KPMG LLP
15 Canada Square
London E14 5GL
United Kingdom

Tel +44 (0) 20 7311 1316
Fax +44 (0) 20 7311 6479

Dipen Gadhia
Competition Commission
Victoria House
Southampton Row
LONDON
WC1B 4AD

Our ref dlg/181

4 May 2012

Dear Mr Gadhia

Audit Market Investigation
KPMG Response to Law and Regulation Working Paper

Introduction

We set out below our comments on the Competition Commission's (CC's) Law and Regulation Working Paper (the "WP") published on 20 April 2012. As set out in our submission in response to the CC's Issues Statement ("Main Submission"), the provision of statutory audit services is subject to an extensive legislative and regulatory framework and substantial requirements to help ensure the quality of the audit, the perception of the audit and ultimately protect shareholders' and the wider public interest.

In our response, we begin by setting out some high level comments on the WP including important aspects or implications that, in our view, the CC needs to consider in this context. Then, in Appendix 1, we present detailed comments on the content of the WP.

We appreciate that the WP sets out to provide a factual presentation of the legal framework and cannot be expected to capture all the aspects and implications of the impact of law and regulation on the provision of audit services. In our view, the WP does not fully capture the interaction between the regulatory background and broader factors that influence the conduct and the quality of an audit. In particular, it does not take full account of the complex and ever-changing nature of the regulatory framework, and understates the impact of international regulations, standards and regulators on the audit of UK companies. After all, accounting standards cannot be expected to cater for all eventualities in terms of the commercial transactions and arrangements that exist in practice.

However, whilst not attempting to provide a complete treatise on the subject, we set out below our views of the important broader context and how an audit is conducted in practice against this regulatory background. In our view, this is important for the broader assessment of

competition in this industry, as we explain below. We have organised our views along the following themes:

1) What an auditor is required by law and regulations to form an opinion upon
2) What else does the market expect an audit to deliver?
3) Law and regulations on who may conduct an audit
4) Law and regulations on how to conduct the actual audit (how to arrive at the opinion)
5) Law and regulations on oversight
6) Law and regulations in the event that things go wrong
7) International law and regulations
8) Regulatory change is constant

Themes (1) - (6) above deal with complexity in the regulatory framework, theme (7) considers the impact of international regulations on the audit of companies in the UK, and theme (8) considers the ever-changing nature of the regulatory framework.

1) What an auditor is required by law and regulations to form an opinion upon

The regulatory description of a statutory audit (paragraphs 3.27 – 3.44 of the WP) clearly cannot give recognition to the enormous task involved in formulating the audit opinion on a large audit client. It requires auditors to exercise professional scepticism and judgment in determining the scope of work necessary in order to render the audit opinion. There are likely to be many considerations in defining the scope of an audit, and an audit firm will take account of the views of the audit committee and management to the extent they want to increase it (also see section 3.1-3.2 of our Main Submission setting out the various stages involved in delivering an audit opinion). As set out in paragraph 5 of our Main Submission, a statutory audit of a large company is not a commodity. It is a complex bespoke service, driven by the scale and complexity of companies, the industries in which they operate and their commercial arrangements.

It is also important to recognise the matters on which the auditor gives his opinion: principally, but not exclusively, that the accounts give a true and fair view and comply with accounting standards. This includes an appropriate interpretation and application of a significant body of accounting standards, as well as accounting that may need to go beyond such standards; and this needs to be applied to companies that may undertake any kind or complexity of business. This requires deep expertise and experience over the full spectrum of business activity and transactions as well as in accounting.

Providing a high quality audit requires more than just detecting and discovering errors in company accounts (as set out in paragraph 4.2-4.4 of the WP). Sections 4 and 5 of our Main Submission and our response to question 100 of the Market and Financial Questionnaire (MFQ) set out that quality has a different meaning for different clients and will be determined by the capabilities required from the audit firms. We firmly believe that audit quality is not just about reaching the right opinion, but how an auditor reaches that opinion (please also see Theme 4 below on the Law and regulations on how to conduct the actual audit - how to arrive at the

opinion). It is about the process, thought and integrity behind the audit report. Although regulation plays a role in ensuring audit quality and reassuring the public about audit quality, there are many other factors behind quality improvements, including the quality of our people and training, innovation, market forces and competition, as we set out in our Main Submission and in response to the MFQ[1].

2) What else does the market expect an audit to deliver?

A statutory audit is not composed solely of the audit opinion, and in this section we set out some important further aspects of the statutory audit.

The market expects the auditor to be able to challenge management and to present the salient challenges and subsequent actions to the Audit Committee, especially on judgements about accounting treatments and policies. These value-added services are also important aspects of the statutory audit itself, as we discuss in paragraph 371 of our Main Submission.

In Section 5 of the WP, no acknowledgement is given to the fact that auditors need to know about company law in general as well as other fields of specialist technical regulation that would need to be drawn upon, e.g. tax, prudential regulation and money laundering. This is not only because such expertise may be necessary in order to judge whether all relevant consequences are appropriately reflected in the accounts, but also that companies have high expectations as to the insights that the external auditor may be able to provide as a by-product of the discharge of its duty to issue an opinion (please also see paragraph 115 and 159 in our Main Submission). This will, most probably, also require interaction with other sector regulators (i.e. 4.97-4.98 on the FSA does not emphasise the required interaction with them as supervisor of banks and financial institutions). We set out our more detailed comments on section 5 of the WP (in particular paragraph 5.97-98) in Appendix 1.

