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Rachel Reeves, MP
Chair Business, Energy and Industrial
Strategy Committee
House of Commons
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Dear Ms Reeves,

Business, Energy and Industrial Strategy Committee Inquiry into the Future of Audit: Response to further information requests

Thank you for the opportunity to give evidence to your Committee on 30 January and for your letter of 13 February. I am pleased to provide the further information you have requested in the attachment to this letter.

In addition I wanted to take this opportunity to provide clarification with regard to some of the questions about the suspension of the partner on the Carillion audit and three of his colleagues.

The audit of Carillion for the year ended 31 December 2016 was completed in March 2017.

In September 2017 the FRC's Audit Quality Review ("AQR") team commenced an inspection of the 2016 audit as part of its routine monitoring programme and the inspection team was provided with a copy of the final audit file.

During the Carillion AQR inspection, at the AQR inspection team's request, certain additional information and documents were provided to the inspection team. It is often the case that AQR inspections involve the provision of information to the AQR inspection team which was not contained in the final audit file.

In November 2018, we identified and reported to the FRC concerns relating to a small number of these documents and it was these concerns that led to the suspension of these individuals pending the outcome of investigation.

Our investigation continues in parallel to that commenced by the FRC in November 2018, with which we are co-operating.

I want to make it clear that, contrary to some of the commentary since I gave evidence, (1) the concerns we raised with the FRC relate only to these additional documents, (2) we have not yet reached a conclusion as to the conduct of the partner on the Carillion audit or any of the other suspended individuals and (3) nothing which occurred during the AQR inspection could impact the audit conclusions reached six months earlier.

If you have any further questions, please do not hesitate to contact me.

Yours sincerely,

Bill Michael

UK Chairman and Senior Partner

Attachments:

KPMG LLP's 6 March 2019 response to BEIS Committee's 13 February 2019 information request

Appendix 1: FTSE 350 audited companies taken on in the last five years – number of hospitality and entertainment events before being appointed as auditor

Appendix 2: Audit quality scorecard - principles

Appendix 3: Pay Gap Report 2018

Appendix 4: Technology tools used by KPMG UK in conducting audits

Audit costs *(Information request 1)*

Background

Our priority is to seek to deliver a high quality audit. For any individual audit we will not compromise quality to secure a particular level of profitability.

Typically, when we price our audits we estimate the amount of work and mix of partners / staff required to meet our objective in terms of audit quality. We then discuss that estimate with the audit committee and seek to agree a fee which is both competitive and makes a positive contribution to profit. We recognise that the outcome cost is unlikely to be exactly as we estimated, but as it is often the case that the assumptions on which we have made our estimate are reasonably borne out, the outcome is usually within an expected and appropriate range of profitability.

In many situations the fee quote will be regarded as being (and in some cases, particularly in competitive tenders, will be expressed as being) a "fixed fee" although it will usually be agreed with the audit committee that the fee quote will be subject to adjustment where companies change the shape of their business through acquisition or disposal, where there are significant changes to regulation, and, where part of the work is undertaken overseas, when exchange rates change.

Where the assumptions underlying a "fixed" fee quote are not borne out in practice and we are required to undertake significantly more audit work than we had estimated during the tender process to ensure the audit is performed to the appropriate standard, we will usually seek to negotiate an increased fee to take account of this additional work.

It is our experience that, where additional work is validly required, audit committees are receptive to additional fees being billed. Where this is not the case, we consider the appropriateness of continuing as auditor for the subsequent year, although such instances are very rare.

Cost overruns of 10% or more (Information request 1)

We have compared the outturn global costs for 483 audits of FTSE 350 companies that we have completed over the last five years.

Of these, after excluding the effects of foreign exchange rate changes and scope changes due to changes in circumstances (which were appropriately taken into account in the final fee positions), 75 (16%) had costs 10% or more in excess of the amount budgeted. In 62 (83%) of these cases we took up the situation with the audit committee with a view to increasing our fees and in all those cases we agreed an increased fee.

There were also many examples of where lesser cost overruns were experienced and we successfully agreed an increased fee.

