment of the quality of audits reviewed: KPMG LLP



FTSE 350: KPMG LLP



The audits inspected in the 2022/23 cycle included above had year ends ranging from December 2020 to June 2022.

Changes to the proportion of audits falling within each category reflect a wide range of factors, including the size, complexity and risk of the audits selected for inspection and the individual inspection scope. Our inspections are also informed by the priority sectors and areas of focus as set out in the Tier 1 Overview Report. For these reasons, and given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm's performance and are not necessarily indicative of any overall change in audit quality at the firm.

Any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

Our key findings related to the audit of impairment assessments for non-current assets and other valuations reliant on cash flow forecasts, certain audit procedures for banks and similar entities, and the assessment of accounting judgements and disclosures in financial statements.

We identified a range of good practice related to risk assessment, execution of the audit and completion and reporting. Further details are set out in Section 2.

Inspection results: arising from our review of the firm's quality control procedures

This year, our firm-wide work focused primarily on evaluating the firm's: compliance with the FRC's Revised Ethical Standard; partner and staff matters; acceptance, continuance, and resignation procedures; and audit methodology relating to settlement and clearing processes.

Our key findings related to compliance with the FRC's Revised Ethical Standard and partner and staff matters. We also identified good practice in the majority of firm-wide areas reviewed.

Further details are set out in Section 3.

Forward-looking supervision

Improving and sustaining audit quality, including a message of high challenge and high support is a key element of the firm's audit strategy and the firm's leadership communicates this clearly to the audit practice.

The firm has made significant changes to and invested in its banking audit practice over the past few years. We have started to see the positive impact of

Our key findings on individual audits included impairment, certain audit procedures for banks and assessment of accounting judgements and disclosures in financial statements.

With respect to quality control procedures, our key findings related to compliance with the FRC's Revised Ethical Standard and partner and staff matters.

these initiatives both in our inspection activity and our active supervision and oversight of the firm's banking audit quality improvement plan. In recognition of the progress made we redesigned our approach to the oversight of BAQIP to ensure we understand and see clear evidence of the effectiveness of the actions implemented, as the firm looks to maintain their market presence in this sector. This focused work and the need to ensure the changes are implemented consistently across the entire portfolio is a specific element of our proposed supervision in this area for 2023/24. BAQIP continues to be a key priority for the firm and its executive and is given appropriate prominence and monitoring through the Single Quality Plan.

The firm commissioned an external review of its RCA, which highlighted several enhancements, including increasing the available resources, reassessing the large volume of root causes and prioritising remedial action. The firm have responded to these findings during the 2022/23 cycle and are reassessing their approach including prioritising recruitment of additional individuals to address the shortcomings identified. The firm must undertake robust RCA with timely remediation to help them achieve sustained improvements to audit quality. In 2023/24 we will continue engaging with the firm to understand and evaluate the changes made.

We will continue to assess the information provided by the firm in response to non-financial sanctions, determine whether appropriate actions have been taken and that demonstrable evidence has been provided to address the concerns arising from the specific enforcement cases. In December 2022, the Public Company Accounting Oversight Board (PCAOB) sanctioned the firm in respect of multiple instances of UK staff cheating in internal assessments. We will assess the remedial actions taken by the firm to respond to this issue as committed to the PCAOB.

The SQP underpins the firm's response to matters raised in this report. The firm have prioritised the implementation of this and are monitoring the effectiveness of actions taken and continued validity of priorities. We will continue regular engagement with the executive and Audit Non-Executives on the SQP throughout 2023/24.

Further details are set out in Section 4.

The Single Quality Plan underpins the firm's response to matters raised in this report and is subject to regular review by the FRC.

Firm's overall response and actions

Introduction

Our vision is to be the most trusted audit firm: by our regulators, the businesses we audit, investors, the public and our people. To achieve this, we have a focus on delivering sustainable audit quality at the heart of our strategy, supported by our other strategic priorities: empowering our people, supporting seamless delivery, and maintaining robust growth.

Despite the decrease in our AQR inspection outcomes this year, our average results over the past two years, along with the improved results from the QAD of the ICAEW inspections and our own internal reviews this year, provide evidence that our focus is delivering sustainable audit quality. In particular, we are pleased to see recognised the improvement in our banking audits including several examples of good practice being highlighted. We are confident that our unwavering commitment to delivering high audit quality, and our significant investment in our people, culture programmes and technology in our audit practice, will continue to drive sustainable audit quality.

We acknowledge, and are addressing, the areas identified for improvement. In particular, we take the fact that one of our non-FTSE 350 audits was rated as requiring significant improvements very seriously and took immediate action, strengthening our central oversight of engagements.

We are also pleased to see many areas of good practice noted by the FRC. With all three improvement areas from both the current and prior year featuring in good practice examples, we know our focus must be on ensuring consistency of execution, and we have embraced our Single Quality Plan to prioritise programmes and actions to deliver sustainable audit quality as our primary goal. To this end, our Root Cause Analysis process is our priority programme this year, reflecting the importance of timely implementation of remedial action to address and combat recurrent findings.

Progress in our resourcing position

We have considered the impact of our resourcing position on the audits with findings in the current AQR cycle: December 2020 to June 2022. Although there were some factors unique to certain audits, an underlying theme was the stretch of our available resources with high attrition across the profession in a post-pandemic market. While the review period marked the return to more normal operating conditions, it presented an uncertain economic environment and included the Omicron outbreak during the peak audit season, making it another challenging year to deliver audits.

This stretch resulted in some teams not fully explaining, or standing back to assess the clarity of, their thought process on file, or focusing on other significant areas of the audit. We have taken steps to address this including improving our onboarding processes and investing more in colleague recognition and well-being measures, and we currently have a strong resourcing profile with improved retention rates. We are particularly pleased to see the positive impact of actions we have taken to invest in our people reflected in our annual Global People Survey and interim 'Pulse' Survey results and, recognising the criticality of our people to audit quality, this investment will continue.

Progress in our investment programmes

Our more balanced resource and portfolio levels will enable our teams to continue to deliver sustainable high-quality audits, and we are confident that this is being enhanced through our work on embedding our culture ambition, the full deployment of our new cloud-enabled audit workflow tool, KPMG Clara (KCw), and our investment in innovative technology.

Our Culture Programme

We are pleased that our work on culture, particularly within the Audit practice, has been recognised by the FRC with a number of good practice examples in its publication "What makes a Good Environment for Auditor Scepticism and Challenge". Our Audit Culture programme, continues with its underlying ambition of 'high challenge, high support', and is critical to delivering sustainable audit quality. This has been a priority area for us for a number of years and it includes programmes focusing on improving coaching and overcoming confirmation bias which are common root causes of findings. We consider our culture programme to be vital to our future success and regularly review it, listen to feedback and continually evolve the activities we undertake to further embed our culture ambition.

We continue to drive engagement with our culture ambition at a local level through our Culture Ambassador network. Our Values Week promoted role models across our firm and externally, with leading personalities from a variety of backgrounds sharing their experience in relation to each of our five values respectively. To continue this engagement, our Partners led 'Values Immersion' sessions with all colleagues, allowing teams to have a meaningful discussion of Our Values and how we can all take greater ownership for living them.

To measure our success in embedding our culture goals across the firm, we are reporting against our culture dashboard and are using technology to help us measure sentiment. We are confident that this continued focus on our culture ambition will help us operate to the highest ethical and quality standards.

Our new audit workflow tool

We are investing heavily in new technology to drive quality. The year reviewed in this report also covers the transition from our former audit software to our next-generation, cloud-enabled audit workflow tool, KCw. It is faster, more intuitive and has a clearer connection between risk assessment and audit response. The new tool also provides our central quality monitoring team with the ability to monitor our teams' progress and highlight where additional support may be needed to ensure effective and timely planning. Half of the audits in this year's inspection sample were delivered using KCw and the results compare favourably to the audits delivered using our previous software.

Further technology in audit

We are also using innovative technology in our audits, expanding our use of advanced data analytics techniques – an area where good practice was recognised in this report. These techniques are now used on most of our audits enabling us to test whole populations more effectively than through sampling, thereby enhancing the results of our audit testing. We are also embracing future-technologies and, following a successful pilot, AI-enabled technology will be used on many audits in 2023.