Further, whilst regarded as "audit-related services" (rather than audit services) under the Auditing Practices' Board's (APB's) Ethical Standards, individual clients will often have needs (for example, under local regulations) for the auditor to report on a variety of other reports, for example in relation to client money, prudential returns, tax computations or other matters that are largely performed by the existing audit team. The auditor may also be required by law and regulation to report on internal financial controls (see section 4.1.4 of our Main Submission).

3) Law and regulations on who may conduct an audit

Over and above what has been set out in the WP, we would like to highlight a few additional key legal and regulatory requirements that should be taken into account when considering who may conduct an audit.

[1] See section 8 of our Main Submission in particular, as well as our response to question 111 of the MFQ.

Provisions on objectivity and independence

The WP sets out all the requirements to remain independent, but should also take into account that independence is also a key consideration when initially considering whether to take on an audit. In our response to question 35 of the MFQ, we set out all the internal risk processes that our firm goes through when deciding whether to work for a new audit client. It is also important not only that actual threats to independence are avoided, but also that the *perception* of threats to independence are avoided, as shown by the response to the recent APB consultation which called for improved transparency and information flows (see section 2.4 of our Main Submission and our response to question 35 of the MFQ).

Overseeing local audits and component audits

In our response to questions 17 and 35 of the MFQ, as well as in paragraph 149 of our Main Submission, we set out the added complexity of overseeing local audits and using component auditors. If a component auditor does not meet the independence requirements that are relevant to the group audit, or the group audit engagement team has serious concerns about the other matters listed above, the group audit engagement team cannot use the component auditor to obtain the necessary audit evidence, but must perform the work itself. In this regard audit firms also need to comply with independence standards in other jurisdictions.

Training

As recognised in section 5 of the WP, audit staff are required by regulation to have certain qualifications and to undertake certain training in order to perform a statutory audit. However, it is important to recognise that in order to provide a high quality audit, firms must invest in recruitment, training and development to ensure that their staff have the skills and expertise that go beyond these minimum requirements. We set out our substantial investments in recruitment, training and development in our Main Submission and in our response to the MFQ[2].

4) Law and regulations on how to conduct the actual audit (how to arrive at the opinion)

The complexity in applying the substantial auditing standards to different businesses should further be acknowledged and explored since it is an important characteristic of the regulatory background (see our detailed comments on section 4 in Appendix 1).

The limited information presented on audit standards (4.8-4.9) underestimates the significance of the large volume of the auditing standards, particularly relative to the description of company law requirements.

In addition, accounting standards themselves are complex (International Financial Reporting Standards (IFRSs) and interpretations now run to more than 2900 pages) and are constantly changing (see our Main Submission paragraph 163). Due to the constant change in these

[2] See in particular section 5.1.2 of our Main Submission.

requirements and best practice, we invest considerable time and expense in training and the development of staff in order to ensure the delivery of quality services.

The application of these standards varies depending on the particular characteristics of a company's business, which is one factor behind the bespoke and complex nature of statutory audit. As a result, the application of these standards to varying and complex businesses requires significant skill and experience. These other aspects of the audit also imply that the definition of what is required to provide a high quality statutory audit is also broader than that definition discussed in the WP. For example, a key aspect of audit quality not considered in the WP, is that the statutory auditor has to have the ability to anticipate where problems might lie and thereby the ability to identify potential misstatements in the financial statements prior to the issuance of an audit opinion. Different sectors and different businesses often have different commercial risks, which flow from the nature of the products and the business models. Experience of these commercial risks and how to deal with them is crucial to the ability to anticipate likely problems as part of the statutory audit (please also see section 5.1.1 of our Main Submission).

5) Law and regulations on oversight

The current section 4 of the WP on the "definition and regulation of audit quality" should reflect the significant change that has taken place in the audit regulatory environment since 2004 when the large audit firms responsible for the statutory audit of public interest entities became subject to independent inspections of the firm and, as part of that, of a sample of their audits. Since 2005 there has been a public report on the overall findings of the inspections focussed on audit quality and independence and, since 2008, there have been public reports on the individual inspections of audit firms (they were previously private). In addition, the reports of the inspections of specific company audits are made available to the Chair of the Company Audit Committee, providing greater information to the company to inform the Audit Committee's discussions on the effectiveness of the auditor and the review of the appointment. There is no doubt that, taken together with the UK transparency and audit firm governance requirements, the UK has the most open, robust and transparent independent regulation, certainly among the International Forum of Independent Audit Regulators (IFIAR) member countries.

This increase in transparency and public reports on audit inspections provides a further resource for audit committee chairs and finance directors when judging the quality of the statutory audit services they receive. We discuss in more detail the ability for audit committee chairs and finance directors to judge quality in our Main Submission (see section 4.2).