Although we spend a significant amount of time understanding a company during an audit tender, it is inevitable that we have a lower level of understanding of such a company's systems, processes, people and control environment than we would have for a company that we have audited for a number of years. There is therefore a higher risk that we under estimate the effort required to deliver a high quality audit to a company where we have recently won a competitive tender. Looking back at first year audits of the 21 FTSE 350 trading companies where we tendered and were appointed over the last three years, on around half of these audits the amount billed in respect of the first year audit included additional fees to reflect costs exceeding budget, though in many cases the level of cost overrun was less than 10%.

FTSE 350 audited company hospitality and entertainment *(Information requests 2, 3 and 4)*

Our policy

Our policy sets out both general financial limits and requirements constraining the types of corporate hospitality that can be provided to (and accepted from) all companies we interact with.

There are stricter limits that apply to companies that we audit, reflecting the requirements of the FRC's Ethical Standard with which we need to comply. This states that we should not provide entertaining to or accept entertaining from a company that the firm audits unless an objective, reasonable and informed third party would consider the value to be trivial or inconsequential. We have a policy that embodies this requirement and includes detailed provisions to interpret the principle that cover: the frequency of entertaining, notification requirements to the lead audit partner, maximum cost and the nature of the event.

The cost of an entertaining event for any company that we audit (irrespective of whether it is a listed or a private company) cannot exceed £200 (excluding VAT) per head and any amount below that must also pass the 'trivial or inconsequential test' both in terms of cost and the nature of the event. Our policies also require that the event must be capable of being purchased by a member of the public at the same cost and that entertaining is infrequent (e.g. not more than a couple of times a year).

Given the heightened public interest in audits of listed companies, the only entertaining that we permit is business dinners or lunches. Under our current policies, the cost of the meal is limited to £60 a head and the cost of wine must be limited to £25 a head.

Our policies also require that once we receive an invitation to tender for an audit, we apply the more restricted entertaining policies that would be applicable if the company were already audited by KPMG. We consider this is important to avoid any perception that an audit tender award had been unduly influenced by either excessive or inappropriate entertaining.

The above is a description of our current policy. Over the past three years we have tightened our policy both in response to changing regulation and in response to the changing environment in which we operate.

Information requested

We set out below the information you have requested.

Total spend on and number of hospitality and entertainment events provided to FTSE 350 audited companies *(Information request 2)*

Type of spend	2018		2017		2016		2015		2014	
	Spend in £	**Events**	**Spend in £**	**Events**	**Spend in £**	**Events**	**Spend in £**	**Events**	**Spend in £**	**Events**
Hospitality - business lunch/dinners etc [1,2]	49,445	n/a	81,241	n/a	85,201	n/a	13,700	n/a	n/a	n/a
Central marketing events [3]	2,444	12	9,087	53	28,941	49	102,515	137	88,410	138
Total	**51,889**	n/a	**90,328**	n/a	**114,142**	n/a	**116,215**	n/a	**88,410**	n/a
Average per company entertained	**711**	n/a	**1,221**	n/a	**1,463**	n/a	**1,788**	n/a	**1,922**	n/a

[1] Data available only from July 2015 when we started monitoring spend in this way ahead of the implementation of revised Ethical Standards in 2016

[2] No event numbers available

[3] Central marketing events largely comprise entertainment at concerts, art exhibitions and sporting events

Total spend on and number of hospitality and entertainment events provided to companies which subsequently became FTSE 350 audited companies *(Information request 3)*

Type of spend	**2018**		**2017**		**2016**		**2015**		**2014**	
	Spend in £	**Events**	**Spend in £**	**Events**	**Spend in £**	**Events**	**Spend in £**	**Events**	**Spend in £**	**Events**
Hospitality - business lunch/dinners etc [1,2]	913	n/a	20,511	n/a	45,052	n/a	15,171	n/a	n/a	n/a
Central marketing events [3]	0	0	1,469	5	9,847	8	25,793	27	17,128	32
Total	**913**	n/a	**21,980**	n/a	**54,899**	n/a	**40,964**	n/a	**17,128**	n/a
Average per company entertained	**457**	n/a	**1,832**	n/a	**2,614**	n/a	**1,463**	n/a	**952**	n/a

