Competition Commission Panel visit

10 January 2012
Introduction

Purpose of discussion

The Panel has been briefed by the ICAEW on the nature of an audit and regulatory framework in which it takes place.

The purpose of the discussion today is to illustrate what happens in practice on a FTSE audit.

As background, we will provide an overview of KPMG and its philosophy, and the position and operation of the audit function within the firm.

We will then use a specific case study to illustrate the challenges of delivering an audit, and compare and contrast this case study with larger / smaller examples in the FTSE.

The session is intended to be interactive and to address any questions that you may have on the nature of an audit (although the overall time constraints mean that we will seek to start and finish each element of the presentation at the specified time).

Agenda

- Introduction (10.00 – 10.10)
  - Purpose of discussion
  - The KPMG team
- Context
  - Introduction to KPMG (10.10 – 10.30)
  - KPMG’s Audit function (10.30 – 11.10)
  - Drivers of audit effort (11.10 – 11.15)
  - Break (11.15 – 11.30)
- The Audit in Practice
  - Case studies (11.30 – 12.45)
- Final questions & wrap-up (12.45 – 13.00)
Introduction
The KPMG team

John Griffith-Jones
UK Senior Partner

David Matthews
Head of Quality & Risk

Mike Ashley
ELLP Quality & Risk

Vanessa Sharp
General Counsel

David Gardner
Director of Public Policy

Nicola Mazzarotto
Head of Competition Economics

Audit Partners

Oliver Tant
Head of Audit

Ian Starkey

Nick Frost

Guy Bainbridge

Simon Figgis
Context
Introduction to KPMG

What we are
- KPMG International
- KPMG ELLP
- KPMG UK – limited liability Partnership

Why we are what we are

Our Philosophy
Introduction to KPMG
What We Are - KPMG International

KPMG Globally
$22.71 bn revenues
145,000 people

152 Separate Partnerships

KPMG International
- The Brand
- Global Strategy
- Methodologies and Standards
- Values
- Shared Services
- Insurance arrangements

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Introduction to KPMG
KPMG ELLP

ELLP Total Revenue: €4589m
ELLP People: 29,845

Norway
- Joined in Nov. 2010
- 900+ people
- 25 offices
- NOK 1094m revenues

United Kingdom
- Joined in Oct. 2007
- 11,000 people
- 22 offices
- £1.707m revenues

Netherlands
- Joined in Oct. 2009
- 3,230 people
- 15 offices
- €498m revenues

Luxembourg
- Joined in Oct. 2009
- 977 people
- 3 offices
- €122m revenues

Germany
-Joined in Oct. 2007
- 8,500 people
- 24 offices
- €1.143m revenues

Switzerland
- Joined in Sept. 2008
- 1,600 people
- 11 offices
- CHF430m revenues

Spain
- Joined in Oct. 2008
- 2,500 people
- 16 offices

Turkey
- Joined in Oct. 2009
- 500 people
- 3 offices

CIS
- Joined in Oct. 2009
- 3,000 people

Gulf Holdings (KSA;KW&JO)
- Joined in Nov. 2010
- 5 offices

Belgium
- Joined in Mar. 2009
- 850 people
- 7 offices
Why we are what we are

Client driven

Synergies

People driven

Geographic coverage

Size

Bench strength

Business process

Shared fixed costs

Seasonality

Umbrella of related talents

Expertise

Law/Regulation

National rules

Liability

Auditors independence

Auditors independence

National rules

Law/Regulation
Our Partnership Philosophy

- Quality
- Values
- "Best" client
- "Best" people

- Lead by example
- Work together
- Respect the individual
- Seek the facts and provide insight
- Open and honest in our communication
- We are committed to our communities
- Above all, we act with integrity

- Global Mindset
- Passionate
- Expert
- Forward thinking
- Value adding

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Competition Commission Panel visit