6) Law and regulations in the event that things go wrong

In addition to the liabilities of a statutory auditor (set out in paragraphs 3.45-3.49) there are additional consequences associated with making a mistake in a statutory audit (or, sometimes, the mere question of whether a mistake has been made). One likely result from making a mistake in a company's statutory audit is the loss of that company as an audit client. As we set

out at various points in our Main Submission[3], an audit firm is constantly aware of what it would lose if the relationship with a given audit client were terminated. Over and above losing the financial value of the audit itself, losing an audit client might imply that the ability to realise some of the economies of scale and scope arising from auditing several large, complex businesses would be reduced. In addition, loss of an audit client represents a reduction in the experience base of an audit firm as well as potentially damaging the audit firm's reputation for high quality, making it less attractive to certain clients. In this way the loss of an existing audit client might also reduce the ability of an audit firm to win work from other clients. The probability of mistakes occurring is mitigated by resource-intensive quality control systems, high quality training and the ability to recruit talented applicants, among other factors, all of which require substantial investment.

7) International law and regulations

Section 5 of the CC's WP focuses solely on UK regulation, which underestimates the regulatory complexity in adhering to reporting requirements at an international level (also please see our detailed comments in Appendix 1 in this regard). In addition to the auditing and ethical standards issued by the APB, the UK audit regulatory framework is determined by UK and European legislation and regulation and by financial reporting standards issued by the International and UK Accounting Standards Boards (also see our response to question 104 of the MFQ).

Large groups will generally have a significant proportion (sometimes almost all) of operations in overseas locations, sometimes including its headquarters, and may even be a non-UK company. Auditing and accounting standards vary from country to country largely because of differing business practices, fiscal systems and company laws. In many jurisdictions, a company's management must produce local statutory accounts for each legal entity, complying with the local reporting requirements, under the appropriate accounting framework (local generally accepted accounting principles/practices), and these will often be required to be audited. For example, in respect of audit clients registered with the United States SEC, the Auditing Standards of the US Public Companies Accounting Oversight Board (PCAOB) will apply. The limited reference in the WP to the SEC requirements in general underplays the importance and impact of these regulations. Engagement teams must ensure they are cognisant of the audit and ethical standards of any applicable overseas regulations and how they apply to their audit client. This has driven the development of our global network and the investments in developing this network and leveraging skills and experience across it in order to increase the efficiency and effectiveness of the provision of global group audits (see section 4.1 and section 5.1 of our Main Submission).

The section on IFRS does not take account of the fact that we are running several systems of accounting standards at once – this increases the complexity as well as, in relation to IFRS, requiring significant effort on international cooperation within the network. As we set out in our

[3] In particular see paragraphs 18, 182 and 261-263.

Main Submission[4] we have invested significant resource in developing global audit tools, in order to enhance the efficiency of the delivery of a global group audit. We dedicate significant resources to keeping standards and tools complete and up to date. Our global audit methodology, developed by the Global Services Centre (GSC), is based on the requirements of the ISAs. The methodology is set out in the KPMG Audit Manual (KAM) and includes additional requirements that go beyond the ISAs where KPMG believes these enhance the quality of our audits. The UK firm also adds local requirements and/or guidance in KAM to comply with additional UK professional, legal or regulatory requirements.

Furthermore, the 20+ major audit firm networks have agreed to observe the International Ethics Standards Board for Accountants' (IESBA) code of ethics (IESBA Code), as we believe adherence to this as a minimum should assist in strengthening confidence in the capital markets generally. Although the APB ethical standards may incorporate or go further than the IESBA Code, in some cases the IESBA Code of ethics sets a higher standard to be applied, for example.

- financial interest restrictions apply to managerial employees (and immediate family) who provide non-audit services to the audit client (IESBA Code section 290.11). There is no equivalent in the APB's Ethical Standard (ES) 2.
- prohibition of internal audit services to Public Interest Entities where the services are significant to internal financial reporting, accounting records, financial statements or disclosures, regardless of whether the audit team places reliance on these controls (IESBA Code section 290.200). ES5, para 63 only operates to the extent that the audit team intends to place significant reliance on internal audit work provided by the auditor, allowing for the possibility of the audit being planned to avoid reliance on controls covered by an internal audit service.
- whilst a "threats and safeguards" approach is allowed for services provided to new audit clients in the first period of the audit, this extends only up to the point that audit work commences (IESBA Code section 290.32). ES5, para 172 is less restrictive in allowing prohibited services to continue for up to one year after the date of appointment provided that any necessary safeguards are applied.

[4] See section 5.1.4.

8) Regulatory change is constant

The WP focuses on the current legal and regulatory context and as such does not discuss the changes to, and increase in, regulation, in particular since the collapse of Andersen in 2001. In our view it is important for the CC to bear in mind the increase in the regulation governing audit practices and procedures, since these have had a significant impact on audit firms' costs. The adoption of IFRS in 2005, the wide application of International Standards of Auditing (ISAs) and a number of iterations to the IESBA Code and APB ESs were all important and significant changes to the regulatory landscape. In addition, audit firms also need to be aware of the 2006 Companies Act provisions and changes to corporate governance codes. In terms of IFRS, approximately half of the current volume of IFRS is new material issued since 2001.

We trust that these comments and observations are useful in informing your consideration of the Working Paper, detailed commentary on the WP is provided below in the appendix. Do not hesitate to contact me if you have any queries or wish to pursue any of these points further.