[1] Data available only from July 2015 when we started monitoring spend in this way ahead of the implementation of revised Ethical Standards in 2016

[2] No event numbers available

[3] Central marketing events largely comprise entertainment at concerts, art exhibitions and sporting events

FTSE 350 audited companies taken on in the last five years – number of hospitality and entertainment events before being appointed as auditor *(Information request 4)*

We have taken on the audit of 59 FTSE 350 companies over the last five years and during the period 1 January 2014 to 31 December 2018 we invited employees of those companies to 72 events. Of the 59 companies, for 35 companies (59%) there were no events, for 15 companies (26%) one or two events, for 7 (12%) between three and five events and for 2 (3%) more than 5 events (8 and 16 events (3 and 5 events per year respectively), which largely involved entertainment at concerts and sporting events).

The number of events by company is provided in appendix 1.

Targets set for audit senior managers to progress to partner *(Information request 5)* and **Impact of audit quality on staff remuneration and progression** *(Information request 6)*

All of the targets set for our audit partners and staff which determine progression and remuneration are grounded, directly or indirectly, in audit quality.

This is embedded into our Audit Quality Matrix scorecard which is the basis on which we assess and record quality performance and is designed to provide a holistic view of quality.

I attach as appendix 2 a copy of our "Audit quality scorecard – principles" which summarises the goals and targets that apply to all audit partners and staff at different grades.

You will see that:

- The primary goals relate directly to audit quality (including use of technology) and include other goals relating to performance, people and values and behaviours
- These other goals largely indirectly support audit quality
- Remuneration of partners (page 2 and 3) has an explicit audit quality override which can increase or decrease the variable element of partner pay (approximately 40% of the total on target estimated pay) and can also be reduced by the application of penalties for ethics and compliance infringements. In addition quality will affect (both positively and negatively) partner base pay and hence their long term remuneration as well as in-year pay
- Remuneration of staff (pages 7 and 8) also has a direct link between audit quality with both salary and bonus being affected
- Progression is determined relative to performance. Senior manager targets (pages 9 to 11) and partner targets (pages 4 to 6) are similar, though the partner targets reflect their greater responsibility. To progress from senior manager to partner, an individual would be expected to exceed 'expected performance' against the senior manager targets and show the potential to perform to at least level 3 ('consistently meets quality expectations' - see page 6) against the partner targets.

Pay ratios and quartiles *(Information request 7)*

As you noted in the evidence session on 30 January, the corporate governance code that came into force in January 2019 and includes CEO to employee pay ratios does not apply to partnerships. However, we understand the vital role transparency and accountability play in building trust in business and I am pleased to confirm that we intend to publish our pay ratios and pay quartiles in our 2019 Annual Review.

In respect of gender and BAME pay reporting, KPMG voluntarily declared its median gender pay gap in 2015 and 2016 as part of its annual reporting process but calculated these in a different way than is now required by law. We have reported our gender pay gap as required by statute for colleagues since 2017 and on an equivalent basis for partners. In addition we have voluntarily published our ethnicity pay gap for the past two years. A copy of our 2018 Pay Gap Report is attached as appendix 3.

Impact of internal reviews on audits *(Information request 8)*

We have a comprehensive set of "in-flight" review processes that operate to reinforce the quality of individual audits as they are performed. In addition, we have a system of Quality Performance Reviews of completed audits and the findings of these reviews, together with the findings of external reviews of audits conducted by regulators, including the FRC, are analysed and the root causes of the findings are fed back into our audit process, training and other measures as part of a continuous improvement loop to support quality across all our audits.