KPMG Audit – Oliver Tant
### KPMG Audit

#### FTSE 350 and FTSE 100 analysis

#### 2010/11 – FTSE 350

<table>
<thead>
<tr>
<th>£000</th>
<th>Audit fee</th>
<th>Non audit fee</th>
<th>Total</th>
<th>No. of audits</th>
</tr>
</thead>
<tbody>
<tr>
<td>PWC</td>
<td>296,410</td>
<td>179,462</td>
<td>475,872</td>
<td>107</td>
</tr>
<tr>
<td>Deloitte</td>
<td>128,813</td>
<td>88,695</td>
<td>217,508</td>
<td>90</td>
</tr>
<tr>
<td>E&amp;Y</td>
<td>102,838</td>
<td>67,867</td>
<td>170,705</td>
<td>62</td>
</tr>
<tr>
<td>BDO</td>
<td>1,886</td>
<td>1,551</td>
<td>3,438</td>
<td>7</td>
</tr>
<tr>
<td>GT</td>
<td>812</td>
<td>701</td>
<td>1,513</td>
<td>5</td>
</tr>
<tr>
<td>PKF</td>
<td>83</td>
<td>90</td>
<td>173</td>
<td>1</td>
</tr>
<tr>
<td>KPMG</td>
<td>153,187</td>
<td>87,776</td>
<td>240,963</td>
<td>78</td>
</tr>
<tr>
<td>Total</td>
<td>530,842</td>
<td>338,366</td>
<td>869,209</td>
<td>272</td>
</tr>
</tbody>
</table>

Source: Hemscott data

#### 2010/11 – FTSE 100

<table>
<thead>
<tr>
<th>£000</th>
<th>Audit fee</th>
<th>Non audit fee</th>
<th>Total</th>
<th>No. of audits</th>
</tr>
</thead>
<tbody>
<tr>
<td>PWC</td>
<td>253,374</td>
<td>142,262</td>
<td>395,636</td>
<td>39</td>
</tr>
<tr>
<td>Deloitte</td>
<td>88,905</td>
<td>51,579</td>
<td>140,484</td>
<td>22</td>
</tr>
<tr>
<td>E&amp;Y</td>
<td>62,568</td>
<td>34,989</td>
<td>97,557</td>
<td>17</td>
</tr>
<tr>
<td>BDO</td>
<td>472</td>
<td>-</td>
<td>472</td>
<td>1</td>
</tr>
<tr>
<td>KPMG</td>
<td>117,257</td>
<td>69,587</td>
<td>186,844</td>
<td>21</td>
</tr>
<tr>
<td>Total</td>
<td>405,319</td>
<td>228,830</td>
<td>634,149</td>
<td>79</td>
</tr>
</tbody>
</table>

Source: Hemscott FTSE 100 and FTSE 350 data
KPMG Audit
Most highly ranking on attributes – auditors (UK)

FT Professional Services Study 2011

- Understands your business
- Offers value for money
- Offers a wide range of services
- Has integrity
- Has a reputation for quality work
- Innovative
- Employs talented professionals
- Has a global network

BDO, Deloitte, Ernst & Young, Grant Thornton, KPMG, PWC, Other
Client and market feedback

The attributes measured externally and by KPMG are very similar

- **Value for money**: Offers value for money
- **Service**
  - Understands a client’s business
  - Has integrity
  - Has a reputation for quality work
- **Innovative**
- **Has a wide range of services**
- **Proactive**
- **Relationship**
  - Employs talented professionals
  - Has a global network
### KPMG Audit
Service – understanding a clients business