Yours sincerely

David L Gardner
Director of Public Policy

Appendix 1

WP paragraph	KPMG comment
2	This section does not identify all of the responsibilities of the directors in relation to the preparation of the annual reports and accounts. There are, in addition, the following: ■ Section 420 of Companies Act 2006 requires a directors' remuneration report from a quoted company. Listing Rule LR9.8.8R also requires a directors' remuneration report, but its contents are slightly different. ■ Listing Rules (LRs) 9.8.4R – 9.8.6R impose a number of other requirements on the directors. Two particularly notable ones are the statement about the company being a going concern and its statements in relation to the UK Corporate Governance Code (LR9.8.6R)(3), (5) and (6)). ■ LR 9.7A.1R permits, but does not require a listed company to issue a preliminary statement of annual results. In such a case the audit is required by that rule to agree to the preliminary announcing. ■ Disclosure and Transparency Rules (DTR) 7.2.5 and 7.2.6 require that the corporate governance statement must contain a description of the main features of the issuer's internal control and risk management systems in relation to the financial reporting process. ■ DTR 4.2 requires that companies whose shares or debt securities are admitted to trading on a regulated market must make public a half-yearly financial report covering the first six months of the financial year. Such companies are not required to obtain an auditor's review of this report, but the market favours it. ■ DTR 4.1.8R – 4.1.11R are similar to the directors' report requirements of the Act. ■ DTR 4.1.12R requires the directors to make a responsibility statement in relation to the accounts giving a true and fair view and the directors' report giving a fair review.
3.6	Whilst this is indeed the statutory definition of an audit, it says no more than an audit is the task performed by a statutory auditor. An audit is not, however, characterised by tasks, but by what it seeks to achieve. For example, whilst law and regulations do not contain a substantive definition of an audit, the APB's standards pre-2005 defined an audit as follows: "An exercise whose objective is to enable auditors to express an opinion whether the financial statements give a true and fair view (or equivalent) of the entity's affairs at the period end and its profit or loss (or income and expenditure) for the period ended and had been properly prepared in accordance with the applicable reporting framework (for example relevant legislation and applicable accounting standards) or, where statutory or other specific requirements prescribe the term, whether the financial statements 'present fairly'." Whilst an audit nowadays includes more than this, we think that this definition is more instructive in terms of emphasising that an audit is not a set of defined procedures but a body of work judged by the auditor to be what is necessary to enable him to meet that objective of giving an unrestricted opinion (that is to say, one that is not limited in its scope) as to the truth and fairness of the accounts.

WP paragraph	**KPMG comment**
3.13	Note that these requirements of the Act do not, however, preclude the members from passing a resolution to authorise the directors to fix the auditor's remuneration. Invariably, this is what is done in practice.
3.14	Footnotes 40 and 41 capture the size limits for small and medium-sized companies. However, first of all, these need to be met on a complicated two-year rolling basis. Second, in order to take advantage of the special provisions for small and medium-sized companies, a company must not be one of those categories that are excluded, for example those under section 384 in relation to small companies.
3.15, 7.6	Whilst the Act does contain provisions permitting a company, subject to procedures being followed, to enter into a liability limitation agreement with its auditor, this is rarely done. The provisions were introduced in the 2006 Act, but none of our clients have been willing to enter in to such an agreement. Company shareholder sentiment has not accepted it as a necessary strategy.
3.25-26	The facility to send a "no circumstances" section 519 statement to a company applies only in relation to unquoted companies. The company has the alternative, within 14 days of receipt of the statement, of referring the question of circulation of the statement to the courts. Furthermore, the timing rule for the auditor to send a copy to the registrar of companies is rather complicated. Having sent the statement to the company, the auditor must wait 21 days. If within that time he has not been notified that the company has made an application to court, then within a further 7 days, after the end of those 21 days, he must deposit a copy of the statement with the registrar.
3.37	Whilst this paragraph captures the wording of the law, the effect of ISA 700 (revised, effective audit for periods ending on or after 23 March 2011) paragraph A17 is that, in effect, the auditor always reports positively on these matters.
3.41	This paragraph captures one of the obligations of auditors arising from the FSA rules, but not all of them. Under LR 9.8.10R the auditor is required to review the directors' statement in relation to going concern and the directors' statement in relation to the UK Corporate Governance Code so far as concerns nine specified provisions of that code; and certain specified details of the directors' remuneration report. LR 9.8.12R requires the auditor to report on this by exception. However, the effect of ISA 700 (as noted above) is that the auditor, in effect, always reports on these matters. Note also that ISA 720 requires the auditor to read all of the other material accompanying (i.e. published with) the accounts.
3.39, 43-44, 50-53	These five paragraphs deal very briefly with the heart of an audit. An audit is directed at giving an unrestricted opinion on the accounts of the client company – which may be conducting any kind of complexity of business – as to whether it gives a true and fair view of the state of affairs and of the results for the year and whether it complies with the relevant accounting standards (the matters enumerated in paragraph 3.39(b)). First of all, this opinion is unrestricted. That is to say, the auditor is not free to give any forms of caveats to his opinion. So the auditor is unable to say, for instance, "so far as we are aware...". The auditor is permitted to limit his opinion only where it is not possible, for

