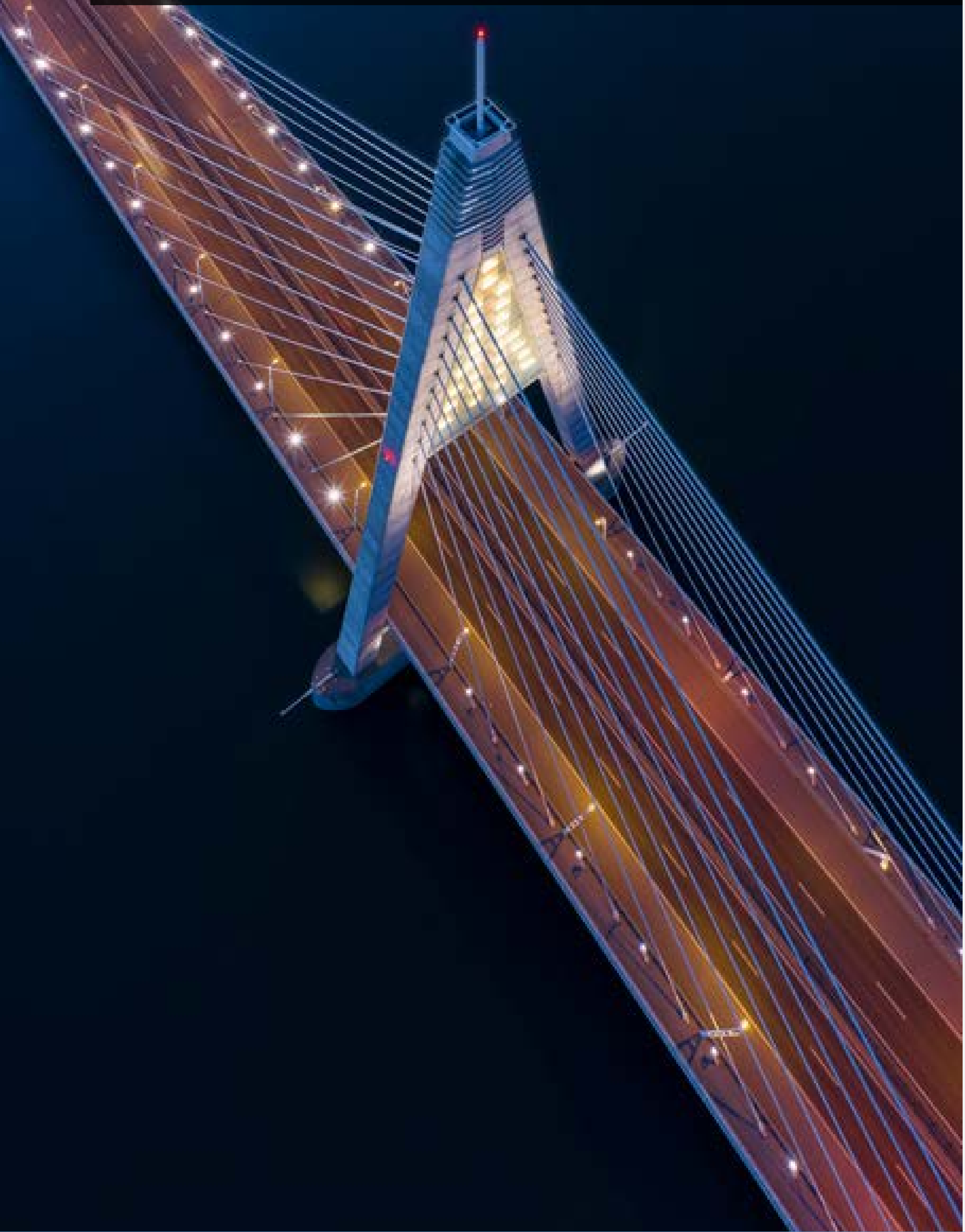
Financial Reporting Council

KPMG LLP

Audit Quality Inspection and Supervision



July 2021

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Appendices

This report sets out the FRC's findings on key matters relevant to audit quality at KPMG LLP (KPMG or the firm). It is based on inspection and supervision work undertaken in our 2020/21 cycle, primarily our review of a sample of individual audits and our assessment of elements of the firm's systems of quality control.

The FRC's focus is on the audit of public interest entities (PIEs[1]). Our selection of individual audits and the areas within those audits for inspection continues to be risk-based focusing, for example, on entities which: are in a high-risk sector; are experiencing financial difficulties; have material account balances with high estimation uncertainty; or, where the auditor has identified governance or internal control weaknesses. The majority of individual audits that we inspect are of PIEs but we also inspect a small number of non-PIE audits on a risk-based basis.

Higher-risk audits are inherently more challenging as they will require audit teams to assess and conclude on complex and often judgemental issues, for example in relation to future cash flows underpinning assessments of impairment and going concern. Rigorous challenge of management and the application of professional scepticism are especially important in such audits.

Our increasing focus on higher risk audits means that our inspection findings may not be representative of audit quality across a firm's entire portfolio of audits or on a year-by-year basis. Our inspection findings cannot therefore be taken as a balanced scorecard of the overall quality of the firm's audit work. However, our forward looking supervision work now provides us with a holistic picture of the firm's approach to audit quality and the future development of its audit quality improvement initiatives.

As well as risk-based selections, we aim to review all FTSE 350 audits periodically.

To provide a more holistic assessment of audit quality, the report also includes reference to other measures of quality at the firm. 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 results of which are summarised on page 8.

The firm also conducts internal quality reviews. A summary of the firm's internal quality review results is included at Appendix 1, together with the actions that the firm is taking in response.

At Appendix 2 are further details of our objectives and approach to audit supervision.

1 Public interest entity – in the UK, PIEs are defined in the Companies Act 2006 (Section 494A) as: - Entities with a full listing (debt or equity) on the London Stock Exchange (Formally "An issuer whose transferable securities are admitted to trading on a regulated market". In the UK, "issuer" and "regulated market" have the same meaning as in Part 6 of the Financial Services and Markets Act 2000); - Credit institutions (UK banks and building societies, and any other UK credit institutions authorised by the Bank of England); - Insurance undertakings authorised by the Bank of England and required to comply with the Solvency II Directive.

1 Overview

Commentary on our inspection work at the largest audit firms

We completed more audit inspections at the largest seven firms in 2020/21 (103) than in 2019/20 (88). Our overall inspection findings are similar to last year, with 71% of audits (73 out of 103 inspections) requiring no more than limited improvements compared to 67% last year (59 out of 88 inspections).

The number of audits that we have assessed as requiring improvements remains unacceptably high. This year the results varied more between firms and we found inconsistencies, with good practice in some audits but deficiencies in the same areas in other audits at the same firm.

The most common key findings in our public reports are in relation to revenue, impairment of assets and group audit oversight. These are recurring issues but we also identified good practice in these areas in some audits.

We also identified good practice during our 2020/21 thematic review of the audit of going concern, where we found that firms had responded positively to the increased risk arising from Covid-19, by enhancing their procedures in this area[2].

Four of the largest firms (Deloitte, EY, Grant Thornton and PwC) had a year-on-year improvement in their overall inspection results, with around 80% or more of audits requiring no more than limited improvements. While this is encouraging, these improved results still fall short of our expectations.

Overall inspection results at KPMG did not improve and it is unacceptable that, for the third year running, we found that improvements were required to KPMG's audits of banks and similar entities. In addition, our firm-wide work on KPMG's IFRS 9 procedures and guidance identified that further improvements are required to provide a stronger basis for KPMG's banking audit teams to deliver high quality audits in this area. KPMG has already invested significantly in its banking audit practice and considers that, based on steps it has already taken, it will be able to demonstrate improvements in 2020 year-end audits. In response to our findings this year, the firm's senior leadership has committed to make the further changes necessary to improve audit quality in time for 2021 year-end audits. We will monitor these closely to assess on a timely basis the extent to which they address our findings.

This year, we increased the sample of audits we selected for review at BDO and Mazars, given their growth, with a focus on complex audits. Five of the nine audits that we reviewed at BDO and three of the seven audits that we reviewed at Mazars needed more than limited improvements. These firms have grown the size of their PIE audit practices and have plans to grow further, which will increase competition and choice in the market. Our engagement indicates that these firms are genuinely committed to improving audit quality but they must put in place the necessary building blocks for the consistent execution of high quality audits as they grow.

71%

Overall, the number of inspections requiring no more than limited improvements fell short of our expectations.