We are providing training and are upskilling our people in new technology, innovation, data analytics and AI to create the Next Generation Auditors which is also vital to our ongoing improvement in audit quality. It complements the investments we've already made in emerging areas such as Climate risk where we have seen good practice recognised for the second year.

Responding to the themes identified by AQR this year

Impairment and other valuations reliant on cash flow forecasts

Impairment is a complex topic with a multiplicity of possible inputs and models and therefore the reasons for the findings have changed from year to year. While we are pleased that the AQR continue to see good practice in this area, we are focused on, and remain committed to, addressing and ensuring consistency.

Last year, the majority of findings in this area related to impairment assessments for multi-site operations. We issued further guidance on this topic to audit teams and only one audit reviewed this year had a similar finding, highlighting the success of the action taken. To address this year's findings, we have implemented a new impairment triage process to focus central technical and valuation support at the planning stage of the audit. Combined with our greater emphasis on extending central technical consultations and revisiting the evidence for how Second Line of Defence (2LD) findings have been reflected and resolved on the audit file, we are confident this will make a positive impact on the complex area of impairment testing.

Banking audits

We continue to invest in, and are pleased to see recognition of, improved quality within our banking audits. This is evidenced by several good practice points being identified by AQR and this year's *Audit methodology: Banks and Building Societies evaluation of Settlement and clearing processes* which did not recommend any additional action to be taken, but we recognise we must now ensure this improvement is sustained and applied consistently. Findings identified in one engagement by the AQR were related to the execution of our methodology by a team faced with unexpected complexities, rather than identifying any gaps in our banking-audit requirements, and our focus is therefore on ensuring consistent execution.

Our Banking Audit Quality Improvement Programme (BAQIP) continues to drive our focus on banking audits, simplifying the large volume of guidance issued, enhancing support and training to implement it and focusing on processes which provide both challenge and support. This will help to ensure consistency and enable our banking audit teams to deliver consistently high-quality banking audits.

Accounting judgements and disclosures

The findings covered by this theme were different but relate to how we articulate judgements made in the audit. In response, we have introduced processes which extend technical specialists' consultations through to seeing workpapers on file which will ensure important decisions are well evidenced. We have also issued clearer guidance to address one specific finding relating to the interpretation of accounting periods.

Responding to the review of firm-wide procedures under ISQC (UK) 1

Relevant ethical requirements – compliance with the FRC's Revised Ethical Standard 2019

We were pleased to see recognition of good practice identified in testing in this year where examples of robust consideration of independence, thorough and comprehensive compliance testing and detailed analysis of conflict checks were reported. However, we identified and reported instances where member firms commenced and performed non-audit services without receiving necessary approvals from UK audit engagement partners. We are taking steps globally to enhance existing controls to prevent this from happening in the future.

Partner and staff matters – recruitment, management of partner and senior staff engagement portfolios, appraisals, remuneration and promotion

Embedding the focus on quality in our key people processes has been a priority and it's positive to see the good practice noted in respect of feedback processes, quality metric reports and pre-promotion file assessments in this area. In addition, during this period, we took action to further strengthen the connection between quality and partner remuneration.

Acceptance, continuance and resignation procedures

Robust application of these policies and procedures is critical in assessing our resources, ability to comply with regulatory and ethical requirements, our capacity to engage teams with the appropriate skills and experience, and the governance procedures and integrity of those we work with. We were pleased to see five elements of good practice noted in this area.

Benefitting from our Single Quality Plan

We have embraced the FRC's requirement for the Tier 1 firms to consolidate their audit quality programmes and actions into a Single Quality Plan (SQP). This is a positive development which has helped us to provide better focus to our programmes and ensure we are operating in a framework that is compliant with ISQM 1. Audit quality must keep pace with the risks audited entities face and so our SQP supports us in being dynamic to respond to emerging issues.

We will continue to work on the priority actions and programmes that are included in the SQP which will help to consolidate the improvements we have made in recent years. In particular, we have reflected that improvements to our Root Cause Analysis process were not made quickly enough, so we have invested in expanding our Root Cause Analysis and Remediation teams to implement a comprehensive action plan to improve our process and deliver robust, effective Root Cause Analysis on a timely basis.

We have found engagement with our firm supervisor constructive and helpful in challenging the sufficiency and appropriateness of the actions we are taking to address findings and, specifically, how we measure effectiveness. This challenge has been mirrored by our Audit Board who oversee our progress against objectives and critically assess both the speed of implementation and the effectiveness of outcomes from our priority programmes.

Other priority programmes in our SQP include: our Banking Audit Quality Improvement Programme, where we continue to prioritise improving the quality and consistency of execution of our banking audits; our Engagement Analytics Programme, which will challenge the phasing of work for audit engagements; and our Scalability, Standardisation and Support programme, focused on the effective execution of audits. In response to engagement-level findings in the year, we have also prioritised a programme seeking to address how review points are responded to and outcomes of consultations are reflected on file ('Close the Loop').

The overall trend of both progress and measures of effectiveness, on all programmes since we implemented the SQP, is positive.

Looking to the future

As we look to the future, we are not complacent and recognise that delivering sustainable audit quality requires a journey of continuous investment, learning and improvement. We are proud that so much of our teams' hard work is evident in the range of good practices recognised by both the AQR and the QAD. This tells us we have the right strategy and foundations in place, and we will continue to work closely with the FRC to build on them. We are excited about the future of audit as we think about forthcoming Audit and Corporate Governance reforms, the speed of emerging, transformative technologies and the increased emphasis on the ESG impact of corporate entities. Against this backdrop, we recognise the importance of the audit profession in serving the public interest and are clear where we need to continue to focus to ensure that we build trust and confidence in our profession and the markets.

2. Review of individual audits

We set out below the key areas where we believe improvements in audit quality are required. As well as findings on audits assessed as requiring improvements or significant improvements, where applicable, the key findings can include those on individual audits assessed as requiring limited improvements but are considered a key finding in this report due to the extent of occurrence across the audits we inspected.

Improve the quality and consistency of audit procedures performed over impairment assessments for non-current assets and other valuations reliant on cash flow forecasts

Valuation assessments based on cash flow forecasts often involve significant judgement. Changes to the methodology adopted or the key assumptions and inputs made by management could result in a material impairment or change in valuation. Auditors are expected to obtain sufficient and appropriate evidence to assess the reasonableness of methodology, cash flows and other judgements to support their conclusions over management's impairment and valuation models.

We have reported key findings in relation to the firm's audit procedures over various aspects of impairment assessments for each of the last three inspection cycles. Although we continue to see examples of good practice in this area, the firm needs to take greater action to ensure that its audit procedures over impairment assessments, and similar valuation exercises based on cash flow forecasts, provide sufficient challenge of all relevant assumptions and are performed consistently.

Greater action is needed to ensure impairment audit procedures meet the required level of audit quality.

Key findings

We reviewed the audit of impairment of non-current assets on seven of the audits inspected this year. We identified issues relating to the evaluation and challenge of aspects of management's impairment assessments on five of these, one of which was assessed as requiring significant improvements, as follows:

- On one audit, the audit team did not obtain sufficient, appropriate audit evidence to conclude whether the valuation of non-current assets was impaired. The audit team did not sufficiently evaluate and challenge the model methodology, cash flow forecasts and other key related assumptions. Our inspection also identified a number of factual errors in the impairment model that the audit team's procedures failed to discover, along with broader deficiencies in the firm’s quality control procedures for this area of the audit.

- On the four other audits where we identified findings, these generally focused on the audit procedures performed over the corroboration and challenge of the cash flow forecasts used in management’s impairment models.

For three further audits we reviewed the audit procedures performed over acquisitions or other business valuations, where the valuations were based on future cash flow forecasts and shared some similarities with impairment assessment audits. We identified issues on two of those audits, one assessed as requiring improvements, including the following:

- On one audit, the audit team did not perform sufficient, appropriate procedures to test the valuation of a liability, or to corroborate and challenge key forecast assumptions. The audit team also failed to identify and report upon specific errors in management’s calculations.
- On another audit, the audit team performed insufficient procedures to corroborate and challenge contract revenue forecasts used in the valuation of acquired intangible assets.

Continue to improve the quality and consistency of certain audit procedures for banks and similar entities

Auditors of banks and similar entities need to design and perform audit procedures that are responsive to the inherent complexities of these entities and the significant judgements that may be involved in the preparation of their financial statements.