WP paragraph	**KPMG comment**
	example arising from circumstances beyond the control of the entity, to obtain sufficient, appropriate audit evidence. As stated above, the audit might be of a company with any kind of complexity of business. The auditor therefore requires deep expertise and experience over the total spectrum of all business activities, transactions and financial structures. It also requires the auditor to have expertise in many fields of law and regulation relevant to the client's business or financial arrangements. For example, expertise may be required in tax legislation, prudential regulation and company law generally (including for example, the ICAEW's TECH 2/10, "Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006"). The auditor's opinion must state, amongst other things, whether the accounts comply with accounting standards, which are themselves a significant body of provisions governing the preparation of accounts. There are in fact four different sets of accounting standards in use in the UK. We discuss accounting standards in more detail in relation to paragraphs 4.6 and 4.9 later on. The key point, however, is that the application of the accounting standards is not a mechanical exercise. It requires not just considerable professional knowledge but also extensive experience in order to be able to apply and interpret them appropriately. However, compliance with accounting standards is not an end in itself. It is, as Martin Moore QC explained in his 2008 opinion provided to the FRC (and available on their website), a means directed at the end of giving a true and fair view. Moreover, whilst compliance with accounting standards is virtually always necessary for giving a true and fair view, it is not necessarily sufficient to do so. After all, accounting standards cannot be expected to cater for all eventualities in terms of the commercial transactions and arrangements that exist in practice. Accordingly, professional judgement must be applied where accounting standards do not provide a complete answer, in order for the accounts do give a true and fair view. Finally, the need for a true and fair view is overriding. Accordingly, if compliance with a provision with an accounting standard would fail to give a true and fair view, then the accounts must depart from that provision and adopt an alternative treatment that does secure a true and fair view (although this is a very rare circumstance).
3.45-49	There is a great deal that could be written on the subject of auditors' liability. These sections of the working paper capture some of it. We do not attempt here to write a complete treatise on the subject. We confine ourselves to just three particular points. First of all, an auditor's liability is joint and several. As noted earlier, the ability to enter into a liability limitation agreement (to limit liability on a proportionate basis) has not been accepted in practice by the market place. The risk to auditors is therefore large, as they are seen as having a deeper pocket being without effective limitation of liability. This has a consequence for the cost and the availability of insurance. Second, the scope of persons to whom auditors may be liable to is not necessarily only the members of the company in their capacity as members. The *Bannerman* case demonstrates that it is possible for a third party to establish a duty of care on the part of the auditor. This case and its practical implications are described in, for example, ICAEW technical release

WP paragraph	**KPMG comment**
	AUDIT 01/3. In order to address this risk, auditors have found it necessary to include certain wording in their audit reports, as described in the ICAEW technical release AUDIT 01/3. Finally, we think that the litigation risk might be said to point, in a general way, to the judgemental nature of audit. That is to say, there is scope for litigants to argue that the auditor made the wrong judgements, for example as to where risks lie, as to what work to do to address those risks and what conclusions to draw from evidence obtained.
4.1	The audit report covers more than these three matters. It covers: ■ whether the accounts give a true and fair view; ■ whether they have been properly prepared in accordance with the relevant accounting framework (accounting standards); ■ if applicable, whether they have been properly prepared in accordance with the EU's IAS Regulation; ■ whether they have been properly prepared in accordance with the Companies Act 2006; ■ whether the relevant part of the directors' remuneration report has been properly prepared in accordance with that Act; ■ whether the directors' report is consistent with the accounts; ■ if a separate (DTR) corporate governance statement is given, whether it is consistent with the accounts. Furthermore, the effect of ISA 700 is that the following matters need, effectively, to be reported upon positively: ■ the adequate keeping of accounting records; ■ the propriety of further directors' remuneration disclosures; ■ the directors' going concern statement; ■ the directors' statement in relation to nine specified provisions of the UK Corporate Governance Code; and ■ certain lesser matters.
4.2,4.4, 4.6	We disagree with DeAngelo's articulation of audit quality. Audit isn't directed at the client's system *per se* but – in a purely regulatory outcome sense – at the resulting accounts. Moreover, quality isn't about the market's perceptions of the probability of the auditor finding and reporting (as implied by 4.2(b)) every misstatement. From a purely regulatory perspective, audit quality is about whether in fact the auditor has done enough, of the right work, to achieve reasonable assurance that the accounts are free from material misstatement and has reported accordingly (please also see our cover note above which considers other aspects of audit quality). Whilst the items listed in paragraph 4.6 are those from the FRC's Audit Quality Framework, they need to be taken in the correct context. In particular, this paragraph could give the impression that shorter reporting deadlines will produce a poor audit quality. However, the point is that longer deadlines make it easier for the auditor to achieve a high quality audit and shorter deadlines make it more difficult. It does not mean that the outcome *will be* a high quality in the former case; in the latter case the auditor has more challenges to overcome and will necessarily work to overcome them.