#### Business model understanding and sector experience

<table>
<thead>
<tr>
<th>Industry sector expertise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking</td>
</tr>
<tr>
<td>Insurance</td>
</tr>
<tr>
<td>Funds</td>
</tr>
<tr>
<td>Automotive</td>
</tr>
<tr>
<td>Aerospace and Defence</td>
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<tr>
<td>Industrial Manufacturing</td>
</tr>
<tr>
<td>Chemicals</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
</tr>
<tr>
<td>Consumer Products</td>
</tr>
<tr>
<td>Food and Drink</td>
</tr>
<tr>
<td>Public sector</td>
</tr>
<tr>
<td>National markets</td>
</tr>
<tr>
<td>Retail</td>
</tr>
<tr>
<td>Oil and Gas</td>
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<tr>
<td>Mining</td>
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<tr>
<td>Utilities</td>
</tr>
<tr>
<td>Communications</td>
</tr>
<tr>
<td>Media</td>
</tr>
<tr>
<td>Transport</td>
</tr>
<tr>
<td>Travel, Leisure and Tourism</td>
</tr>
<tr>
<td>Building and Construction</td>
</tr>
<tr>
<td>Business Services</td>
</tr>
</tbody>
</table>

#### Audit methodologies
Sector specific modules

#### Sector clusters

#### Specialisation of our people

#### Training

#### Management structure
KPMG Audit
Relationships – choosing the signing partner

Partners available to sign large FTSE audits

- National markets
- Public sector
- Technical experts
- Less than 7 years partner experience
- Internal audit

large corporates

Financial sector
KPMG Audit
Relationships – a global network

KPMG Globally
$22.71 billion revenues
145,000 people
152 separate partnerships

Consistent service provision
Country expertise
Managing effective process for reporting and communication
## Extended Assurance

**Offers wide range of services**

<table>
<thead>
<tr>
<th>Rentokil</th>
</tr>
</thead>
</table>

- In 2009, KPMG designed a tailored audit package for Rentokil which enhances the audit service by avoiding duplication of external auditors work by internal auditors.
- This extended audit service has been given the ‘green light’ by the AIU in its recent annual review. Inspectors found “no adverse impact on audit quality” and concluded that all relevant ethical standard requirements had been met.
- As a result of this initiative the APB amended its guidance as a result of the Rentokil deal to include extended audit services within the definition of audit related services.

## Cutting clutter

**Has a reputation for quality work**

<table>
<thead>
<tr>
<th>Transforming ITV</th>
</tr>
</thead>
</table>

- In April 2011, ASB issued a discussion paper ‘Cutting clutter’: Combating clutter in annual reports.
- The issue of clearer communication was also highlighted by FRC in 2009 ‘Louder than Words: Principles and actions for making corporate reports less complex and more relevant’ and in the FRRP 2010 annual report.
- The financial statements in the 2010 ITV annual report were substantially restructured to give clearer explanations and disclosures and make the information more relevant to stakeholders.
- The accounts were featured in the PwC website as an example on good corporate reporting.
Centres of Excellence

KPMG Global Services (KGS) in India is used by the audit practice to drive more efficient audits and improve audit quality.

KPMG staff in India undertake certain routine audit tasks on audits enabling staff in the UK to maximise time spent with clients, understanding the business and business risks.

Advantage is taken of the time difference to extend the time within a day when KPMG staff are working on a client's audit whether in the UK or India.

This drives a quicker, more efficient audit which adds value due to quality of engagement onshore staff have with the client.

School leavers programme

100-150 18 year old students on a six year training programme leading to obtaining a BSc degree from Durham, Exeter and Birmingham universities together with a professional chartered accountancy qualification with ICAEW or ICAS.

First training programme to offer degree and ACA/CA qualification.

KPMG pays full university and professional tuition fees together with a starting salary.

David Willets, the Minister for Universities and Science

“I warmly welcome this new scheme, as it provides a new entry route to a prestigious profession for people from a wide range of backgrounds. I hope other employers and universities will study the concept carefully. It is the kind of initiative that we hope will flourish as we reform higher education.”
KPMG Audit
Proactivity – offers a wide range of services

- Services that are an implicit part of the audit
- Client expectations
KPMG Audit

Value for money

Price

Quality & Service
FTSE 100 formal audit tenders

- Formal tenders
- Benchmarking the market
- Negotiations

... and others where there was 'informal testing' of the market
**Drivers of audit effort**

**Geographic diversity**
- Number of countries
- Growing importance of emerging, less developed, markets

**Reporting complexity**
- Number of units/entities
- Separate (local) reporting requirements
- IFRS and Different GAAPs
- Different year ends
- JVs
- Regulatory reporting