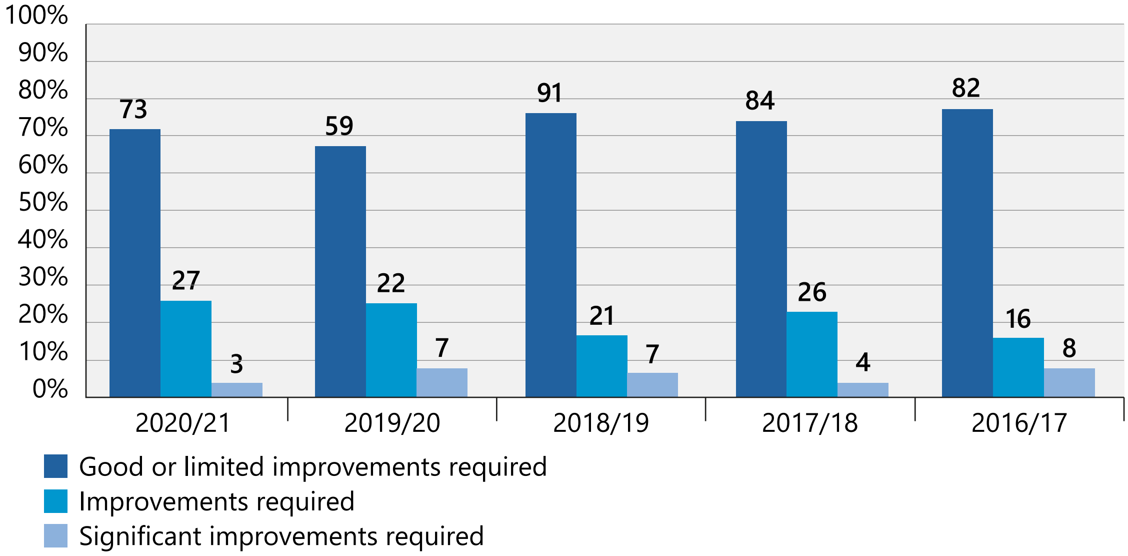
This year, results varied more between firms and we found inconsistencies, with good practice in some audits but deficiencies in the same areas in other audits at the same firm.

2 https://www.frc.org.uk/getattachment/953261bc-b4cb-44fa-8566-868be0ff48dc/FRC-going-concern-review-letter.pdf; and https://www.frc.org.uk/getattachment/c1ec4c8f-0eb3-44b9-a4c7-5fe5e4c0e0f1/FRC-going-concern-review-letter-(phase-2).pdf

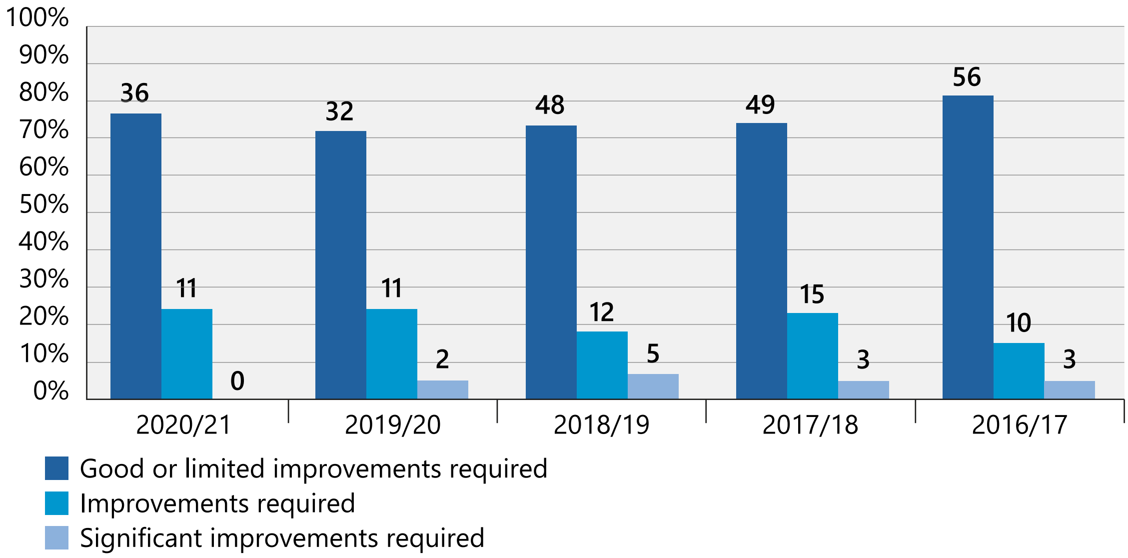
Central to achieving consistent audit quality is a healthy culture within the audit practice that encourages challenge and professional scepticism, as we set out in our letter to Heads of Audit in December 2020. We have a major project underway to examine audit culture, including an international conference held in June this year on the subject. Operational separation of audit practices from the rest of the firm should help the largest firms to focus on developing an appropriate audit culture.

Our supervision teams[3] are increasing the range of pro-active and forward-looking work they are carrying out with the largest seven firms in areas such as audit quality plans, root cause analysis, quality control procedures and audit quality indicators with a focus on how firms are responding to recurring findings. We report privately to firms on our findings in these areas, in order to share good practice. In 2021/22 we will continue to focus our inspections on KPMG banking audits and we will increase audit inspections at BDO and Mazars. Our 2021/22 inspections will also focus on and take into account the impact of Covid-19 on audits.

All reviews



FTSE 350



Our supervision teams are increasing the range of pro-active and forward-looking work.

In 2021/22 we will continue to focus our inspections on KPMG banking audits and we will increase audit inspections at BDO and Mazars.

3 Our approach to supervision is set out in the March 2021 publication, https://www.frc.org.uk/getattachment/db4ef2e0-72f6-4449-bda0-c8679137d1b1/FRC-Approach-to-Audit-Supervision-FINAL.pdf

KPMG overall assessment

We reviewed 22 individual audits this year and assessed 13 (59%) of them as requiring no more than limited improvements, a similar proportion to last year. Of the twelve FTSE 350 audits reviewed this year, we assessed nine (75%) as achieving this standard.

Improvements required to the quality of the firm's audit work on banks and similar entities contributed significantly to these results. It is unacceptable that we have now reported key findings in this area in three consecutive years. This year, we also reviewed and found weaknesses in the firm's documented audit approach and guidance for auditing the requirements of IFRS 9. In our view, the firm does not currently provide its banking audit teams with sufficiently clear expectations and guidance as to the minimum procedures to be performed and this is likely to have contributed to our findings on the individual audits we reviewed.

We acknowledge that KPMG has already invested significantly in its banking practice and considers that, based on steps it has already taken, it will be able to demonstrate improvements in its 2020 year-end audits (which we will inspect in 2021/22). In response to our findings this year the firm's senior leadership has committed to make the further changes necessary to improve audit quality in time for 2021 year-end banking audits. We will monitor these closely to assess on a timely basis the extent to which they address our findings. We will also continue to focus our inspections on KPMG banking audits.

We identified improvements in the level of challenge and scepticism on high-risk audits (excluding banking audits), a key finding last year, and we also identified good practice in the audit of going concern.

Audit quality is one of the pillars underpinning KPMG's current audit strategy, launched in 2019. The strategy is supported by a comprehensive Audit Quality Transformation Plan (the Plan), which includes the recommendations of the independent review of the firm's audit practice that we commissioned in 2019 as part of a programme of increased scrutiny in response to audit quality concerns.

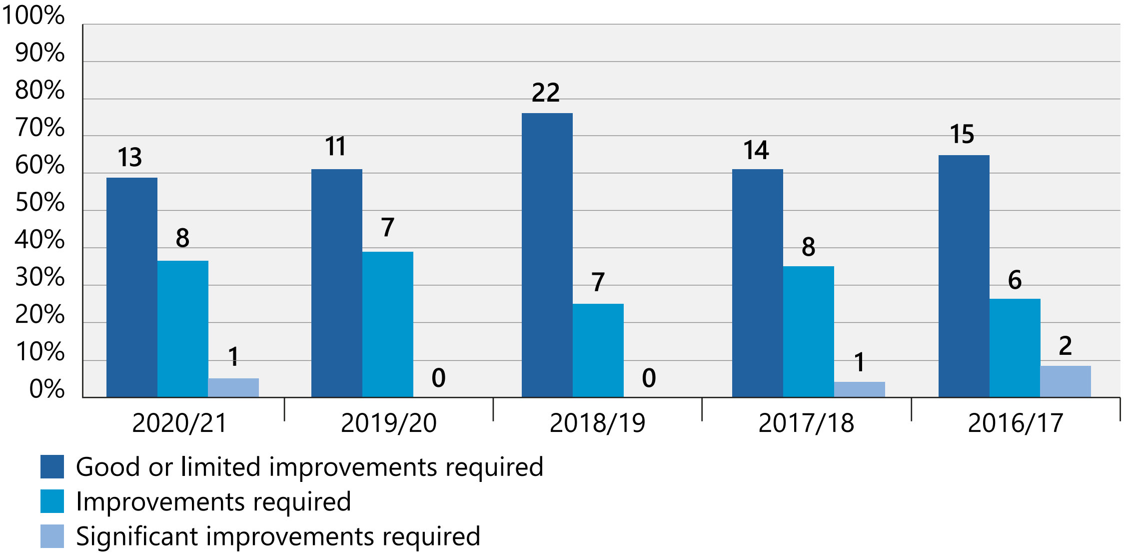
We acknowledge that the firm has taken numerous actions under the Plan and that it performs Root Cause Analysis (RCA) on quality issues that are identified. Given that our inspection results show that high audit quality is still not being achieved consistently, the firm should further examine:

- The content and direction of the Plan, particularly in relation to the audits of banks and similar entities.
- Whether its RCA process produces sufficiently targeted actions, particularly in relation to cultural and behavioural factors.
- How it monitors, on a timely basis, the impact of actions and how effectively they are embedded.