Last year, we reported that the firm needed to take action to further improve the quality of its audit work on banks and similar entities, in particular in the area of expected credit losses. This followed key findings raised in relation to audits of banks and similar entities in each of the previous three quality inspection cycles.

We are encouraged by improvements in the quality of the firm's banking audits, however, inconsistencies remain.

Key findings

We have inspected the audits of two banks in this inspection cycle, one was assessed as requiring limited improvements and one as requiring improvements. We are encouraged to have seen improvements in the audit work performed in a number of areas, including examples of good practice. However, the quality of audit work for these entities remains inconsistent, and we have continued to identify findings across the two audits that we have inspected. The most significant of these findings were in relation to the audit of expected credit losses and settlement and clearing accounts.

- **Expected credit losses:** On one audit, the audit team did not obtain sufficient, appropriate audit evidence in relation to material post model adjustments recognised by the bank.

  We also identified another finding over the testing of relevant data elements on this audit, and findings relating to model monitoring, individual credit file reviews and the assessment of multiple economic scenarios on the second audit.

- **Settlement and clearing accounts:** On the first audit noted above, the audit team performed insufficient procedures to test the reconciliation and clearing of nostro breaks. On the other audit, the audit team did not perform or evidence sufficient testing of certain controls within the settlement and clearing process.

Further details of our supervision and inspection work on KPMG's banking audit methodology and banking audit quality improvement plan are set out in Sections 3 and 4 of this report.

Exercise greater professional scepticism in the assessment of accounting judgements and disclosures in financial statements

Auditors should adopt an appropriate level of professional scepticism when assessing and concluding on key accounting judgements and the sufficiency of disclosures in the financial statements. Where errors or omissions are identified, auditors should ensure that the actions taken by management to address these matters are adequate and, if not, consider the impact on their audit reporting.

Key findings

We identified weaknesses in the audit procedures performed over accounting errors and the sufficiency of financial statement disclosures on three audits, including two audits assessed as requiring more than limited improvements.

- **Evaluation of accounting errors:** On the first of these audits, the audit team did not sufficiently justify its conclusion that the impact of an uncorrected accounting error in relation to revenue recognition was not material to the financial statements, nor did it assess that the associated disclosures were sufficient.
- **Financial statement disclosures:** On the second of these audits, the audit team did not satisfactorily evaluate or challenge a disclosure deficiency in relation to the accounting period, including whether this was material or significant to users of the financial statements.

Good practice

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

Risk assessment and planning

The risk assessment and planning phase of an audit is important to ensure a timely and appropriate risk assessment, enabling the audit team to tailor an effective audit approach responding to those risks.

- **Climate change risk assessment:** On three audits, we observed detailed and high quality evaluations by the audit team of climate change risks and their impact on financial statement disclosures.
- **Audit continuance and fraud risk assessment:** On one audit, the audit team performed a robust continuance assessment following the identification of certain fraud risk factors, which included agreeing certain undertakings with the audited entity. The audit team also developed a comprehensive suite of audit procedures to respond to the increased risks of management override of controls that were identified.

Execution

The execution of an audit plan needs to be individually tailored to the facts and circumstances of the audit.

Good practice examples included robust challenge of management, high quality audit procedures on one bank and effective involvement of specialists.

- **Challenge of management:** Similar to our last inspection cycle, we observed several examples of well-evidenced and robust challenge of management across the audits inspected. These included, on one or more audits, procedures in the areas of impairment, other fair value measures and insurance provisioning.
- **Audits of banks and similar entities:** On one bank audit, we identified several examples of good practice, including high quality procedures over general IT controls, the performance of independent partial rebuilds of expected credit loss models and the testing of valuation models for financial instruments.
- **Use of specialists:** We saw examples of particularly effective involvement of audit team specialists on two audits, which supported robust audit procedures over certain fair value measures, insurance provisioning, and related financial statement disclosures.
- **Other areas:** Other areas of good practice related to group audit oversight, revenue data analytic procedures in the audit of revenue, and the assessment of accounting policies and financial statement disclosures on a first-year audit.

Completion and reporting

The completion and reporting phase of an audit is an opportunity to stand back and assess the level of work performed against the audit plan and ensure that the reporting of the outcome of the audit is appropriate and timely.

- **Climate change risk assessment:** On one audit, the audit report included several additional disclosures around the audit team's response to climate change risks, which provided useful additional information to the users of the financial statements.

Monitoring review by the Quality Assurance Department of ICAEW

The firm is subject to independent monitoring by ICAEW. ICAEW undertakes its reviews under delegation from the FRC as the Competent Authority. ICAEW reviews audits outside the FRC's population of retained audits, and accordingly its work covers private companies, smaller AIM listed companies, charities and pension schemes. ICAEW does not undertake work on the firm's firm-wide controls as it places reliance on the work performed by the FRC, except for review of continuing professional development (CPD) records for a sample of the firm's staff involved in audit work within ICAEW remit.

ICAEW reviews are designed to form an overall view of the quality of the audit. ICAEW assesses these audits as 'good', 'generally acceptable', 'improvement required' or 'significant improvement required'. Files are selected to cover a broad cross-section of entities audited by the firm and the selection is focused towards higher risk and potentially complex audits within the scope of ICAEW review.

ICAEW has completed its 2022 monitoring review and the report summarising the audit file review findings and any follow up action proposed by the firm will be considered by ICAEW's Audit Registration Committee in July 2023.

Summary

The audit work ICAEW reviews continues to be of a satisfactory standard in most areas, with ten out of eleven standard file reviews being either good or generally acceptable. For comparison, in 2021, nine of the twelve standard file reviews were graded good or generally acceptable, two needed improvement and one needed significant improvement.

On the file requiring improvement in 2022, the business had been significantly impacted by the Covid-19 pandemic. There were gaps in audit evidence in three areas, including aspects of revenue and creditors linked to the Covid-19 impacts.

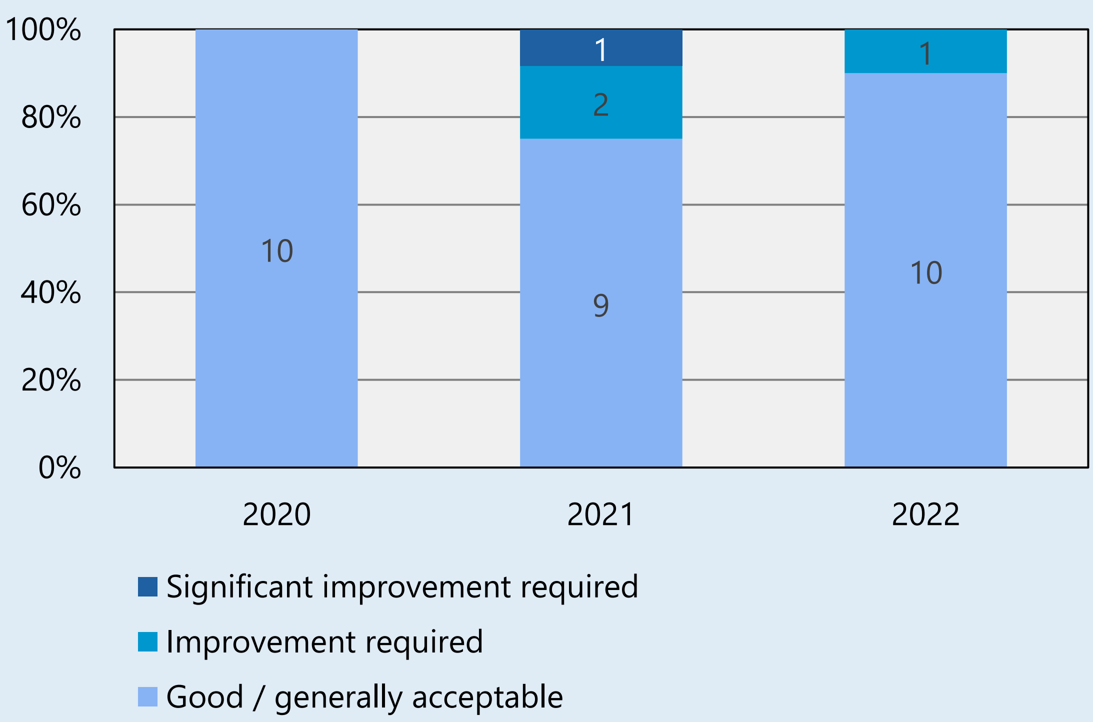
As part of routine QAD focused follow-up of more significant matters arising at the previous visit, the actions taken in relation to the specific issue on one audit were ineffective and the audit still required improvement.