WP paragraph	**KPMG comment**
4.8-4.9	These paragraphs are a brief treatment of a very significant body of literature. Auditing standards, bulletins and practice notes, as noted, include over 30 standards alone, and which, altogether, account for about 2,300 pages of "Auditing and reporting"[5] compared with the 160 pages of ethical standards (which receive 50 paragraphs of attention in the WP). Whilst we agree that auditing standards contribute to "reduce uncertainty regarding what amounts to a high-quality audit", we doubt that this could be said to be their sole purpose. For example, they are also intended to clarify what an audit is. To describe this body of regulatory literature, which is aimed at describing how an audit option is formed and reported, we should start by noting that the main aim of audit, in relation to the accounts (there are other opinions formed too), is giving reasonable assurance that the accounts are free from material misstatement whether caused by error, fraud or otherwise. Audit quality, from a purely regulatory outcome point of view, means reaching this standard. APB auditing standards, bulletins and practice notes do not aim at prescribing precisely what an auditor does in under all circumstances. It's a judgment framework as well as a non-exhaustive "manual" of mandatory and potentially applicable procedures. So an audit involves: ■ determining whether the client has captured all of its transactions, assets and liabilities – and only what are its transactions, asset and liabilities – completely, accurately and at appropriate values in its records: – Much judgment, and a sceptical frame of mind, is required to decide to what extent the possible procedures, described in the standards etc, are merited by the client's circumstances. A client's circumstances could be any kind or complexity of business and could be well governed/controlled or less well so. It involves a challenging task of anticipating where the issues could be; – A mixture of judgments/ scepticism and significant manpower are required to carry out the procedures. It's not just about running computer-based checks. It's about obtaining independent evidence (based on risk assessments) across the whole panoply of the client's activities. Evidence obtained may require one to re-assess judgments on the scope of work, and do more; ■ determining whether these transactions, asset and liabilities are appropriately presented in the accounts so as to give a true and fair view and comply with accounting standards etc. As above, this is a significantly "top heavy", judgmental/ scepticism-based part of the audit; ■ reporting to the audit committee and then to shareholders; and ■ documenting all of the above work and evidence. To revert to a point of detail about paragraph 4.8, paragraph (c) is not a complete résumé of ISA 600. For example, it establishes more than merely the principle of the group auditor's

[5] "Auditing and reporting: 2011-12",; ed, Selwood,; pub, Wolters Kluwer, 2011.

WP paragraph	**KPMG comment**
	responsibility.
4.11	Although there are additional provisions for listed companies there is not an additional set of rules that apply.
4.20	ES5 states "performed largely by the existing audit team" rather than by the audit team as noted in the document. It may be that certain specialists or other persons experienced in the particular area of work are used in the completion of audit-related services.
4.20	ES5's definition of non-audit services is wider than just the audited entity; it includes the audited entity's affiliates or other entities in respect of the audited entity.
4.25	The discussion here is incomplete. Provisions on contingent fees for non-audit services are addressed both in ES4 and ES5. ES4 additionally requires notification of proposed contingent fees for non-audit services to the audit engagement partner and the Ethics Partner and disclosure of actual contingent fees to the audit committee in writing in respect both of the auditor and its network firms. ES5 additionally prohibits contingent fees for tax services where the outcome of those tax services is dependent on the proposed application of tax law which is uncertain or has not been established.
4.26	In the first sentence, should the word "amounts" should be "accounts" – as per ES5.
4.26	ES5 says "[the audit firm] may be (or appear to be) unable to take an impartial view of the relevant aspects of those financial statements." ES5 recognises, therefore, that the inability to take an impartial view may be a matter of appearance rather than fact.
4.27(a)	There is a clause in ES5 whereby we could provide accounting services to a listed client in the exceptional circumstances which are set out in paragraph 164 of ES5, provided that we do not make management decisions.
4.27(b)	ES5 talks about "significant reliance" not just reliance.
4.31	The second sentence is only correct where the threat is above an acceptable level. If the threat is already at or below an acceptable level then the auditor could do the work without applying safeguards and without resigning.
4.35	The ICAEW Audit Regulations and guidance set out the ownership requirements at paragraph 2.03. If the firm is a partnership or limited liability partnership the partners and members (respectively) must fulfil one of the criteria on the list. One of these is being an "audit affiliate of the registering Institute". Chapter 5 of the regulations deals with "audit affiliates". As the guidance says, the status of an audit affiliate "does not confer membership of the Institute or entitle the individual or corporate body to use the title 'chartered accountant'. However, it does mean that an audit affiliate is bound by the same rules and regulations as govern a full member of the Institute."
4.42	This relates to affiliates of an audited entity as well. There are also exceptions in specific cases as set out in paragraphs 9, 10, 12, 19 and 21 of ES2.