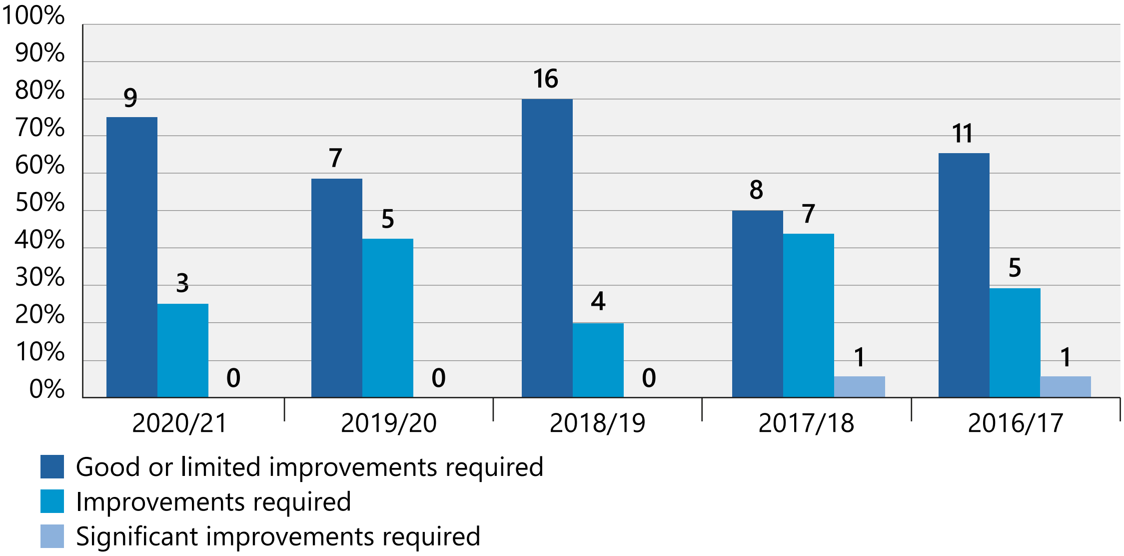
59%

At KPMG, the level of audits reviewed that required no more than limited improvements is unacceptable.

Our assessment of the quality of audits reviewed: KPMG LLP



FTSE 350



The audits inspected in the 2020/21 cycle included above had year-ends ranging from 30 June 2019 to 30 April 2020.

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 review and the scope of individual reviews. Our inspections are also informed by the priority sectors and areas of focus as set out in Appendix 2. 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.

Monitoring review by the Quality Assurance Department of ICAEW

The firm is subject to independent monitoring by the ICAEW, which 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-wide controls as it places reliance on the work performed by the FRC. ICAEW reviews are designed to form an overall view of the quality of the audit. ICAEW assesses these audits as 'satisfactory', 'generally acceptable', 'improvement required' or 'significant improvement required'. Audits are selected to cover a broad cross-section of entities audited by the firm and the selection is weighted towards higher-risk and potentially complex audits within the scope of ICAEW review.

ICAEW has completed its 2020 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 September 2021.

Summary

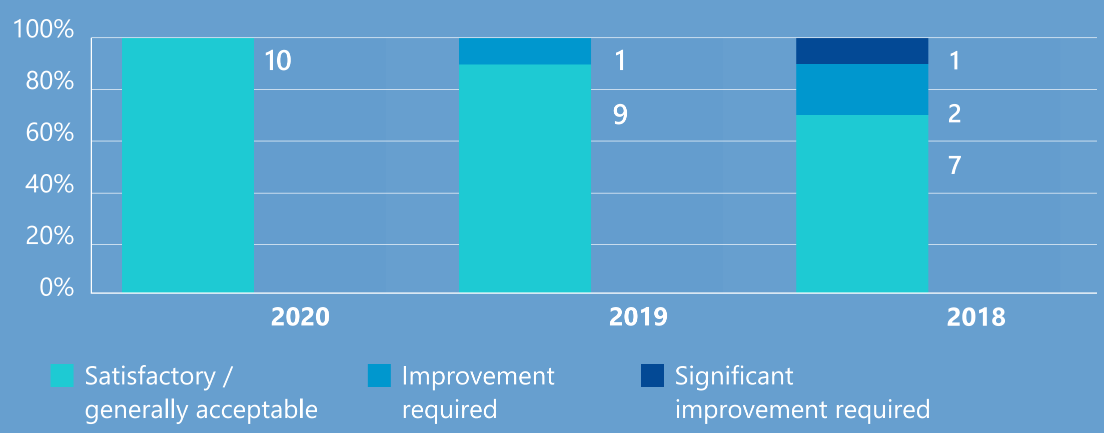
Audit work is of a good standard in most areas and all the reviews were either satisfactory or generally acceptable. This year's grading profile is better than in 2019, with no audits requiring improvement.

On the audits assessed as generally acceptable, there were isolated weaknesses in audit evidence relating to the audit of inventory and operating lease commitments, and a limited number of weaknesses in documentation. There were financial statement presentation and disclosure deficiencies on three audits and a weakness in quality control related to disclosures on one of these files. These points suggest that teams may need to pay more attention to audit work in this area.

ICAEW identified and shared examples of good practice on the majority of the reviews.

Results

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



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.

ICAEW

100%

All ten ICAEW reviews were either satisfactory or generally acceptable.

Review of individual audits

Our key findings related primarily to the need to:

- Urgently and comprehensively address the continuing deficiencies in the quality of audit work on banks and similar entities.
- Improve the quality of the firm's audit work on certain areas of revenue.
- Enhance the evaluation and challenge of management's impairment assessment for tangible and intangible non-current assets.

Good practice observations

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

- Going concern.
- Challenge of management.
- Group audit oversight.

Review of firm-wide procedures

This year, our firm-wide work focused primarily on the following areas:

- Audit quality initiatives.
- RCA process.
- Audit methodology and training.

The reason for the focus on audit quality initiatives and RCA is the importance of taking effective action to address recurring inspection findings. On both of these areas we have assessed the firm's progress on the findings set out in last year's public report and re-assessed overall progress.

Audit quality initiatives

Our key findings related primarily to the need to:

- Consider further how actions being taken under the Plan are prioritised and ensure that appropriate indicators and measures of effectiveness are in place.
- Extend its banking audit quality improvement plan to address our findings this year.

RCA process

Our key findings related primarily to the need to:

- Consider whether its RCA process has identified the full extent of underlying causes which then result in appropriately prioritised and targeted actions being taken and embedded, given the recurring nature of some of our findings.

Audit methodology and training

Our key findings related primarily to the need to:

- Improve the quality and extent of IFRS 9 procedures and guidance relating to the audit of banks and similar entities.

Good practice observations

We identified examples of good practice in our review of firm-wide areas, including the following:

- **Audit quality initiatives** – Governance over the Plan and individual projects within it, has remained strong, with clear accountabilities and regular reports and updates to the firm's audit oversight bodies.
- **RCA process** – RCA findings and actions may be challenged at various levels, including by the firm's audit oversight bodies.
- **Audit methodology and training** – The firm provides extensive training to experienced hires.

Firm's overall response

We are pleased that the impact of the previous investments made by the firm have been reflected in improvements to our FTSE 350 FRC gradings with 75% of inspections requiring no more than limited improvements (an increase from 58%), and our QAD scores where we achieved equivalent grades on 100% of inspections. However, we are disappointed that this ongoing improvement is not yet evidenced in our overall scores across all inspections and note the comments made by the FRC in respect of our banking inspections. We also note that comparison with year-on-year results is difficult considering the small sample size.

We have invested heavily in our Audit Quality Transformation Plan in the period since the audits under inspection were delivered over a year ago to continue to develop and enhance the foundations of audit quality within the firm. We remain focused on achieving consistent application of procedures and equipping our staff with the tools they require to deliver audits to the high standards expected of auditors. Much of the recent investment referred to relates to our banking audits where we recognise that the actions that we have taken as a result of previous inspections have not yet consistently yielded the standards that we set for ourselves.

The actions taken throughout 2020, which are set out in more detail in our response in Section Two of this report, were implemented for our 2020 year-end audits and will therefore be reflected in the 2021/22 inspection cycle. As noted in section 2 our 2021 improvements will include further actions and refinements that we have discussed with the FRC during the current inspection cycle. We are confident that the steps we have taken to date will result in improvements in our future inspection results in this part of our business.

We are pleased to note the good practice points that the FRC have raised, particularly in relation to Going Concern where there were no reported findings across all audits inspected. In the current economic environment Going Concern is rightly a key focus for entities, investors and other stakeholders. We are also pleased to note the examples of good practice identified by the FRC in respect of our challenge of management and of oversight of group audits.

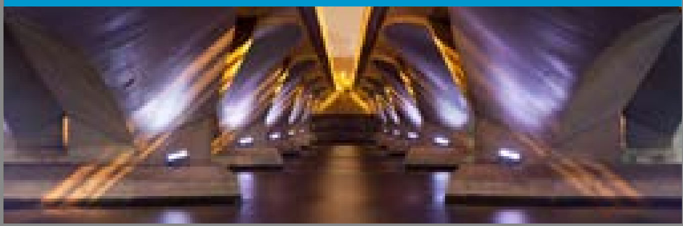
We have performed root cause analysis ("RCA") over all of the FRC findings from this cycle of inspections and have taken, or have plans to take, actions for each finding. In many cases RCA has shown that we have the right tools, methodology and guidance in place, but the challenge remains achieving consistent application. The findings in relation to bank audits, however, identified specific areas for attention which have been, or are being, addressed. Through the RCA we have identified a lack of clarity relating to the level of evidence required in respect of IFRS 9, including how consistency is achieved within a matrix of global regulation, and this undermines auditor confidence. We are committed to achieving clarity of understanding so that we can address any remaining concerns in this area.