Results

Results of ICAEW's reviews for the last three years are set out below.

91%

of the ICAEW reviews were assessed as either good or generally acceptable.



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

Good practice

ICAEW identified good practice across all but one of the files reviewed. Broad themes were:

- Effective use of internal specialists with clear linkage to audit work done and conclusions.
- Clear evidence of appropriate consultation with the firm's technical department, particularly in areas of judgement.
- Comprehensive audit documentation in areas of estimation and judgement, including property and derivative valuations, and pension related work.

3. Review of firm-wide procedures

We reviewed firm-wide procedures, based on those areas set out in ISQC (UK) 1, on an annual basis in certain areas, and on a three-year rotational basis in others.

In this section, we set out the key findings and good practice we identified in our review of the four areas of the firm's quality control procedures which we reviewed this year under our three-year rotational testing. We performed the majority of our review based on the policies and procedures the firm had in place on 31 March 2022.

Matters arising from our review of the quality control procedures assessed on an annual basis are included, where applicable, in Section 4.

The table below sets out the areas that we have covered this year and in the previous two years:

Annual	Current year 2022/23	Prior year 2021/22	Two years ago 2020/21
• Audit quality focus and tone of the firm's senior management • RCA process • Audit quality initiatives, including plans to improve audit quality • Complaints and allegations processes	• Relevant ethical requirements – Compliance with the FRC's Revised Ethical Standard (2019) • Partner and staff matters, including recruitment, appraisals, remuneration, and promotion • Acceptance, continuance and resignation procedures • Audit methodology (settlements and clearing processes for banks and building societies)	• Implementation of the FRC's Revised Ethical Standard (2019) • Engagement Quality Control Reviewers (EQCRs), consultations and audit documentation • Audit methodology (fair value of financial instruments with a focus on banks) • Internal quality monitoring	• Audit methodology (recent changes to auditing and accounting standards) • Training for auditors

We also set out a summary of our prior year findings (in the two previous years) later in this section.

Going forward firm-wide monitoring will be performed under ISQM (UK) 1, which came into effect on 15 December 2022 (see further detail on our approach later in this section).

Relevant ethical requirements – Compliance with the FRC's Revised Ethical Standard 2019

In the current year, we evaluated the firm's compliance with the FRC's Revised Ethical Standard 2019. The work considered the breadth of the Ethical Standard, focusing on areas where there were more significant changes to the requirements in the 2019 revisions. This testing involved checking for:

- Prohibited non-audit services
- Timely approvals of non-audit services
- Identification and assessment of threats and safeguards for non-audit services
- Compliance with fee ratios for non-audit services
- Robust evidencing of consultations
- Timely rotation of individuals off audit teams
- Financial independence of individuals

We also held biannual meetings with the Ethics Partners to inform our understanding of their current challenges and priorities.

Key findings

We identified the following key findings where the firm needs to:

- Enhance existing controls to prevent a network firm providing non-audit services alongside audit engagements without obtaining relevant UK approvals for the non-audit service. We welcome the firm's commitment to engage a third-party to perform a root cause analysis, which is currently underway.
- Ensure its systems and procedures identify all non-audit services provided to connected parties, including controlling individuals, that may compromise auditor independence. Identification of such services will enable audit engagement partners to assess and conclude on the associated threats.

Firms must have policies, procedures, and internal monitoring to drive compliance with the FRC's Revised Ethical Standard 2019 and identify and address deficiencies and breaches.

Good practice

We identified the following areas of good practice:

- A demonstration of robust consideration of the independence of an external consultant used on an audit. This included conflict checks for the company the individual was contracting through, completeness checks of contractor's disclosed directorships, an assessment of the contractor's immediate family dependencies, and a confirmation of their completed Ethics & Independence training.
- The firm's own compliance testing approach to personal investment testing. This is particularly thorough and comprehensive, for example, the firm review the time charged by an individual in comparison to the investments held and utilise a detailed questionnaire to prompt the checking of numerous scenarios, such as powers of attorney.
- Conflict checks provide a detailed analysis of the findings. The analysis incorporated not just prohibited services with the acquired entity, but also business and firm relationships; employment and other matters; contingent fees; and personal investments.

Partner and staff matters – recruitment, management of partner and senior staff engagement portfolios, appraisals, remuneration and promotion

Recognition and reward of partners and staff, particularly those involved in the delivery of external audits, is a key element of a firm's overall system of quality control and is integral to support and appropriately incentivise audit quality. Robust recruitment processes are also essential in creating a culture and environment that supports audit quality. We reviewed the firm's policies and procedures in these areas and tested their application for a sample of partners and staff for the firm's 2021 appraisal year processes.

Appropriate allocation and management of partner and senior staff portfolios enables a firm to ensure its audits are being led and staffed by auditors with appropriate skills, experience and time. We reviewed the firm's policies and procedures around the accreditation of auditors (Responsible Individuals or RIs) to sign audit reports, the allocation of RIs to audits, and the review of responsibilities and workloads for audit staff and partners. We tested the application of these policies for a sample of RI accreditations.

Recognition and reward of partners and staff, particularly those involved in the delivery of external audits, is a key element of a firm's overall system of quality control.

Key findings

The firm had improved some of its policies and processes since our last review of this area, particularly in respect of inclusion of quality metrics in appraisal and promotion processes. However, we identified the following key finding:

- When concluding on the 2021 remuneration decisions, there was an inconsistent approach to the reflection of audit quality in partner remuneration. Our sample identified several instances where it was not apparent that adverse quality results had been considered when awarding increases to remuneration, particularly in the case of new partners. Since our review, the firm has strengthened its quality checks prior to awarding increases in partners' base remuneration.

Good practice

We identified the following areas of good practice:

- The firm has robust feedback processes, including requiring staff to collect feedback for all engagements where they charge more than trivial time. The feedback is obtained through the use of mandatory feedback forms and robust mechanisms for the collection of upwards feedback. These procedures ensure that all individuals of manager grade and above collect upwards feedback that reflects on their behaviour and demonstration of the firm's values.
- For all managers and above, the firm produces quality metric reports, showing internal and external file results, compliance with mandatory training deadlines, compliance with archiving deadlines and any ethics breaches. These are rated red, amber or green and used in appraisal and promotion processes to drive consistent and complete consideration of quality metrics.
- The firm assesses all managers and above based on their quality metrics and results to award individual quality ratings. There are clear guidelines as to how quality ratings should be determined based on the quality metrics in the year.
- The firm undertakes internal reviews of audit files for director promotion candidates to assess their audit quality and technical skills.

Acceptance, continuance, and resignation procedures

A firm is required to establish policies and procedures for the acceptance and continuance of entities and audits to ensure that it only undertakes audits: that it is competent to and has the resources to perform, where it can comply with the ethical requirements, and where it has considered the integrity of management, those charged with governance and, where relevant, the owners of the entity. This assessment needs to be made prior to the acceptance or continuance decision for each engagement.

We have reviewed these policies and procedures, including the firm's wider risk assessment of entities and audits as part of acceptance and continuance decisions. In addition, we have considered the firm's policies relating to withdrawal or dismissal from audits and the required communication on ceasing to hold office.

We also reviewed the application of these policies, and quality of evidence retained, for a sample of audits accepted, continued and ceased in the year.

Key findings

We had no key findings to report.

Good practice

We identified the following areas of good practice:

- The firm's bid form requires the audit team to justify why the prospective audited entity's values and reputation would align with the firm's and that risks identified can be appropriately mitigated. This emphasises the firm's goal of only accepting audits that align with their quality objectives.
- The bid form also requires identification of expected areas of technical challenge that might arise and how the firm plans to address these. This helps drive a clear assessment of whether the firm has adequate resources to perform the audit.
- The firm also has a comprehensive risk appetite policy, that includes consideration of industry and geographical risk factors and management's behaviours and is introducing a new acceptance framework focused on public interest, environmental, social, and governance factors and reputational risks.

Firms must have comprehensive policies and procedures in respect of acceptance and continuance.