Our in-flight reviews, the results of which are taken into account in our audit conclusions, include:

- On our listed company audits (and on other selected audits) we have an Engagement Quality Control Review Partner who, acting independently from the engagement team, objectively evaluates the significant judgements the engagement team made and the conclusions reached
- We have a process for identifying higher risk audits and for the leadership of the audit business to review whether these are appropriately staffed
- We have an annual process that reviews the portfolios of individual audit partners to ensure that they are allocated only audits that they are suitably experienced and qualified to undertake and that their portfolios allow them sufficient time to undertake their audits
- We have a panel of senior partners (both audit partners and partners from our Department of Professional Practice (our central team that is made up of senior professionals who have extensive experience in auditing and accounting)) who undertake reviews of the planning and of the final outcomes on significant risk areas on high risk audits
- We have an independent team that carries out reviews of the audit files of our higher risk audits and other FTSE 350 audits
- Our Department of Professional Practice undertakes pre-issuance reviews of the annual reports of the larger listed companies we audit
- Where (1) there are complex technical accounting or auditing considerations or (2) there are high profile matters being considered or (3) where it is necessary in order to convince an audited company that a key audit conclusion reached by the audit team has the backing of the firm, we form a "Technical Panel" of partners, chaired by a partner from our Department of Professional Practice, to decide the firm's position on the matter under consideration. These panels are often instigated at the request of the engagement team but sometimes will be the result of other review activities.

Some of these have been in place for some time and some have been initiated or enhanced as part of our current Audit Quality Improvement Plan, which was launched in the autumn of 2017 when our new firm and audit function leadership took over.

As these interventions occur throughout the course of individual audits, it is difficult to say whether (and if so how) a specific review activity supported the quality or affected the outcome of an audit. However, it is clear that all the reviews affect the audit to a greater or lesser extent.

In some cases this results in changes to the planned audit approach or to the way the team's thinking is documented to make this clearer.

In others they reinforce the work and conclusions of audit teams. For instance, Technical Panels and consultations with the Department of Professional Practice have resulted in material changes to audited companies' financial statements and / or qualified audit reports (or mentions of going concern uncertainties). Some examples on listed companies include:

- An audited company had made significant one off non-trading profits and had included these within ordinary trading revenue without highlighting them, which would have misled the market. When we identified the transactions, the company refused to disclose the profits appropriately. The panel agreed with the team's conclusion that this would result in a qualified audit opinion if not corrected. The company then acceded to our request to make appropriate disclosure in its financial statements and, as we concluded that management had tried to hide these transactions from the audit team, we resigned as auditor
- An audited company had made significant one off share awards to directors and did not disclose this remuneration in its remuneration report. The panel agreed with the team's conclusion that this would result in a qualified opinion on the remuneration report and disclosure by us in our audit report of the omitted remuneration amounts. The company then acceded to our request to make disclosure in the remuneration report
- At least three audited companies had not identified that there was a material uncertainty affecting the going concern basis of accounting that needed to be disclosed in their financial statements. In each case, the panel concluded that, as there was a material uncertainty, such disclosure was needed and that if it were not made a qualified audit opinion would be issued. All three companies ultimately acceded to our request to make appropriate disclosure in their financial statements and we referred to the material uncertainties in our audit reports. Two of the companies subsequently entered administration.

Shared technology *(Information request 9)*

We set out in Appendix 4:

- A list of key technologies we use in KPMG UK audits
- Where the technology was originated / developed. Where significant technology is developed through global collaboration, KPMG UK has involvement in development which is often significant given KPMG UK's significance within the global network and the skills and capabilities we have
- A description of the technology.

We also note:

- In some cases third parties assist with the development of technology tools
- A small number of tools were developed by third parties and bought / licenced by KPMG member firms – these are indicated in the description
- The technology listed as having been developed by KPMG UK is not currently used by other member firms although there are a number of UK tools (the NGA tool suite) which are currently undergoing local (foreign) member firm testing to enable use by those firms
- Globally KPMG is continually innovating audit technology to drive audit quality and effectiveness with tools in various stages of development: pilot, limited deployment and accreditation. There are many examples of technologies in development such as artificial intelligence based automation tools (for instance to review financial statement compliance with disclosure requirements, to read and audit lease agreements, and to read and audit bank/mortgage loan documents) and transactional based technology (for instance invoice vouching).