We know that having the right culture in place is crucial if we are to deliver quality, every time. Our ambition is to enhance our culture of "high challenge and high support" across Audit so we deliver high quality work, fulfil our public interest role, and ensure the role of auditors is highly valued, giving us engaging and rewarding careers. Our Culture Change Programme has continued to develop and grow throughout the last 12 months. During FY20, we have continued to run focus groups across the firm to allow colleagues to discuss behaviour; created the Audit Evolution Board and continued to roll out our Coaching for Quality Programme which was launched during 2019. The theme of the 2020 KPMG Audit University was 'Embedding a culture of challenge' focused on mindset, behaviours and documentation of challenge.

With the advent of the first lockdown, almost overnight, our entire audit practice switched to remote working introducing a range of additional challenges for audit teams. We issued guidance and support around practical areas such as conducting virtual inventory counts; evaluating the risks around the source, quality and reliability of audit evidence obtained virtually; engaging with management teams; and perhaps most importantly, how to continue to work effectively as a team providing appropriate support, coaching and oversight. We issued our Virtual & Agile Playbook to the Audit practice which included guidance, for example, on virtual audit rooms. We supported engagement teams in potentially difficult decisions with management and audit committees where we concluded that more work and more time was needed to deliver high quality audits responsive to the changed circumstances. Coaching and oversight, where possible in person, remains critical for maintaining audit quality, ensuring continuous development of individuals and supporting wellbeing.

Our supervisory approach

The **AFS, AMS** and **AQR** 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

70+

The **AFS, AMS** and **AQR** teams comprise over **70** 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[4]

RIs
302

Offices
21

13,674
Professional Staff

KPMG
Audits within the FRC's inspection scope

Inspection Cycle[5]	FTSE 100 audits	FTSE 250 audits	Total audits in FRC scope
2021-22	24	48	362
2020-21	23	49	498
2019-20	26	51	549

KPMG
Audit fee income[6]

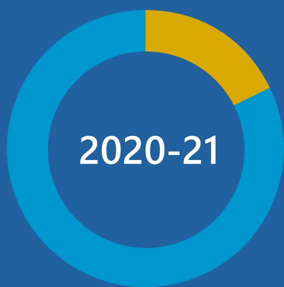
£m

2018	2019	2020
572	631	639

KPMG
Audits inspected by the FRC[7]

2020-21	22
2019-20	19
2018-19	29

KPMG
Local audits[8]



Major audits **24**
Non-Major audits **109**
Major audits inspected by the FRC **1**

4 Source – the ICAEW's 2021 QAD report on the firm.
5 Based on data compiled by the FRC, dated 31 December 2020, 2019 and 2018 respectively and used to select audits for inspection in the relevant inspection cycle.
6 Source – the FRC's 2019, 2020 and 2021 editions of Key Facts and Trends in the Accountancy Profession.
7 Excludes the inspection of local audits.
8 The FRC's inspection of Major Local Audits are published in a separate annual report to be issued later in 2021. The October 2020 report can be found here.

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. We asked the firm to provide a response setting out the actions it has taken or will be taking in each of these areas.

Urgently and comprehensively address the continuing deficiencies in the quality of audit work on banks and similar entities

Last year we reported that the firm needed to improve, as a matter of urgency, the quality of its audit work on banks and similar entities, in particular in relation to the valuation of financial instruments and the allowance for expected credit losses for loans and advances to customers. This followed similar audit quality observations in our 2018/19 quality inspection cycle.

We have continued to identify key findings over these issues across the audits of banks and similar entities inspected in 2020/21. In addition, we have identified key findings in a number of other areas, as set out below.

With our last three inspection cycles reporting key findings in relation to the audit work performed on banks and similar entities, the firm needs to take further, comprehensive action to improve the quality of audit work in this area. The firm should specifically consider the further actions required, over and above those contained in its 2020 banking audit quality improvement plan, to assist its banking audit teams to perform sufficient, appropriate audit procedures which support the opinion on a set of financial statements.

The firm should also continue to monitor the progress and effectiveness of its audit quality initiatives, at least quarterly, to assess whether the required improvements are implemented on a timely basis to achieve a satisfactory and consistent level of audit quality on banks and similar entities.

Key findings

We identified significant weaknesses in the audit procedures performed across the banking audits inspected. The most significant findings were as follows:

- Expected credit losses: For three of the audits we reviewed, insufficient audit procedures were performed, or evidence obtained, relating to key aspects of the audit of expected credit losses. Most notably, these included procedures relating to the assessment of significant increases in credit risk and related testing, individually assessed exposure credit file review procedures, and the testing of models and related data elements.
- Valuation of financial instruments: On two audits, we identified deficiencies in the testing of financial instrument valuation. These primarily related to the audit approach and testing performed over model risk management.
- Settlement and clearing accounts: On three audits, we identified deficiencies in the audit testing of the core banking payment and operations processes.

We found significant weaknesses in the audit of expected credit losses, valuation of financial instruments, settlement and clearing accounts.

- IT specialist testing: On one audit where privileged user access was determined to be a Key Audit Matter, we identified significant deficiencies in the IT specialist team's related testing, and the audit team's overall assessment and response to the risk identified.
- Other audit procedure weaknesses: We also identified, on up to three audits, weaknesses in audit procedures designed and performed to respond to the risk of unauthorised and unconfirmed trading, the oversight of work performed by component or parent group auditors, and the effectiveness of the firm's quality control and review procedures.

Firm's actions:

As noted in our response in Section One, we recognise that the actions that we have taken as a result of previous inspections have not yet yielded the standards that we set for ourselves and that the FRC expects. Improving our inspection results in this area is an absolute priority of the firm and we continue to share with the FRC our response to inspection findings.

We have made a considerable investment in our Banking audits and in our quality control procedures, in particular in the period since the findings of the 2019/20 inspection cycle were available to us in early 2020. During 2020 we established a formal Banking Audit Quality Improvement Programme ("BAQIP" or "the Programme") designed to provide a holistic response to the inspection findings.

Our updated methodology and approach to banking audits has been implemented for our 31 December 2020 year-end audits, including:

- Simplify and standardise – revision of our banking work papers, guidance and an improved clarity of approach to risk assessment for key risk areas;
- Plan – banking specific planning directive with central monitoring and remapping of skillsets to engagement allocations;
- Challenge – earlier review of planning by the second line of defence team and creation of independent challenge panels for IFRS 9, risk assessment and final significant risk conclusions;
- Execute consistently – additional training and coaching for our engagement teams, additional challenge from our second line of defence team for engagements identified as higher risk, central tracking of milestones, development of centres of excellence and more consistent use of specialists.

We delivered all the work papers and guidance that were due to be released in year one of the Programme. Our 2021 improvement plan has been developed to ensure we address, as a priority, findings arising during the latest inspection cycle, including those that relate to methodology. All ongoing actions will be incorporated as we commence the second year of the Programme and are targeted for completion in advance of December 2021 year end audits.

As indicated above, the actions taken throughout 2020, were implemented for our 2020 year-end audits and will therefore be reflected in the 2021/22 inspection cycle. We are confident that the steps we have taken to date will result in improvements in our future inspection results in this part of our business.

Improve the quality of the firm's audit work on certain areas of revenue

Revenue is generally a key driver of an entity's performance, and a common area of audit focus. Audit teams should design and perform procedures, tailored to the audited entity's risks and business, to obtain sufficient, appropriate audit evidence that there is no material misstatement over revenue.

Key findings

In the prior year, we reported that the firm needed to enhance the quality of audit work on certain aspects of revenue. We reviewed the audit work performed over revenue on the majority of audits we inspected. We have seen progress against the specific findings reported previously. We did, however, identify weaknesses in the audit work performed on certain other areas of revenue across five audits reviewed in this inspection cycle, including three assessed as requiring more than limited improvements:

- Reconciling cash receipts to revenue recognised is an effective audit procedure in businesses where these amounts are closely linked. On one audit where this was the planned approach, the audit team performed insufficient procedures to reconcile cash receipts to revenue for a material revenue stream. On another audit, insufficient procedures were performed to evaluate and test certain material reconciling items.
- The recognition of revenue rebate accruals is often judgemental and can be susceptible to management bias. On one audit, we identified weaknesses in the group audit team's risk assessment and the sufficiency of its supervision of component auditors over the adequacy of audit procedures it had performed.
- We also identified findings over other aspects of the audit work performed over revenue and related balances across the five audits. These included weaknesses in audit procedures performed over VAT deductions, and the matching of year-end receivables to subsequent cash receipts.

Firm's actions:

We have performed RCA over each of these findings. We have also considered the features behind good practices identified by both the FRC and QAD in this area and also assessed the impact of actions taken in response to prior year findings.

There is little commonality of current year findings with those in the prior year indicating that actions taken in response to prior year findings were largely effective. This is supported by our own monitoring especially in relation to last year's findings on long term contracts.

In relation to cash to revenue reconciliations, we identified that certain outputs from our data specialists were unclear resulting in audit teams not performing all of the required testing. When this was first identified, we used our Emerging Issues process to develop an immediate response. This included identifying any other teams performing the same routine. We then provided direct support and amended the reporting templates used to remove the lack of clarity. In addition, we have used the specific examples identified by the FRC to create case studies used in training and workshops to highlight the importance of obtaining sufficient appropriate audit evidence over reconciliations and reconciling items.