- The firm has a formal process for notifying the management of an audited entity, where they have concerns regarding management's behaviour and attitude towards the audit that may lead them to resign from the audit, unless prompt remedial action is taken by management.
- The firm has developed template wording for statements of reasons of resignation for a wide range of scenarios and requires central consultation for all resignation letters.

Audit methodology (settlements and clearing processes for banks and building societies)

In the current year, we evaluated the quality and extent of the firm's methodology and guidance relating to the audit of the cash and payments process cycle for the audit of banks, building societies, other credit institutions and payment services providers. Our evaluation focused on assessing the firm's guidance and templates provided in relation to:

- Understanding the relevant financial statement line items and their linkage to internal and external applications.
- Performing appropriate risk assessment procedures.
- IT specific guidance including the assessment of matching and other configuration rules and system generated report logic.
- Testing bank reconciliations (both controls and substantive testing.)
- Guidance over external confirmations.

Key findings

We had no key findings to report.

Good practice

We identified no specific examples of good practice in our review.

The firm's audit methodology, and the guidance provided to auditors on how to apply it, are important elements of the firm's overall system of quality control.

We identified good practice in ethical compliance, partner and staff matters, and acceptance, continuance and resignation procedures.

Firm-wide key findings and good practice in prior inspections

In our previous two public reports we identified key findings in relation to the following areas we reviewed on a rotational basis:

- Implementation of the FRC's Revised Ethical Standard (2021/22): The firm needed to improve its guidance on how to consider the perspective of an Objective Reasonable and Informed Third Party when taking decisions relating to ethics and independence. The firm also needed to embed their new gifts and entertainment system to ensure pre-approvals.
- Audit methodology (fair value of financial instruments with a focus on banks) (2021/22): The firm needed to issue methodology and improve the quality and extent of IFRS 13 guidance in relation to auditing the fair value of financial instruments for banks and similar entities.
- Internal quality monitoring (2021/22): The firm needed to increase the number of focus areas scoped into the reviews of large and complex audits and ensure that reviewer's professional judgements were sufficiently recorded to support the depth of their review and the conclusions reached in key areas where no findings have been raised.
- Audit methodology and training (2020/21): The firm needed to improve the quality and extent of its IFRS 9 methodology and guidance relating to the audit of banks and similar entities.

Further information on the firm's actions against these areas can be found in the 2021/22 and 2020/21 reports.

Good practice

Good practice was identified in two areas:

- On EQCR, consultations and audit documentation, the firm has a thorough audit accreditation framework determining who can work on audits in different sectors, including as the EQCR. The firm had also shortened the archiving period for audit files to 14 days with audit teams having 2 days to assemble the file.
- On audit methodology and training the firm provides extensive training to experienced hires including detailed scenarios and case studies to prepare the individual for their new role.

Implementation of ISQM (UK) 1

In the 2022/23 inspection cycle, prior to the implementation of ISQM (UK) 1, we have held discussions with the firm to understand its plans and progress for implementation, focusing on how the firm had:

- Ensured adequate oversight of and accountability for its system of quality management.
- Identified quality objectives, risks and responses and assessed the significance of its quality risks and the design and implementation of its responses.
- Identified the service providers and network resources that it relies upon in its system of quality management and how it will assess the reliability of these on an ongoing basis.
- Planned to undertake monitoring activities over its system of quality management on an ongoing basis.

Since the implementation of ISQM (UK) 1 we have begun our statutory monitoring under this standard.

In the first inspection cycle under ISQM (UK) 1 in full (2023/24), we are focusing on the firm's identification of objectives, risk assessment processes and the completeness of the risks identified. In addition, we are reviewing certain components of the system of quality management, including governance and leadership, acceptance and continuance, network resources and service providers. In these areas we are looking at the design and implementation of responses. We will also review the firm's plans for ongoing monitoring and remediation of the system of quality management and the annual evaluation process.

On an ongoing basis, our inspection will be undertaken on a risk focused and cyclical basis, supported by targeted thematic work where we will perform in-depth reviews of particular aspects of the firm's systems of quality management. Our thematic reviews in the 2023/24 inspection cycle will also cover the following areas:

- Audit sampling methodology, within the engagement performance and intellectual resources components.
- Hot reviews, within the engagement performance component.
- Identification and assessment of network resources and service providers, within the resources component.
- Root cause analysis, within the monitoring and remediation component.

We will also annually review elements of the ethics component as this continues to be a priority area for the FRC, where our work will again focus on ensuring firms adhere to the FRC's Revised Ethical Standard through: compliance testing, review of breaches reported and regular interaction with the firm's ethics functions.

Other annual areas of review will include elements of monitoring and remediation, including root cause analysis and audit quality plans, and leadership and governance, including tone at the top.

4. Forward-looking supervision

This section of the report focuses on our forward-looking supervisory approach – identifying and prioritising what firms must do to improve audit quality and enhance resilience. We balance an assertive approach, holding audit firms accountable, with acting as an improvement regulator, identifying and sharing good audit practice to drive further improvements across the sector.

We employ, to differing extents, all four faces of supervision in our work. A fuller explanation of our forward-looking supervision approach is set out in [Our Approach to Audit Firm Supervision 2023].

We hold the firms to account through assessment, challenge, setting actions and monitoring progress. We do this through: assessing and challenging the effectiveness of the firm's RCA processes; evaluating the developments of the firm's audit quality plans (AQPs); reviewing a firm's action plans – now including their Single Quality Plan (SQP) - and monitoring the effectiveness of the firm's responses to our prior year findings; assessing the spirit and effectiveness of the firm's response to non-financial sanctions; and through PIE auditor registration.

We also seek to promote continuous improvement of standards and quality across firms by sharing good practice, carrying out benchmarking and thematic work, and holding roundtables on topical areas. In 2022/23 we held a roundtable, attended by the Tier 1 firms, sharing good practices and success stories on in-flight or hot reviews (internal reviews that take place during the audit, prior to the audit report being signed). We also carried out thematic work including on tone at the top and aspects of IFRS 9.

Our observations from the work we have conducted this year, and updates from previously reported findings, are set out under the following areas:

- The firm's SQP, other quality improvement plans and audit quality initiatives
- Root cause analysis
- PIE auditor registration

Single Quality Plans should enable firms to identify the areas which contribute directly or indirectly to audit quality and to prioritise their actions.

- Other activities focused on holding the firms to account
- Culture and conduct
- Initiatives to ensure compliance with the FRC's Revised Ethical Standard
- Quality and consistency of audits of banks and similar entities
- Operational separation

Where our observation requires an action from the firm, we require its inclusion in the firm's SQP.

The firm's Single Quality Plan, other quality improvement plans and audit quality initiatives

Background

The SQP was introduced, as we required, by the Tier 1 firms during the year and is maintained by each firm as a mechanism to further facilitate our holding firms to account. Each firm should develop an SQP that drives measurable improvements in audit quality and resilience. The firm should also have an overarching plan and strategy for audit (Audit Quality Plan or AQP). The AQP should include initiatives that respond to identified quality deficiencies as well as forward-looking measures which contribute directly or indirectly to audit quality. Where a firm has poorer results, these audit quality plans should either be transformational in themselves or be supplemented with a plan that prioritises those initiatives that will quickly bring about the transformation needed to improve audit quality. These overarching plans should then be used in the development of the SQP in terms of purpose and prioritisation of individual actions or in the development of core pillars or similar. The SQP allows the firm and us to monitor whether changes are being prioritised and made in a timely and effective way. Where they are not achieving the objectives, we will hold the firm to account against their plan and consider whether further actions are necessary.

The firm has positively embraced the SQP initiative and embedded it throughout their business, as a framework to deliver sustainable audit quality.

Observations

We assessed the following:

- **Introduction of the SQP:** The firm has positively embraced the SQP initiative and embedded it throughout their business, using it as an overarching framework to deliver sustainable audit quality. The SQP identifies the firm's priority areas, which have evolved and adapted since its inception, to respond to challenges and emerging issues identified through active monitoring and ongoing FRC engagement and supervision. The plan is supported by underlying corroborative evidence and data that provide a clear explanation for the key priorities and any changes to the prioritisation of these. The quantitative and qualitative risk of priority areas is compared to other issues, programmes and initiatives, clearly demonstrating why these are the firm's current priorities.