WP paragraph	**KPMG comment**
4.43	In fact, this relates to ES2 paragraph 8 "where a direct financial interest or a material indirect financial interest in the audited entity is held by the audit firm or by one of the individuals specified" in 4.42.
4.44	In the case of loans from an audited entity to a firm, additionally the loan must not be material to the firm or the audited entity.
4.45	Should note that such loans are acceptable only where they are on normal business terms and are not material to the audited entity. If loans are not on normal business terms this would create a potential independence issue.
4.46	The actual rule is more restrictive than this. As well as being in the ordinary course of business, it must also be at arm's length and immaterial or if not in the ordinary course of business must be clearly inconsequential to both the audited entity and the firm. If it isn't permitted then the other option to terminating it is resigning the audit.
4.47	It is unclear whether by 'that individual' it implies the influencer or the family member. However, it should be the former who should report the matter. They have to report to the Engagement Partner (EP) unless it is a close family member of the EP or if the EP is in doubt on what to do, in which case it is to be referred to the Ethics Partner.
4.51	There is also a 2 year cooling off period – "...having acted as audit engagement partner or similar in the past 2 years..." For another team member it is only if they have joined as a director or have been in a key management position (although in practice any team member joining the client would be considered by the remaining team).
4.55	See our comment with respect to 4.25 above regarding additional requirements for contingent fees for non-audit services.
4.56	The audit engagement partner must also inform the Ethics Partner and those charged with governance if the non-audit fees are regularly between 5-10% (listed) and 15-20% (non-listed) and for non-listed will arrange an external independent quality control review of the audit engagement prior to finalisation of the audit report.
4.58	Once they have assessed the threats they need to consider the safeguards.
4.59	The standards say more than this. They also require that safeguards be applied to reduce any threats to an acceptable level and that after an EP has been in place for 10 yrs, either safeguards are applied or the reason why they are not is documented and the facts reported to those charged with governance. Additionally, the audit firm has to consider which non-listed entities ought also to be treated as per listed entities.
4.60	There are additional requirements other than those listed e.g.: ■ The EQCR must have a five year cooling off period.

WP paragraph	**KPMG comment**
	■ If the EQCR or other key partner involved in the audit becomes the audit partner, the combined period of service in these positions shall not exceed seven years. ■ A key partner involved in the audit for a particular entity for a period of seven year shall not participate in the audit until a further period of two years has elapsed.
5.1	The institutional architecture of the FRC and international bodies are not solely about audit quality in a direct way. That is to say, auditing standards etc are one part of what this architecture is concerned with. The other part is the accounting standards. This is, of course, as explained earlier, very important to the audit as it is a key component of the "yardstick" against which an auditor judges the accounts when giving its opinion. However, the institutional architecture develops accounting standards in the first instance for companies that have the original legal responsibility for preparing the accounts.
5.2-5.6	Even before the 2004 Act there was legislation underpinning the regulation of audit, by means of the Companies Act 1989. Note also that the provisions of the 2004 are now largely incorporated into the 2006 Act.
5.10	We believe that it would be more appropriate to say that the contribution of the ASB and the FRRP have a less direct impact. As described earlier, the subject matter of the auditor's opinion – the financial statements and the question as to whether these give a True and Fair view and comply with Accounting Standards – is important since, for example, the failure of the auditor to detect material non-compliance with accounting standards would itself represent an audit failure. As explained under theme 4 in the above cover note, the body of accounting standards is substantial and requires both extensive knowledge and extensive experience to ensure appropriate application in practice.
5.12	Although it is perhaps of historical interest, we note that the APB had predecessor bodies. The Auditing Practices Committee had been in operation from the late 1970's, and before that the ICAEW issued occasional guidance on auditing.
5.18	We do not understand why this paragraph states that 60% of the APB membership is merely "intended to have some degree of independence." This seems inadvertently to imply some judgement on the part of the WP that those persons are not entirely independent.
5.25	This paragraph mentions the move has been from "essentially self-regulation to a mixed system". However, our strong assertion would be that for the large public company audit market oversight it is independently regulated by the FRC and its component bodies. The professional Institutes retain a regulatory role in respect of other audits for non-PIEs, but then the FRC has an oversight role in relation to the regulatory functions of the Registered Supervisory and Qualifying Bodies (eg regulation of smaller audits and firms, professional qualifications, continuing professional development, registration, small audit inspections, practising certificates etc.) which is largely set out in 5.28 and 5.29.
5.36	The 2012/13 categories have now been released.
5.42	In our view the AIU's approach "is" challenging and not merely "intended to be" so. We also note that their challenges to appropriateness of key audit judgments are not just

WP paragraph	**KPMG comment**
	about judgments as to audit procedures but about judgments as to the propriety of the accounting.
5.43b	More recent information is available.
5.47	These do not seem to be consistent with the AIU's current year report.
5.64	We do not agree with the sole emphasis in this paragraph on consistency as the objective of accounting standards. Consistency is not necessarily the same thing as a true and fair view. Accounting standards aim at enabling accounts to be prepared so as to give a true and fair view. Moreover, contrary to the point set out in 5.46(a), they do not set out treatments permissible for "any" individual event or transaction. Accounting standards do not provide ready-made answers to every eventuality. Indeed, the ideal accounting standard is often said to be one that specifies principles and not rules. That is to say, rules-based standards would be a vast dictionary of mandated treatments for every individual possibility. Principle-based standards would be those that identify a smaller (more concentrated) population of over-arching principles, which professionals then need to judge how to apply to particular circumstances. Accounting standards aim at being principles-based, albeit that the breadth and diversity of business transactions and arrangements mean that there is a very significant population of principles set out in them. Thus, judgement nevertheless remains a very significant factor in the application of standards. We also note that judgement is important in relation to the level of detail disclosed. It would be inappropriate and impractical for every set of accounts to give every disclosure requirement set out in accounting standards. Indeed the number of disclosure requirements could, we estimate, run to a few thousands. Judgement is required to determine which are material and therefore need to be given, and which are immaterial and therefore need not be given.