We have seen progress in the audit of revenue but we identified weaknesses in five audits.

The root cause of the risk assessment issue related to rebate accruals was over-familiarity of the engagement team with the underlying process resulting in an insufficiently granular risk assessment being evidenced. No 'stand back' procedure was performed to ensure that the evidence obtained was sufficient to support the basis for the conclusions reached. The risk of audit evidence or documentation being impacted by teams being too close to the detail has been covered in both training and workshops where practical experiences are used to provide real world examples. The group audit oversight point was linked to the engagement team being focussed on ensuring that component auditors consistently performed the procedures set out in the group audit instructions rather than assessing the totality of the audit evidence obtained. Additional guidance and training has been released to ensure audit teams are aware of this requirement.

Other findings included in the report are largely engagement specific with limited common root causes. We have shared these findings, their root causes and the expected response across the audit practice and included certain matters in training modules as appropriate.

Our Culture Change Programme, discussed in more detail in our responses in Section Three, is designed to reinforce expected behaviours across our audit practice to create consistent, high quality, audit delivery across our entire portfolio of audits. We use various metrics to measure the progress and impact of the remedial actions taken in response to findings via our monitoring programme and, if required, use our Emerging Issues process to modify actions in response to findings from this monitoring.

Enhance the evaluation and challenge of management's impairment assessment for tangible and intangible non-current assets

The assessment of impairment usually involves the estimation of future cash flows and may be highly judgemental and subject to potential management bias. Changes in the key assumptions used in management's assessments could result in additional impairment charges being recognised. Auditors should obtain sufficient and appropriate evidence to assess the reasonableness of cash flows and other judgements made by management to support their conclusions over the extent of impairment.

Key findings

We reviewed the audit of impairment of tangible and intangible non-current assets on 16 of the audits inspected this year. We identified issues relating to the consideration and challenge of management's impairment assessments on six of these, including the following:

- On one audit assessed as requiring more than limited improvements, the audit team did not sufficiently consider or challenge certain key sales and cost assumptions used in management's cashflow forecasts for individual cash generating units. We also identified three further audits, with weaknesses in the procedures performed over certain aspects of forecast assumptions for the assessment of goodwill or tangible asset impairment.
- On a second audit assessed as requiring more than limited improvements, the audit team obtained insufficient evidence to determine whether the carrying value of individual investments held in the parent company balance sheet was impaired.
- We also identified weaknesses on certain audits in the audit procedures performed over sensitivity testing, the assessment of management's historical forecasting accuracy and the evaluation of impairment triggers.

We identified issues relating to the consideration and challenge of certain key assumptions in the audit of asset impairment.

Firm's actions:

We have performed RCA over each of these findings and are pleased to note that four of the six findings did not result in review outcomes requiring more than limited improvements. We have also considered the features behind good practices identified by both the FRC and QAD in this area. This included a scenario where our challenge resulted in impairment charges not initially anticipated by management.

The most frequent root cause behind these findings is the need to perform a stand back review of the audit file to ensure that it clearly sets out the thought processes followed, the evidence obtained and the basis for the conclusions reached. In these cases, the audit team had generally obtained sufficient audit evidence but had not provided evidence that was sufficiently precise to demonstrate this in a complex area. This was typically due to a level of accumulated knowledge of the audited entity that resulted in some evidence being assessed as self-evident and hence not required. In one case, the omission was due to oversight and miscommunication within the engagement team. The finding in relation to the carrying value of parent company investments was impacted by the audit team being too focused on the group level goodwill impairment consideration and weaknesses in management's own analysis of investment carrying values.

Our remedial actions are centred on highlighting the behaviours and approaches of the engagement teams identified for good practices in this area and providing a contrast between these and those engagements with findings. This includes actions to showcase what good 'looks like' and why specific teams fell short of these requirements. These actions sit alongside tactical measures related to training and tools which are designed to address the identified shortcomings. Importantly they are aligned with our Culture Change Programme covered in more detail in our responses in Section Three. Our monitoring programme is also relevant to these findings. We have also used the parent company investments finding and aspects of other findings, as examples in training and workshops.

Implement enhancements to improve audit quality in response to other issues driving lower audit quality assessments

On one audit that was assessed as requiring significant improvements, we identified deficiencies in the procedures performed over inventory existence and related quality control procedures. In particular, the audit team failed to retain adequate evidence of the inventory counts attended, or perform sufficient, appropriate procedures to respond to the count errors identified. The firm's quality control procedures should have identified these deficiencies.

Firm's actions:

This was a difficult audit and one of our first audit engagements delivered almost entirely remotely due to Covid-19. Physical inventory counts were performed prior to the first national lockdown but when the results were evaluated, and it was determined that additional evidence and audit procedures were required, lockdown conditions impacted the audit team's ability to respond. Additional steps were taken, without adequate consultation, and these were ultimately determined to be flawed. This was also impacted by specific resourcing issues that affected the performance of this audit. The quality control process was impacted by both the resource issue and the fact that Covid-19 created additional challenges that diverted senior team attention to other aspects of the audit considered to be more significant.

Shortly after lockdowns were introduced, we developed extensive guidance for audit teams dealing with the remote auditing of inventory including greater consultation requirements in relation to scenarios where the audit team identified weaknesses in available audit evidence. We believe that this material, if available and used on this engagement, would have addressed the findings that led to this inspection rating.

Good practice

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

- **Going concern:** On five audits, the audit teams' detailed challenge of management's going concern assessments and, where applicable, their testing of the completeness and accuracy of going concern material uncertainty disclosures, were of a high standard.
- **Challenge of management:** We identified good practice in this area. In addition to going concern, these included examples on three audits where there had been a robust challenge of the judgements taken by management for impairment, PPE residual values and deferred revenue. As highlighted in the key findings above we have equally identified instances where audit teams did not sufficiently challenge management. The firm should address the inconsistency and use these examples of good practice to assist in their remediation.
- **Group audit oversight:** While the quality of the oversight of the work performed by component auditors continues to be an area of inconsistency, we identified good practice in this area on four audits. This included examples where there had been a high degree of group audit team involvement, and robust and clearly evidenced challenge of component audit work.

Good practice examples included the extent of group audit team oversight and the assessment of going concern.

3 Review of firm-wide procedures

We review firm-wide procedures based on those areas set out in International Standard on Quality Control (UK) 1 (ISQC1), in some areas on an annual basis and others on a three-year rotational basis. The table below sets outs the areas we have covered this year and in the previous two years:

Annual	Current year 2020/2021	Prior year 2019/2020	Two years ago 2018/2019
• Audit quality initiatives, including action plans to improve audit quality. • RCA process. • Audit quality focus and tone of the firm's senior management. • Complaints and allegations processes.	• Audit methodology and training.	• Partner and staff matters. • Acceptance and continuance procedures.	• Ethics and Independence. • Internal Quality Monitoring. • Quality Control matters (including consultation and EQCR). • Audit documentation and data security.

In this section we set out the key findings and good practice we identified in the firm-wide work we have conducted this year, and a summary of our findings reported publicly in the previous two years and the firm's related actions, as follows:

- Audit quality initiatives.
- RCA process.
- Audit methodology and training.
- Firm-wide findings and good practice in prior inspections.

Audit quality initiatives

Background

Firms should develop audit quality plans that drive measurable improvements in audit quality. Audit quality plans should include initiatives which respond to identified quality deficiencies as well as forward-looking measures which contribute directly or indirectly to audit quality.

Audit quality plans should include forward-looking measures which contribute directly or indirectly to audit quality.

KPMG first introduced an audit quality improvement plan in 2017. The current Plan was issued in 2019, covering a three-year period, and takes a holistic view across factors which contribute directly and indirectly to audit quality. Embedded into the Plan are the recommendations of the independent review of KPMG's audit practice, commissioned by the FRC in 2019 as part of a programme of increased scrutiny over the firm in response to audit quality concerns. Our 2019/20 report noted that the firm had implemented some of these recommendations. The firm has now implemented the majority of the recommendations. Aspects of the Plan are supported by separate project plans, each with their own governance. The Plan is also updated to capture new requirements as they arise, whether from external or internal quality reviews or other sources, and is due to be refreshed later this year.

Last year we reviewed key aspects of the Plan, and reported that governance over it demonstrated the firm's commitment to improving audit quality, but that further focus was needed on:

- Developing and strengthening the culture of challenge in the audit practice.
- Extending project management milestones to each stage of the audit.
- Improving the quality of financial services audits (focused on banks and similar entities).

The firm's response to our findings last year indicated that it had initiatives already under way or would introduce new ones to address our findings.

This year, we have not conducted a detailed benchmarking of all firms' audit quality plans and quality initiatives, but at each of the seven firms we have brought our view up to date by work including:

- Assessing any key changes to the Plan in response to our findings last year, or for other reasons.
- Undertaking meetings with the firm to discuss and challenge aspects of the Plan.
- Considering the oversight of the Plan, including presentations made to the firm's audit oversight bodies.
- Assessing the extent to which culture and the culture of challenge have been incorporated into the Plan.
- Considering, in hindsight, the effectiveness of the Plan and key initiatives with reference to current year findings and observations.