- **Evaluation of progress:** Progress of delivery is assessed using two measures. Firstly, progress of underlying projects and actions. Secondly, qualitative measurement metrics, which consider how effective the actions in the SQP are at developing the right quality framework and how consistently they are applied. The progress of projects and actions is actively tracked and the effectiveness of the actions taken will affect the overall risk assessment of the individual priority area. Where delays arise or actions are overdue this is clearly flagged to the executive and Audit Non-Executives (ANEs) /Independent Non-Executives (INEs) with mitigating actions and responses provided.

  The firm have identified specific key performance indicators (KPIs) as measures of the effectiveness of actions taken for each priority. The importance of individual KPIs has been assessed and the firm have now applied a weighted average measurement to reflect the criticality of specific priority indicators. We continue to challenge the firm on its choice of KPIs and whether these are the most appropriate measures against which priority areas should be assessed. The assessment of importance of specific KPIs has enhanced the evaluation process.

- **Oversight of the SQP:** The Audit Board and executive are regularly provided with the latest version of the SQP, to understand progress on key priorities. Audit Board meetings are well facilitated and evidence of challenge by the ANEs along with requests for 'deep dives' on specific areas have been observed. This two-way timely communication is essential in ensuring effective governance and oversight.

- **Strong links with foundational and strategic quality initiatives:** The priority areas identified within the SQP are closely linked and supported by the firm's foundational and strategic priorities. These priorities include cultural initiatives, successful implementation of ISQM (UK) 1, resources and rightsizing their portfolio. The link between these is crucial to driving the success of the firm's key priorities.

We will continue to regularly engage with the firm on their SQP, tracking the progress of the initiatives and the effectiveness of the measures to improve audit quality.

Single Quality Plans should enable firms to identify the areas which contribute directly or indirectly to audit quality and to prioritise their actions.

Root cause analysis process

Background

The RCA process is an important part of a continuous improvement cycle designed to identify the causes of specific audit quality issues (whether identified from internal or external quality reviews or other sources) so that appropriate actions may be designed to address the risk of repetition.

ISQM (UK) 1 introduced a new quality management process that is focused on proactively identifying and responding to risks to quality, and requires firms to use RCA as part of their quality remediation process.

When we reviewed the firm's RCA process last year, we noted that the firm had commissioned an external, independent review focusing on their RCA and whether the process: followed methodology; was fit for purpose and linked to the firm's culture programme; and whether remediation steps were implemented and monitored effectively. The review highlighted areas where RCA could be enhanced, including: increasing the available dedicated resource, the need to integrate the culture team into the process, reassessing the large volume of root causes and prioritising targeted remedial action. The firm has increased the priority of this investment and developments in their RCA are being made. However, further actions are necessary to implement a comprehensive and robust process that delivers improvement to audit quality and change.

In recognition of the importance of RCA as a tool to improve audit quality the firm have identified this as a key priority in their SQP and are investing heavily. Significant recruitment has occurred and the firm is undertaking an evaluation of the RCA process and the underlying root causes to drive improvement in this area.

The firm have identified RCA as a key priority in their SQP. Further actions are necessary to implement a comprehensive and robust process.

Observations

We assessed the following:

- **The RCA team:** During Q1 of 2023 the firm successfully filled all roles within the RCA team (onboarding of these individuals was completed late May 2023). In recognition of the importance of RCA and the need for it to be undertaken on a timely basis, senior leadership have committed to continue to monitor its resource levels and respond as required. During 2022, the RCA performed on AQR reviews was delayed and, in some instances, not performed in line with the firm's timetable. A delay in RCA hinders the effectiveness and importance of the RCA and could lead to remediation not being undertaken ahead of the subsequent audit.

- **Involvement of the engagement team:** The initial steps of the process requires the RCA team to review the audit working papers, where deemed appropriate, and interact with all relevant members of the engagement team via interviews (where necessary and possible, this includes members of overseas component teams and specialists). The firm must improve the communication of their findings and conclusions arising, to include sharing these with the engagement team along with the specific remedial action for that engagement. This step ensures that the engagement team is involved in the complete process and will assist with the success of remedial actions.

- **RCA on this cycle of AQR reviews:** We have received details of the RCA conducted by the firm on seven of their AQR reviews – including three categorised as more than limited improvements required. We have highlighted to the firm shortcomings in the work performed, including whether the firm has gone far enough to identify the underlying root cause. The firm have undertaken a review of their current procedures to improve and refine the process. This review has reduced the overall number of root causes and will include an assessment of the available root causes with the aim to consider different levels of aggregation. Embedding the revisions and monitoring these changes are vital to demonstrate that they address the matters arising. The firm must continue to prioritise this work to provide greater consistency and drive forward improvements in audit quality.

- **Behavioural causal factors:** The firm recognises that behavioural factors form a significant part of overall causal factors. KPMG have not engaged external behavioural specialists to assist with the RCA process or trained their RCA team in this area. In 2023/24 the firm will be introducing psychological and behavioural training to upskill their RCA team. This should assist in the identification of specific behavioural and cultural factors that the firm can learn from and appropriately respond to.

- **Recurring findings:** Despite the firm responding to previous inspection findings, a number of issues have recurred, including the audit of impairment assessments and estimates. The firm must undertake robust, comprehensive, effective RCA on a timely basis, identifying appropriate remedial action, which considers why previous actions did not address the findings.

- **Emerging issues and remedial action:** Closely related to RCA are the firm's processes to identify emerging issues, develop remedial actions and assess their effectiveness. The firm are expecting that improvements in the RCA process will accelerate and bring more precision to the identification of emerging themes and issues. The firm must align these processes and identify appropriate timely remediation, which must be regularly monitored, assessed and adjusted to ensure the actions taken are effective.

We will continue to assess the firm's RCA process as a crucial part of the feedback loop within ISQM (UK) 1 as well as part of our holding the firm to

We will monitor and assess the changes made to the RCA process and their effectiveness.

account. Specifically, for this firm we will monitor and assess the changes made to the RCA process and the effectiveness of these respective changes. This engagement will occur on a quarterly basis. We are pleased with the prominence that the firm has given this area in their SQP and it is important that appropriate monitoring and challenge is provided by the executive and the ANEs / INEs.

PIE auditor registration

Background

The FRC is now responsible for the registration of all firms which carry out statutory audit work on PIEs. This registration is in addition to the ongoing requirement for firms and Responsible Individuals (RIs[8]) to register with their Recognised Supervisory Body (RSB). The FRC's PIE auditor registration remit covers all firms and relevant RIs which audit one or more PIEs which include: UK incorporated entities listed on the London Stock Exchange (or another UK-regulated market); a UK registered bank, building society or other credit institution (but not credit unions or friendly societies); or are a UK insurance entity which is required to comply with the Solvency II regulations.

The FRC is now responsible for the registration of all firms which carry out statutory audit work on public interest entities (PIEs).

All firms and RIs carrying out statutory audit work on PIEs were required to register with the FRC by 5 December 2022 under a set of transitional provisions. Thereafter, any firm that plans to take on a PIE audit or remain auditor to an entity that is to become a PIE (for example, if it obtains a listing on the London Stock Exchange), together with relevant RIs, must register with the FRC before undertaking any PIE audit work.

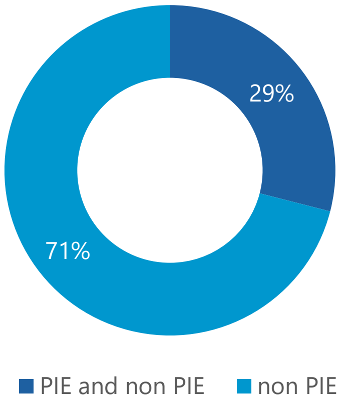
Where appropriate, firms and / or RIs can be held to account through conditions, undertakings and suspension or involuntary removal of registration, adding to our activities focused on holding firms to account. Measures used through the PIE auditor registration process are not always published.

Observations

On 5 December 2022 KPMG's transitional application for registration as a PIE auditor was approved and as at 31 March 2023 99 RIs at the firm had been approved. The following diagram shows the number of PIE and non-PIE RIs as a percentage of the total RIs at KPMG:

[8] Defined as a natural person who is a Principal or employee (but not a subcontractor or a consultant) of a Statutory Audit Firm and is registered with an RSB as a Statutory Auditor.