WP paragraph	**KPMG comment**
5.65	Without wishing to write treaties comparing ASB accounting standards with IFRS, in our view it is not the case that IFRS are largely adopted into UK standards. Some of IFRS have been included, in the specific area of financial instruments, but some of those incorporated standards are not applicable to all UK companies (broadly speaking, unlisted companies may use ASB standards as they stood before the inclusion of certain IFRS by the ASB). Moreover, the ASB has spent the last several years working on a project to incorporate more of IFRS into its standards but this is still some way off from fruition. At present, then, there are four sets of standards current in the UK: IFRS, the two versions of ASB standards referred to; and, for small companies, the ASB's "financial reporting standard for smaller entities". We agree, however, that IFRS is the most significant for the subject of the enquiry. In relation to IFRS, it must be appreciated that an auditor in the UK cannot make judgments to interpret and apply IFRS in a UK vacuum. It requires significant effort to reach consistent interpretations within that auditor's international network. For example, in our network we publish, externally, guidance book in IFRS, revised and updated annually, which is now running at over 1,600 pages[6]. Please note, in terms of the IASB's output, that it is not limited to IFRS themselves, but also pronouncements of its Interpretations Committee. Further, please note that, although the effect is minor, that in the UK and the rest of the EU it is EU-endorsed IFRS, not IASB-IFRS that is applicable. For example, IASB's new consolidation standard, IFRS 10, looks likely to be applicable in the EU one year later than in the rest of the world.
5.68	Contrary to the footnote, the FRRP's review of interims, it does not arise from any statutory power devolved upon it (which is the way that its review of annual accounts and directors' reports arises). It arises by agreement with the Listing Authority.
5.70	Please note that the Secretary of State has powers similar to those of the FRRP.
5.74	The FRRP does not often appoint a group. In most cases the panel is satisfied by explanations provided, or action agreed to be taken by the directors, set out in preliminary correspondence of the company with the panel's staff. Not only is that level of engagement proportionate to the initial stages of the panel's work, but there are too many reviews of accounts undertaken for a formal group to be empanelled every time.
5.92-96	Please note that the ICAEW also issues occasional technical releases relevant to auditing. Please refer to the ICAEW technical releases series prefixed "AUDIT" and "AAF".
5.94	For the purposes of the WP, it is the ICAEW's public interest objective that is key. We note, for example, that the ICAEW also says of itself: "One of the aims in our charter is 'to maintain high standards of practice and professional conduct by all our members'. As a professional membership organisation, we are committed to acting in the public interest."
5.97-98	Please note that auditors are also required to report to the FSA as a prudential regulator in relation to audit clients. For example, refer to ISA 250B; and the recent refreshing of the

[6] Insights into IFRS", 8th edition, 2011/.12; pub, Sweet & Maxwell.

WP paragraph	**KPMG comment**
	dialogue between auditors and the FSA following the recent FSA "Code of Practice for the relationship between the external auditor and the supervisor".
5.101-105	These paragraphs omit to mention IFIAR and ESMA (the latter, for example, recently active in relation to Greek debt). In addition, IESBA is independent no less than is the IAASB.
5.105	The IASB does not publish a complete and precise analysis of its funding. So whether it is mostly funded by the banks is unclear. The contribution made by the audit firm networks is only a percentage of the total funding, and going forward the IASB will try and secure funding from public authorities.
6.6	While the Cadbury Report recommended the formation of audit committees in 1992, this was not an altogether new idea. Audit committees had been common place in the US since the 1970's (and subject to SEC disclosure requirements) and by the early 1990's a number of leading UK companies already had audit committees. From 1994, the LR have required companies that do not have an audit committee to disclose why they do not have one. Furthermore, the LR have imposed various related duties on auditors cumulating in the current rule (LR 9.8.10, referred to earlier) that requires issuers to require auditors to review specified parts of its corporate governance statement (including those relating to audit committees) before the annual report is published. APB Bulletins provide authoritative guidance for auditors on how to discharge their duties in this area.
6.7	A key feature of the UK Corporate Governance framework is the LR requirement that companies disclose the extent of compliance with the UK Corporate Governance Code (Code) and explains any non-compliance – this is the so-called 'comply or explain' approach.
6.9	Please note that the Smith material was revised several times (2005, 2008, 2010).
6.11	This is not required by the Code but by ES1 and ISAs 260 and 265.
B	Given the nature of the review, considerations should be made to the FRC's Guidance on Audit Committees (Smith Guidance) – one of the three major reports supporting the Code. Furthermore, it is important that the UK corporate governance regime isn't seen as static. The Code has been regularly reviewed and updated since it was first released. Indeed, recently the FRC issued proposals to amend the Code with a view to increasing transparency around the role of the audit committee including its role in auditor appointment.
B1	This states that the Cadbury Report introduced three basic recommendations, whereas it did, in fact, introduce 18 recommendations. Perhaps the most significant recommendation (not referred to in this report) was that "directors should report on the effectiveness of the company's system of internal control". It also included seven pages of guidance for audit committees in the appendices to the report.

WP paragraph	**KPMG comment**
B3	Greenbury added to rather than changed the principles.
B4	This paragraph suggests the changes introduced by Hampel were minimal, whereas his report was the genesis of the Combined Code which saw the number of 'Code Provisions' approximately double. Item (c), which purports to be a change introduced by Hampel, was in fact introduced by the Greenbury report in 1995.