As a result of our work, we have observed that:

- The firm has commenced its Culture Change Programme, which is a multi-year programme with a focus on developing a 'high challenge, high support' culture. Our 2019/20 audit inspections have indicated some improvement in this area but cultural change takes time to embed. The firm's 2020 summer training programme was focused on developing a culture of challenge and other activities are ongoing. The firm should ensure that all aspects of its business model are aligned with the desired culture and that progress is measured regularly.
- The firm has established a dedicated project management team and introduced more quality control checks at the planning and closing stages of an audit, as well as providing mandatory project management training to audit staff. The firm does not yet have an end-to-end suite of audit milestones but its new audit software platform contains enhanced audit milestone measuring capabilities. The roll-out of this platform has been delayed due to the Covid-19 outbreak but will be completed by 2022.

- The firm has recently introduced a new package of management information, including audit quality indicators, to allow more comprehensive and timely identification of risks to audit quality and the development of mitigating actions. The information is shared with the firm's governing bodies to facilitate oversight and challenge of the information and the actions being taken. The information and indicators are due to be refined during the year and it is too early assess their effectiveness. The firm should focus on developing leading or 'real time' indicators, particularly in areas which have been highlighted in quality reviews and the firm's RCA.

- The firm has also recently introduced a process to assess the effectiveness of actions taken. This process is at an early stage and the firm should focus on ensuring that a wide range of indicators are considered, especially in relation to areas where audit quality issues are being found to recur.

Key findings

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

- Ensure its quality initiatives are appropriately prioritised and measured: The Plan is extensive, comprising a number of major projects as well as smaller initiatives, and new items have been added to the Plan during the year. While implementation is well advanced, the extent of change gives rise to challenges in embedding new approaches. The firm is aware of this risk and has put in place some mitigating actions, but should further consider how quality improvement initiatives are prioritised, alongside ensuring that appropriate indicators and measures of effectiveness are in place.

- Extend its banking quality improvement plan: In response to our findings in 2019/20 with regard to the firm's audits of banks and building societies, the firm initiated in mid-2020 a banking audit quality improvement plan, which included developing additional audit working papers and adding quality control measures to challenge audit teams' conclusions at all stages of the audit. We have not yet inspected any audits conducted under these revised processes. However, as set out above, our firm-wide work has concluded that KPMG needs to develop additional procedures and guidance for certain key elements of the audit of banks and similar entities in time for 2021 year-end audits.

KPMG's audit quality plan is comprehensive. The firm needs to extend its banking quality improvement plan in response to our findings.

Good practice

We identified the following area of good practice:

- **Governance over the Plan:** This has remained strong, with individual project plans for major initiatives, clear accountabilities and regular reports and updates to the firm's audit oversight bodies.

We will continue to assess the audit quality plans and encourage all firms to develop or continue to develop their audit quality plans, including the focus on continuous improvement and measuring the effectiveness of the key initiatives.

Firm's response and actions:

Audit Quality Plan

Our Audit Quality Transformation Plan ("AQTP") commenced in FY17 and comprised three phases (Stabilise, Embed and Embrace), each year the plan includes a number of projects designed to enhance Audit Quality. The projects included in the Embrace phase, which commenced on 1 October 2020, form the foundation for our three-year audit strategy and transformation plan.

We acknowledge the importance of a robust and verifiable issues management system to capture, aggregate and prioritise quality findings from numerous sources. A significant achievement last year included formalising the Emerging Issues process, a process which captures audit quality issues emerging from a variety of data sources and promptly develops remedial actions to address them. This process alongside the RCA process ensures a continuous assessment of audit quality issues and a timely response to remediate any immediate concerns.

Our priority actions for 2021 are the Banking Audit Quality Improvement Programme, referred to in Section Two, implementation of our new global workflow "KCw" and our Culture Change Programme.

KCw

The phased deployment of our new global audit workflow, KCw, is well underway, is on track and is due for completion in 2022. Alongside direct project management support to engagement teams, we have increased our focus on training auditors in project management, as well as developing a range of digital tools, templates and procedures to support improved audit delivery.

Culture

As noted in Section One, our ambition, is to create a culture of 'high challenge and high support' across Audit so we deliver high quality work, fulfil our public interest role, build a sustainable audit business and ensure the role of auditors is highly valued, giving us engaging and rewarding careers. We have taken a holistic approach to the Culture Change Programme, which has been developed and built on a foundation of the three pillars of our audit strategy.

We have achieved significant progress in the first year of our Culture Change Programme. Positive change has taken place. People are thinking and acting differently but systemic culture change takes time. In our first year we appointed the Audit Evolution Board, which provides challenge, diversity of thought, new insight and recommendations on matters for discussion by the Audit Board, delivered our 2020 KPMG Audit University with the theme 'Embedding a culture of challenge', held Fraud Awareness week, highlighting the importance of challenging management, held Audit Support Week bringing together a diverse group of speakers on mental health and wellbeing, elite listening skills and high performance achieved through a growth mindset, and we continued our focus on coaching building on the significant investment we made in coaching the previous year.

As the Culture Change Programme moves into its second year, we will embed our culture ambition and language of 'high challenge and high support' across the Audit practice, building ownership and accountability at a local level. We plan to make real the clear and explicit link between our culture ambition and how this impacts our wider Audit strategy in delivering audit quality.

We have started to baseline and measure our culture, using a variety of different sources of management information. Using focus group output and a variety of other data sources we will continuously assess our Culture Change Programme to ensure it will deliver our culture ambition in the context of the three pillars of the strategy for Audit.

RCA 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.

The firm has been performing RCA for a number of years and follows methodology and guidance issued to it by the global firm, supplemented by additional UK specific procedures.

When we reviewed the firm's RCA process last year and the RCA it conducted on our 2019/20 inspection findings, we found various areas of good practice, but that:

- The RCA process could be further improved by considering whether individual inspection findings, that are identified as having a firm-wide application, require stronger actions.
- Unlike some firms, KPMG did not focus its RCA on inspection findings regarding good practice and did not routinely conduct RCA on our firm-wide findings. In addition, the firm's RCA reports had less detail on the themes than those of other firms.

This year, we have not conducted a detailed benchmarking of all firms' RCA processes, but at each of the seven firms we have brought our view up to date by performing work including:

- Assessing any key changes to the firm's RCA process, arising from the actions taken in response to our findings last year or for other reasons.
- Conducting follow-up meetings with the firm to discuss and challenge aspects of the RCA process.
- Considering the oversight of RCA at the firm and communication of key findings.
- Considering, in hindsight, the efficacy of the historical RCA process and the actions taken with reference to current year inspection findings.

During our work, we observed that the firm continues to invest in the RCA process and has taken steps to address the findings we raised last year. This year the firm has:

- Produced detailed RCA reports on the key findings raised by the FRC and the key themes arising from its internal quality monitoring reviews. These RCA exercises include inputs from a wide range of sources and the firm has also introduced focus groups to challenge the root causes identified and provide additional insights from behavioural specialists.
- Expanded the scope of its RCA projects beyond specific quality review findings, to cover areas with firm-wide application such as prior year adjustments made to previous audited results and certain ethical breaches. The firm has also begun to undertake RCA on the FRC's firm-wide findings but this process requires further development.

Root cause analysis is an important part of a continuous improvement cycle.

- Incorporated themes arising in good practice findings into the RCA process and used these to inform remedial actions to address adverse findings.

- Compared outputs to previous years findings to assess on a more granular level where issues may have recurred but the underlying root causes are evolving, in order to develop more targeted remedial actions.

- Linked its RCA process with other processes designed to identify and address new issues as they emerge, as well as introduced a monitoring process to assess the effectiveness of actions.

Key Findings

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

- Review the depth of its RCA process in light of our recurring findings: Our recurring quality findings in certain audit areas raise questions about the efficacy of the execution of the RCA process in prior years and whether it has identified the full extent of underlying root causes which then result in appropriately prioritised and targeted actions being taken and embedded effectively.

Good practice

We identified the following area of good practice:

- **Challenge of RCA findings:** RCA findings and actions may be subjected to several levels of review and challenge, including by the firm's audit oversight bodies.

KPMG's root cause analysis processes are well developed.

We will continue to assess the firm's RCA process. We encourage all firms to develop their RCA techniques further as well as focus on measuring the effectiveness of the actions taken as a result.

Firm's response and actions:

We recognise the importance of effective RCA and continue to invest in our root cause programme. Over the last twelve months we have made a number of improvements as acknowledged by the FRC. This included working with the culture team to host a series of focus groups to explore and discuss the causes of behaviours, both good and bad, that influence quality outcomes. The output of these discussions was then used to enhance the quality of the remedial actions that respond to inspection findings.

We are aware that certain quality findings recur year-on-year, and to gain a greater understanding of this, we have introduced a more formal remedial action monitoring process. By comparing root causes year-on-year, we assess on a more granular level where issues may have recurred, but the underlying root causes have evolved. In addition, given the difficulty of monitoring the direct impact individual remediation actions have on a root cause we have identified a series of elements, that, if monitored, we can use to provide insight into the potential impact of actions taken. As we are now more actively reviewing and developing how we monitor, on a timely basis, the impact of actions and how effectively they are embedded, we can more thoroughly assess the effectiveness of our RCA process.