KPMG LLP



Other activities focused on holding firms to account

Background

Our forward-looking supervisory approach includes a number of other activities designed to hold firms to account. We have carried out certain procedures during the year to consider tone at the top, the contents of the firm's Transparency Report and the firm's responsiveness to feedback, and where relevant, to constructive engagement and non-financial Sanctions. During the year we continued to increase supervisory activities on this firm in respect of bank audits and similar entities. We have continued to engage with the firm to understand their changes to methodology in this area, changes to delivery and resources and the effectiveness of actions taken to date. We will continue to monitor the embedding of actions taken.

Observations

We assessed the following:

- **Tone at the top:** The firm is clear and consistent in its communications around the importance of audit quality and the firm's strategy and commitment to the public interest. The firm's commitment to transparency, the public interest and driving improvements have been evidenced during our supervisory activities this year. In response to a non-financial sanction, the firm provided details and evidence of a process implemented that gives notice to entities of concerns they have which may impact on their ability to act as auditor. Such concerns cover a wide range of topics including, but not limited to: cultural and behavioural concerns, inadequate financial reporting systems, resource issues and governance concerns. Letters outlining the issues with the necessary remediation and timeframe are sent to those

The firm's commitment to transparency, and the public interest has been evidenced during our supervisory activities this year.

charged with governance. Where the firm resigns as auditors, this information and all related correspondence will be shared with the incoming auditor. Further, where the reason for resignation relates to the matters highlighted to the entity this will be disclosed publicly.

- **Non-financial sanctions:** In response to enforcement cases KPMG has nine open non-financial sanctions at various stages of implementation. We have received the final reports for five of these and are considering whether any additional action needs to be taken to address the matters raised in the initial decision notice. As two of the cases reaching closure relate to bank audits a wider assessment of the actions being undertaken within the BAQIP is being considered to determine whether follow up can be encompassed through the increased supervision and oversight we already undertake on this programme. Of the remaining four non-financial sanctions, three require the use of a third-party reviewer to undertake specific work. The introduction of a third-party and the need to agree terms and a waiver of legal privilege has substantially delayed progress in one case. The firm must be mindful of these delays and consider learnings from this for future external reviews.
- **Second line of defence:** The firm responded to our inspection findings five years ago by establishing a second line of defence team, which provides coaching to audit teams and independent challenge on the quality of their work prior to signing. During our inspection activity we have identified instances where matters raised within this hot review process had not been resolved, thereby undermining the effectiveness of this quality control procedure. Further evidence of this control not operating effectively was identified in a recent enforcement case. The firm identified similar observations in relation to this control through their IQM process. Consequently, prioritisation of this has been escalated within the SQP and action is being taken to ensure that timely and appropriate resolution of matters occurs. We will monitor the effectiveness of the changes through our regular engagement on the SQP.

Culture and conduct

Background

The firm's culture has a significant impact on audit quality and the speed at which audit quality is improved. Firms that have more advanced cultural programmes, where desired audit specific behaviours are promoted through their wider policies and procedures (in particular training and coaching, performance management and reward and recognition), typically have better or improving audit quality.

Reported instances of integrity issues or misconduct matters have a significant impact on trust and confidence in the profession. Ethical conduct must therefore be an intrinsic part of all firms' cultural programmes and the profession must strive to maintain a culture of integrity in which the highest standards of ethical values and professional behaviour are upheld.

The firm's culture has a significant impact on audit quality and the speed at which audit quality is improved.

Observations

We assessed the following:

- **Audit culture ambition:** The audit practice communicates a strong culture of "high challenge, high support" and are embedding several initiatives to drive this behaviour across audits. The most recent global people survey results were encouraging and demonstrate how the firm's investment in this area is positively impacting culture, mindset and behaviour.
- **Ethical conduct:** We have seen examples of misconduct including exam cheating and breaches of integrity, including at KPMG, that impact the reputation of the profession as a whole. The PCAOB sanctioned the firm in December 2022 relating to multiple instances of UK staff cheating in internal assessments. We will assess the remedial actions taken by the firm to respond to the PCAOB's report. All firms need to ensure that their culture promotes individuals to operate to the highest ethical standards in order to maintain public confidence and trust. As a continuation of a values-led culture, KPMG launched a new ethical health plan that supports the firm's ambition to operate to the highest ethical standards. Whilst the programme is in early stages, the firm needs to monitor outcomes to ensure that it achieves the desired ambition.

Initiatives to ensure compliance with the FRC's Revised Ethical Standard

Background

During 2022, we held biannual meetings with the Ethics Partner, undertook compliance testing and reviewed the firm's biannual reporting of identified breaches. The specific findings from this work are detailed in Section 3. However, we have the following additional observations on the steps being taken to ensure compliance with the FRC's Revised Ethical Standard going forward.

Observations

We assessed the following:

- **Provision of restricted / prohibited non-audit services:** The firm have identified a number of instances where specific network firms have been providing accounts preparation, word processing and translation services to audited entities and including such services within their component audit fee. We have been informed that for the specific jurisdictions it is considered common practice to provide these services alongside the audit engagement. As soon as the matter was identified, the UK firm took responsive action to identify all affected groups (including UK PIEs and Other Entities of Public

Interest). All of the entities identified as affected were contacted and, where applicable, the breaches have been or will be disclosed within the individual financial statements. The UK firm and KPMG International are in the process of undertaking RCA. The global network has been alerted of the issue and released updated information in this area. We acknowledge the firm's transparency on this matter with the affected entities, their entire PIE portfolio and the FRC. We will continue to engage with the firm on this issue.

Quality and consistency of audits of banks and similar entities

Background

Last year, we reported that the firm needed to take action to further improve the quality and consistency of its audit work on banks and similar entities. This followed key findings raised in this area in each of the previous three quality inspection cycles. The firm redesigned the BAQIP in 2021 to review and reset its approach. As noted last year the firm has invested heavily in the BAQIP in terms of changes to methodology, cultural initiatives and other delivery mechanisms (rightsizing the banking portfolio and strengthening banking resource within the central technical teams including second line of defence). Steps taken to date have seen specific improvements in the quality of output and the attitude of partners and staff.

The firm's investment in the audit of banks and similar entities has resulted in specific improvements in the quality of output and the attitude of partners and staff.

Observations

This year, we have closely monitored the progress of the banking audit quality improvement plan and have revisited and updated our approach for continued engagement, in view of the actions taken and progress made. We continue to hold the firm to account, evaluating how the changes to methodology, culture, consultation and review have been embedded to address the concerns raised, seeking demonstrable evidence in all aspects.

- **Methodology:** The firm has made substantial changes to methodology particularly within areas of IFRS 9 and 13 in response to previous FRC inspections and thematic work. It has enhanced the mandatory training in this area and devised specific work programmes. Section 3 of this report does not identify any key findings in respect of the settlement and clearing process since these changes have been made. The changes made to methodology appear to address the previous shortfalls identified. The firm must monitor the effectiveness of these changes and their application for all banking entities, regardless of size, when assessing the quality and consistency of the output from December 2022 year ends, making timely changes as required.
- **Audit team support:** As identified last year the firm has enhanced the quality control procedures within banking audits. Specifically, obtaining expertise in banking within the audit technical department and introducing mandatory challenge panels on specific aspects of judgement within IFRS 9. Feedback on

these changes is monitored and the firm must continue to assess whether matters were adequately followed up or consulted on and whether further consultation is needed.

- **Culture:** The firm's leadership has demonstrated that it is committed to improving the quality of bank audits and the BAQIP took various steps to address the actual and perceived cultural issues arising within the banking audit practice. Several cultural initiatives have been piloted throughout the year and, in view of the success of these, the firm is rolling these out to the whole banking practice in 2023.

We recognise the actions taken by the firm and their commitment to improvement in this area, including the identification of this as a key priority in their SQP.

As outlined in Section 2, the firm has been able to demonstrate improvements in their inspections of banks and similar entities but must ensure that this is sustained and delivered consistently across their entire portfolio. In 2023/24 we will directly monitor the firm's progress in delivering the BAQIP with further inspections undertaken throughout the cycle and detailed follow up on changes to methodology, the enhanced quality control procedures, resources, tendering activity, along with the roll out of specific culture initiatives. Successful implementation of the changes should assist with moving this programme to the next phase away from enhanced supervision and towards business as usual.

Operational separation of audit practices

Operational separation aims to ensure that audit practices are focused, above all, on the delivery of high quality audits in the public interest and are financially resilient. In October 2021, KPMG started its transition to operating the audit practice separately from the rest of the firm and has taken a number of steps to implement the principles of operational separation including the restructuring of its governance framework, forming an Audit Board, appointment of ANEs, and its work on promoting a differentiated audit culture.

KPMG has six Independent Non-Executives in total and they perform the following roles: three are INEs who sit on the firm's Public Interest Committee; two are ANEs who sit on the firm's Audit Board; and one is both an INE and an ANE (dual function). The chair of the Public Interest Committee is an INE, and the chair of the Audit Board is an ANE.

After the end of the transitional period in 2024 we intend to publish an assessment of whether the four largest firms are delivering the objectives and outcomes of operational separation.

Appendix

Firm's internal quality monitoring

This appendix sets out information prepared by the firm relating to its internal quality monitoring for individual audit engagements. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified the accuracy or appropriateness of these results.

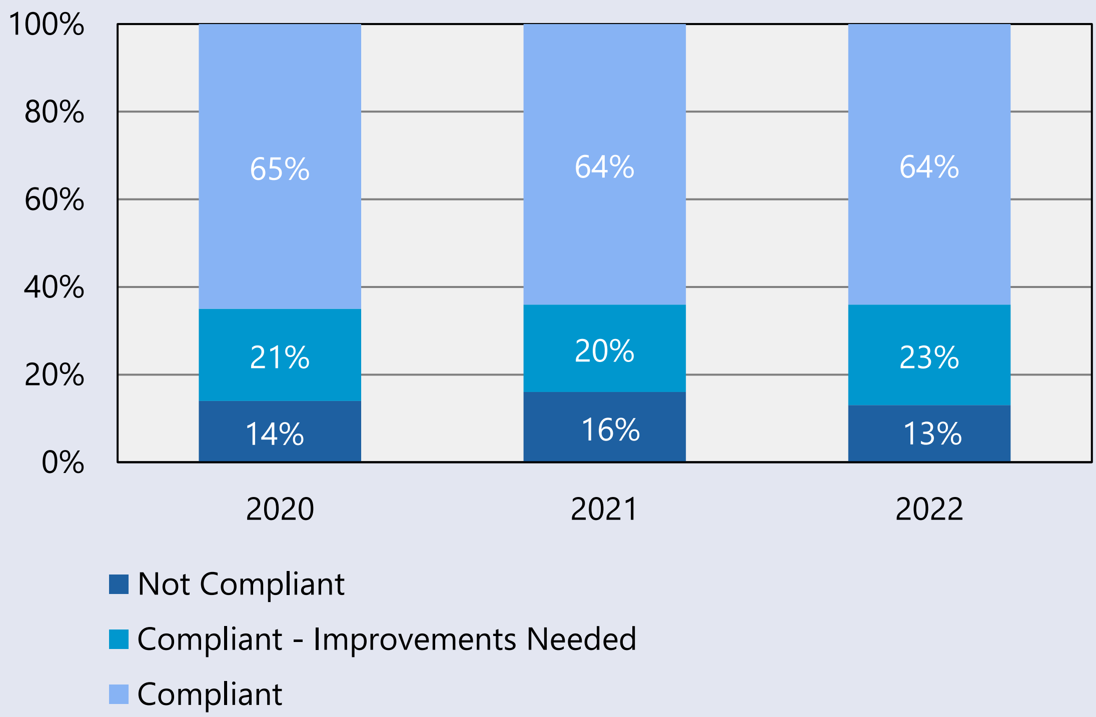
The appendix should be read in conjunction with the firm's Transparency Report for 2022 which provides further detail of the firm's internal quality monitoring approach and results, and the firm's wider system of quality control.

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

Results of internal quality monitoring

The results of the firm's most recent Quality Performance Review (QPR), which comprised internal inspections of 102 audit engagements (for periods ending between 31 July 2020 and 31 March 2022), are set out below along with the results for the previous two years, where 92 and 122 audits were inspected in the 2021 and 2020 review cycles respectively.

During the year our rating structure for QPR findings was refined to align more closely with market practice and to reflect the fact that, for reviews performed in the 2022 cycle, only reviews rated as Not Compliant are considered to be an adverse quality outcome.



Inspections are graded as Compliant where the relevant auditing, assurance, accounting, and professional standards have been complied with in all significant respects with no or only minor instance(s) of non-compliance. Inspections are graded as Compliant - Improvements Needed ('CIN') where the auditor's report is supported by evidence, but the independent reviewer required additional information to reach the same conclusion as the auditor; or where supplementary evidence obtained as part of the audit was not sufficiently documented; or specific requirements of the firm's audit methodology were not followed. Such a rating is not considered an adverse quality outcome. Inspections are graded as being Not Compliant where the audit was not performed in line with KPMG's professional standards and policies in a more significant area, or where there are deficiencies in the related financial statements.

Firm's approach to internal quality monitoring

The firm's internal review cycle is aligned with its annual performance review cycle and completes in the Autumn each year. The 2022 internal QPR programme described above covered audits with year-ends of 31 March 2022 and earlier.

The firm's QPR programme considers the full population of audits performed. All individuals acting as engagement leaders are subject to selection for review at least once in a three-year cycle. Engagements for review are selected by the QPR inspection team after review of individual engagement leader portfolios to ensure an appropriate mix of engagements is selected taking account of size, risk and profile. In particular, audit engagements of each FTSE350 audited entity will ordinarily be reviewed at least once every five years. Each QPR inspection is overseen by an Independent Lead Reviewer from outside KPMG UK and the programme is monitored by the firm's Global Audit Quality Monitoring Group. The Independent Lead Reviewer participates in a moderation process at both national and regional level, designed to achieve consistency of results both between engagement findings in the UK and other KPMG member firms. Where significant deficiencies are identified through internal inspections, a remedial action plan is prepared, applicable at both an engagement level and at a firm level where findings are considered pervasive.

The firm undertakes root Cause Analysis ('RCA') on engagements rated as Not Compliant and other pervasive findings. A selection of engagements assessed as Compliant and CIN are included within the RCA process. This informs further remedial actions at a firm level incremental to the team level actions described above. A pervasive matter is one that occurs on 10% or more relevant engagements generally without regard to the severity of the finding although qualitative factors are also considered in making this determination. The identification of such matters happens progressively throughout the review cycle which means we take some remedial actions identified on individual inspections as soon as their need is identified accelerating their impact on audit delivery across the audit practice. Findings from a range of inspections are considered to ensure that robust remedial actions are developed and implemented. The effectiveness of such actions is monitored. Engagement teams also undertake specific incremental or remedial training based on the deficiencies identified for Not Compliant-rated engagements.

Internal quality monitoring themes arising

The most frequently occurring issues identified through the 2022 QPR programme included the audit of journals; evidencing risk assessment decisions; aspects of sampling and specific item testing; and elements of work over estimates. Our programme of standardised workpapers continues to drive consistency and higher quality but issues have arisen when teams have not used the workpapers effectively. Teams continue to face challenges in sufficiently testing high-risk journals or in aligning their high-risk criteria with business understanding. Findings on sampling and specific item testing relate to teams' assessments of residual populations and their documentation and evaluation of statistical samples. Findings on Estimates were observed as specific to engagements rather than pertaining to the firm's audit methodology in this area.

All RCA projects in respect of the prior year have been completed and actions have either been implemented or continue to be embedded.

We have seen tangible progress in a number of areas, but some remain to be fully addressed. The audit of Internal Controls, the performance of Group Audits and the execution of Substantive Analytical Procedures, identified as pervasive issues in the 2021 QPR programme, were not considered pervasive issues in the 2022 QPR programme reflecting the effectiveness of the implementation of actions following previous RCA projects.

Areas that contributed most significantly to Not Compliant ratings were insufficient clarity or evidence on the audit file to allow an independent reviewer to understand the basis for individual conclusions, weaknesses in the preparation of KPMG-mandated workpapers, insufficient procedures and weaknesses in the performance or documented explanation of specific substantive audit procedures. These areas are broadly consistent with those identified in respect of the 2021 cycle. As in the prior year, we did not identify any engagements where we concluded the underlying financial statements were inappropriate or that the audit opinion was not appropriately delivered.

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