The remedial actions we take as part of the RCA process are a holistic package of measures designed to complement each other. This year we included behavioural specialists in the RCA process to broaden the types of actions taken. Actions fall across a range of areas including training, tools and guidance as well as actions taken to address the environment and culture in which audits are delivered. These include coaching, support, challenge and monitoring of engagement teams, resourcing, scheduling, portfolio management and tone-at-the-top messaging. This year a number of the remedial actions will be directed at embedding cultural and behavioural change.

Audit methodology and training

Background

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. Our inspection primarily evaluated key changes to the firm's methodology and guidance including how it had been updated to incorporate recent changes to auditing and accounting standards, including:

- ISA 540 revised (Auditing accounting estimates and related disclosures).
- ISA 570 revised (Going concern).
- IFRS 9 (Financial instruments) with a focus on the audits of banks, building societies and other credit institutions (banking audits).
- IFRS 16 (Leases).

We also considered other key topics such as the policies for using specialists and experts on audits and updates to audit software. We performed the majority of this work on the methodology and guidance in place as at 31 March 2020 together with updates made by the firm between then and February 2021, including a consideration of the firm's initial response to the impact of Covid-19.

Firms' training arrangements must provide auditors with the knowledge and skills necessary to fulfil their role effectively, and as such, are also an important element of the firm's overall system of quality control. Our inspection included an evaluation of the amount of training provided by the firm in the year ended 31 March 2020, the subjects covered and how the training was delivered. We also considered the firm's processes for monitoring course attendance and evaluating whether participants had met the learning objectives by conducting post course assessments.

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.

Key findings

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

- Improve the quality and extent of IFRS 9 procedures and guidance relating to the audit of banks and similar entities: The firm should develop additional, comprehensive procedures and guidance on how to audit the various elements of IFRS 9, in particular relating to classification and measurement of financial instruments and expected credit losses. This should include illustrative risks, controls and substantive procedures for each element of the standard; and it should also provide audit teams with a clear expectation of the minimum procedures to be performed. Immediate action is required given the size and complexity of the banking audits performed by the firm and the results of our inspections of the firm's banking audits in recent years.

The firm needs to improve the quality and extent of its IFRS 9 procedures and guidance relating to the audit of banks and similar entities.

Good practice

We identified the following area of good practice:

- **The firm provides extensive training to experienced hires:** the training includes detailed scenarios and case studies to prepare the individual for their new role.

In addition to the firm-wide procedures above, we performed a thematic review on the enhanced audit policies and procedures at the seven largest firms in relation to going concern, given the impact of Covid-19. The themes we observed were publicly reported in June 2020 and November 2020 and have not been included here.

Firm's response and actions:

We are pleased that we received no key findings in relation to our audit methodology relating to accounting estimates, going concern and leases given the significant changes in these standards. Examples of good practice were identified in respect of going concern and challenge of management, which is a testament to the hard work of our auditors particularly given the challenges faced this year due to Covid-19.

Training is a key deliverable and fundamental to maintaining the competency and technical expertise of our partners and staff. Training is also one of the primary actions we take to remedy audit quality findings, it was therefore pleasing there were no key findings. In addition, the Qualified New Joiner program was a particular initiative of last years 'Embed' phase of our AQTP, which the FRC acknowledged as good practice.

We delivered all the work papers and guidance that were due to be released in year one of the Programme. As outlined in Section Two above, our 2021 improvement plan has been developed to ensure we address, as a priority, findings arising during the latest inspection cycle, including those that relate to methodology. All ongoing actions will be incorporated as we commence the second year of the Programme and are targeted for completion in advance of our December 2021 year end audits.

Firm-wide key findings and good practice in prior inspections

The following table summarises the firm-wide key findings and good practice included in our previous two public reports, as well as the actions taken by the firm in response to our key findings, in those areas of ISQC 1 which we review on a rotational basis. We consider that the firm has appropriately responded to these findings based on the actions taken.

Key findings in previous public report	Update on firm's actions in response	Good practice
Partner and staff matters (2019/20): Human resource processes are a key element of a firm's overall System of Quality Control and are integral to supporting and appropriately incentivising audit quality. Our inspection included an evaluation of the firm's policies and procedures and their application to a sample of partners and staff for the FY18 appraisal year, across the following areas: Appraisals and remuneration; Promotions; Recruitment; and Portfolio and resource management.		
• A sample review of partner appraisals identified instances of insufficient evidence of how adverse quality findings had been considered in appraisals, objective setting and, in one case, promotion decisions. Also, the firm did not have a formal process to ensure that all relevant quality metrics (including the results of internal or external inspections) were appropriately considered and reflected in manager and senior manager appraisals.	• We implemented a formal process to record quality metrics for Managers and Senior Managers in FY19, consistent with that deployed for Partners and Directors in FY18. We reinforce throughout our goal setting, performance assessment and promotion that quality considerations should be explicitly evidenced.	No specific good practice examples raised.

We had no key findings on the other areas we reviewed and we identified the following good practice:

Acceptance and continuance procedures (2019/20)
• The firm had introduced new acceptance and continuance form, which provides a robust control to help audit teams address the risks facing the firm. The firm goes further than its peers to reiterate to teams the importance of potential damage to values, reputation and brand during the process, including asking teams to consider explicitly how their decision would be perceived by third parties.

Appendix 1

Firm's internal quality monitoring

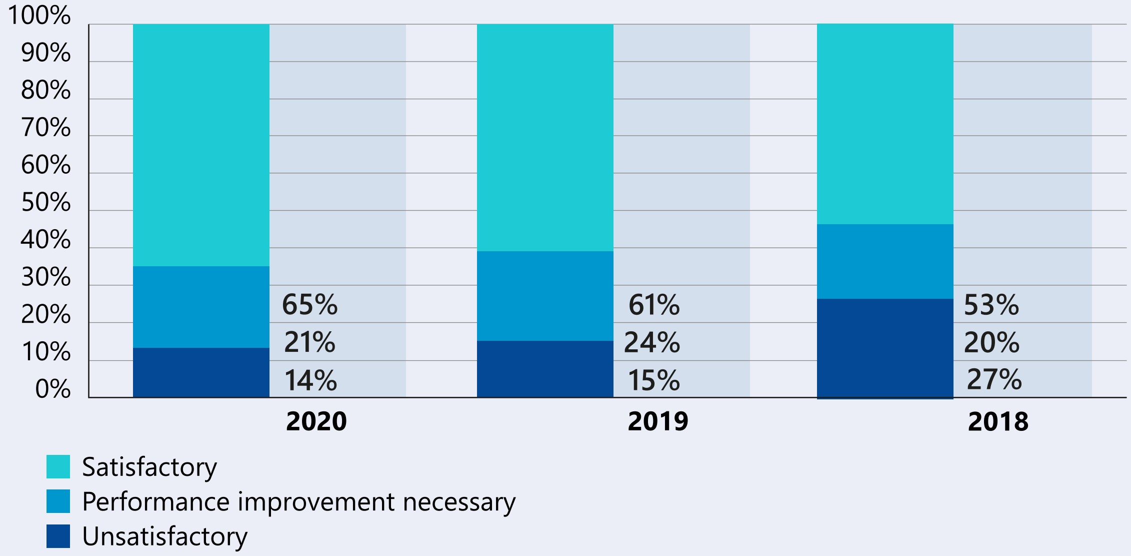
This appendix sets out information prepared by the firm relating to its internal quality monitoring for individual audit engagements. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified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

The appendix should be read in conjunction with the firm's Transparency Report for 2020, 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 122 audit engagements (for periods ending up to 31 March 2020), are set out below along with the results for the previous two years, where 129 and 108 audits were inspected in the years ended 31 March 2018 and 2019 respectively:



Inspections are graded as performance improvement necessary 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. Inspections are graded as being unsatisfactory 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.

Our inspection results continue to show improvement year-on-year although we would like to see the rate of improvement accelerate.

Firm's approach to internal quality monitoring

Our internal review cycle is aligned with our annual performance review cycle and completes in the Autumn each year. The 2020 internal QPR programme described above covered audits with year-ends of 31 March 2020 and earlier, which is contemporaneous with those reviewed by the FRC in this report.

The firm's QPR program considers the full population of audits performed. All 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 are selected taking account of size, risk and profile. Each QPR inspection is overseen by an Independent Lead Reviewer from outside KPMG UK and the program is monitored globally. 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 the QPR identifies significant deficiencies, a remedial action plan is prepared, applicable at both an engagement and firm level. Remedial action is generally in respect of future periods unless the review highlights evidence of an inappropriate opinion.

The scope of a review under our internal QPR is broad and normally considers elements of the audit that are not assessed by an external inspection. Our QPR programme is designed to hold audit teams to quality levels that assess not only compliance with auditing standards but also adherence to internal requirements such as the performance of specified procedures or completion of specific mandated consultations. As such teams that perform audits that are very substantially compliant with auditing standards may receive a rating other than satisfactory in our internal reviews. Accordingly it is difficult to make direct comparisons between the results of our internal and external inspection processes.

The firm undertakes RCA on Unsatisfactory engagements and other findings considered to be more pervasive, including some arising on engagements assessed as Satisfactory and PIN, which informs further remedial actions at a firm level incremental to the team level actions described above. Engagement teams also undertake specific incremental or remedial training based on the QPR.

A pervasive matter is one that occurs on 10% or more relevant engagements generally without regard to the severity of the finding. This process 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. We also consider findings from a range of inspections to ensure that we develop robust remedial actions. We also assess the success of actions taken in prior periods as part of our process.

Internal quality monitoring themes arising

The most frequently occurring issues identified through the QPR programme remain largely consistent with the prior year, albeit in a different order. Issues continue to be identified in aspects of risk assessment, documenting processes and testing controls. There were also issues identified with sampling, substantive analytical procedures and the audit of journals. Our programme of standardised workpapers has brought consistency and higher quality but issues have arisen when teams have not used the workpapers effectively, usually driven by the work not having been allocated to an appropriate member of the audit team. Areas where sufficient improvement was seen for them to drop out of the list of pervasive issues included the audit of groups, audit of impairment of non-financial assets and audit of IPE.

It is encouraging that five topics subject to RCA and resulting remedial actions from the prior QPR cycle were not identified as pervasive in this cycle of QPR reviews. Whilst it is disappointing that the actions taken on seven areas have not reduced the level of findings such that they are no longer considered pervasive we have identified a narrowing in the nature of findings and a reduction in the assessed severity of findings in these areas indicating that the actions taken are having a positive impact, albeit more slowly that desired.

Areas that contributed most significantly to unsatisfactory 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 and in the performance or documented explanation of specific substantive audit procedures. 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.

We monitor review outcomes over time and a key data point for us is that the later audits within this QPR cycle (measured as 31 December 2019 and later year ends) achieved improved results compared with the audits performed earlier in this cycle. There was a further reduction in the proportion of engagements rated Unsatisfactory, although this remained higher than we expected, and a corresponding increase in the level of engagements rated as Satisfactory.

Firm's actions

As noted above, in order to learn from our inspection process we perform RCA to consider the details of findings from across the full spectrum of reviews to identify remedial actions. We have performed RCA across ten topics assessed as pervasive in this cycle of QPR reviews (PY: 12 topics). Three of these were new topics whilst seven were recurring. Overall, the number of findings that have led to adverse inspection results has decreased as the findings identified are assessed as less severe. In addition, in a number of areas the findings have evolved, with the nature of findings and identified root causes changing over time.

We have completed interviews with 197 team members and other individuals including, EQC reviewers and KPMG Specialists where relevant to the inspection findings. This includes interviews with teams subject to FRC inspection where the findings are complementary to those from our internal inspections. Recognising the recurring nature of some of the pervasive topics we have also performed a variety of focus groups to both challenge the identified root causes and support the development of our remedial actions. We have also introduced a formal process for supporting our monitoring of the assessed success of actions previously taken.

As in prior years the root causes identified largely reflect engagement specific factors with a reduction in common findings. Accordingly, a key element of our response to internal inspection findings is the direct support provided to individual engagement teams.

At a firm level we have identified root causes in the following areas:

- Ongoing challenges with the quality and timeliness of information provided by certain audited entities and our audit response to the difficulties this presents at the engagement level;
- In common with the profession more widely, the level of change of personnel within our audit practice has increased resulting in a need for more proactive and flexible coaching and support arrangements. The integration of new hires and secondees, the support for individuals delivering stretching and challenging new work, and the oversight of individuals working notice periods are all examples where proactive and tailored coaching and support is required;
- Weaknesses in risk assessment and planning on some engagements which, when coupled with potential shortcomings in coaching, means that the audit team default to following prior year procedures rather than using current requirements increasing audit delivery risks;
- Inconsistent use by engagement teams of materials and guidance available to them and, in some cases, weaknesses in those underlying materials;
- Issues with our project management disciplines that impact the effectiveness of our review processes on some engagements as work is reviewed too late in the audit process when individuals are under increased time pressure.

These are not new challenges, but they have evolved as they are progressively implemented by our remedial actions. To respond to the current findings we have developed a series of actions that range from specific topic near term training, support and monitoring through to our longer term Culture Change Programme which is focussed on further embedding our ‘high challenge, high support’ ambitions. These actions have been developed and challenged reflecting on our prior year experience of what accelerates and embeds change most effectively. We are building a culture where everyone:

- Understands their role in the delivery of audit quality;
- Is challenged to take personal responsibility for their work and recognised for this;
- Is coached, mentored and supported on this journey and has the necessary skills, tools and training to succeed;
- Holds each other, and themselves, accountable; and
- Is confident and willing to challenge management and audit committees and to do the right thing, every time.

We are pleased that, whilst we continue to expect increasingly high standards, the rate of engagement files rated Unsatisfactory continued to decline. We believe the actions we are taking in response to these findings will continue to reduce this trend.

Appendix 2

FRC audit quality objective and approach to audit supervision

Audit quality objective

The FRC is the Competent Authority for statutory audit in the UK and is responsible for the regulation of UK statutory auditors and audit firms, and for monitoring developments, including risk and resilience, in the market. We aim, through our supervision and oversight, to develop a fair, evidence-based and comprehensive view of firms, to judge whether they are being run in a manner that enhances audit quality and supports the resilience of individual firms and the wider audit market. We adopt a forward-looking supervisory approach to audit firms, and we hold firms to account for making the changes needed to safeguard and improve audit quality.

Auditors play a vital role in upholding trust and integrity in business by providing opinions on financial statements. The FRC's objective is to achieve consistently high audit quality so that users of financial statements can have confidence in company accounts and statements. To support this objective, we have powers to:

- Issue ethical, audit and assurance standards and guidance;
- Inspect the quality of audits performed;
- Set eligibility criteria for auditors and oversee delegated regulatory tasks carried out by professional bodies such as qualification, training, registration and monitoring of non-public interest audits; and
- Bring enforcement action against auditors, if appropriate, in cases of a breach of the relevant requirements.

In March 2021 the Department for Business Energy & Industrial Strategy (BEIS) published a consultation document, Restoring Trust in Audit and Corporate Governance, which proposes broader supervisory powers for the FRC/ARGA covering auditors, audit committees and directors. The legislation that follows the consultation process will create ARGA and provide it with further powers.

Approach to audit supervision

In March 2021 we published Our Approach to Audit Supervision which explains the work that our audit supervision teams do.

These reports published in July 2021 provide an overview of the key messages from our supervision and inspection work during the year ended 31 March 2021 (2020/21) at the seven largest audit firms[9], and how the firms have responded to our findings.

In accordance with our commitment to transparency, for the first time we will also be publishing later this year anonymised details of the key inspection findings and good practice points on the individual audits we reviewed.

In addition to our public reporting, we report our findings in more detail privately to the firms and also to their Recognised Supervisory Body for the purposes of its decision on their audit registration. From 2022, the FRC will be assuming responsibility for the registration of all firms which audit PIEs.

9 The seven largest firms are: 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.

Our inspection and supervisory work in 2020/21 included:

- 103 statutory audits conducted by the largest seven firms, 16 at smaller firms and four at the National Audit Office. These audits were of financial statements for years ended between 30 June 2019 and 2 May 2020. We also inspected 22 local audits, which we report on separately later in the year, three other audits at the National Audit Office and one Third Country Audit, making an overall 149 inspections.

- Certain areas of the firms' quality control procedures (against the requirements of ISQC 1). We review these on a three year rotation basis at the seven largest audit firms and periodically for smaller firms.

- A focus on the firms' audit quality plans and RCA, both of which are important means of addressing audit quality issues and driving continuous improvement.

In 2020/21 our inspections focused on the following priority sectors and audit areas[10]:

Sectors	Audit areas
• Financial Services	• Going concern and the viability statement
• Retail, including Retail Property and Travel & Leisure	• The Other Information in the Annual Report
• Construction and Materials	• Long-term contracts
• Manufacturing	• The impairment of non-financial assets
	• Fraud risk
	• Application of new accounting standards (IFRS 15: revenue and IFRS 16: Leasing)

Our firm-wide inspection work in 2020/21 focused on audit firms' methodology and training, particularly relating to: revised auditing standards on going concern and the audit of estimates; and new or recently issued accounting standards on financial instruments (IFRS 9), revenue (IFRS 15) and leasing (IFRS 16).

At the conclusion of all individual audit inspections that are assessed as requiring more than limited improvements, we will consider whether the audit should be referred for consideration under the FRC's enforcement procedures. UK statutory audits may be referred to FRC's Case Examiner for consideration under the Audit Enforcement Procedure (AEP)[11]. The Case Examiner then decides on the appropriate course of action, which may involve Constructive Engagement with the audit firm to resolve less serious potential breaches of auditing standards and other requirements or referral to the FRC's Conduct Committee to consider whether an investigation should be opened. An investigation may result in financial and non-financial sanctions being imposed on an individual statutory auditor and/or the statutory audit firm. The FRC publishes details of all sanctions imposed. From our 2020/21 inspections, 18 audits have so far been referred to the Case Examiner (compared to 13 from our 2019/20 inspection cycle). The FRC's Annual Enforcement Review, published annually in July, contains further details of audits considered under the AEP.

As well as planned supervision and inspection activities, we also respond quickly to emerging issues. For example, during 2020/21 we responded to Covid-19 by issuing guidance to audit firms (and companies) and carrying out a thematic review of the audit of going concern which included inspecting samples of audit work. Our findings were that firms had reacted well to the new challenges. Our 2021/22 inspections will also focus on and take into account the impact of Covid-19 on audits.

10 https://www.frc.org.uk/news/december-2019-(1)/frc-announces-its-thematic-reviews-of-corporate-re
11 Other procedures apply to audits of non-UK entities (such as those incorporated in the Crown Dependencies)

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