**Operational complexity**
- Commercial arrangements (business/contracts)
- Tax structuring (operational, financing)
- Operational

**Accounting complexity**
- Legal versus management reporting mismatch
- Non-standard systems
- Centralisation of transaction processing:
  - offshoring
  - outsourcing
- Accounting

**Cultural complexity**
- Values
- Politics/personal agendas
- Organisational behaviours
To illustrate the applications of audit theory in the context of some of the practical complexities, we will use a ‘real life’ example:

- We have chosen Diageo as the company
- This is one of our large audit clients, but neither the largest nor the most complex
- To provide contrast, we also use examples of other audit clients and have the partners for a larger, more complex client (HSBC) and a smaller client outside of the FTSE 100 (Rentokil)
- The information contained herein is commercially confidential
### HSBC Comments:

1. HSBC reports in US Dollars (amounts presented here are translated at 2010 average rate of 0.648 for income statement and audit fee and closing rate of 0.644 for balance sheet).
2. HSBC does not report turnover (amount presented here is total operating income before interest and fee expense).
4. Includes £14 million of ‘other services pursuant to legislation’.

#### Financial information (£m)

<table>
<thead>
<tr>
<th></th>
<th>Diageo</th>
<th>HSBC</th>
<th>Rentokil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>13,232</td>
<td>66,537 (^1,2)</td>
<td>2,497</td>
</tr>
<tr>
<td>PBT</td>
<td>2,360</td>
<td>12,336 (^1)</td>
<td>15</td>
</tr>
<tr>
<td>Total Assets</td>
<td>19,777</td>
<td>1,580,820 (^1)</td>
<td>1,802</td>
</tr>
<tr>
<td>Net Assets</td>
<td>5,985</td>
<td>99,765 (^1)</td>
<td>(125)</td>
</tr>
</tbody>
</table>

#### Geographic (No.)

<table>
<thead>
<tr>
<th></th>
<th>Diageo</th>
<th>HSBC</th>
<th>Rentokil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countries</td>
<td>80</td>
<td>87</td>
<td>c50</td>
</tr>
</tbody>
</table>

#### Audit fee (£m)

<table>
<thead>
<tr>
<th></th>
<th>Diageo</th>
<th>HSBC</th>
<th>Rentokil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit fee</td>
<td>8.2</td>
<td>32 (^1)</td>
<td>2.8</td>
</tr>
<tr>
<td>Non audit fees</td>
<td>1.9</td>
<td>19 (^1,4)</td>
<td>0.9</td>
</tr>
</tbody>
</table>
# The audit in practice
## Particular features of the Financial Sector

<table>
<thead>
<tr>
<th>Features of the sector relate to:</th>
<th>Group structure</th>
<th>Business activities</th>
<th>Financial and other reporting</th>
<th>Stakeholders</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Size</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>■ Typically more likely to be amongst the largest global companies</td>
<td>■ Enormous volume of routine, and significant number of more complex, transactions</td>
<td>■ Financial statements are significantly more lengthy, frequent and detailed</td>
<td>■ Typically more likely to be ‘public interest entities’</td>
</tr>
<tr>
<td></td>
<td>■ Significantly more legal entities in group</td>
<td>■ Complex products and systems which require more industry specific audit skills</td>
<td>■ Greater degree of more complex accounting and judgements which require more ‘specialist’ audit assistance</td>
<td>■ Higher and increasing regulatory burden for companies and their auditors</td>
</tr>
<tr>
<td></td>
<td>■ More complex legal entity structure and financing arrangements</td>
<td>■ Pervasive and rapidly changing regulatory requirements</td>
<td>■ Substantial and highly technical regulatory reports from auditors</td>
<td>■ More direct assurance provided to, and interaction with, regulators</td>
</tr>
<tr>
<td><strong>Complexity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Environment</strong></td>
<td></td>
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This is an abridged public version of the full commercially confidential presentation to the Competition Commission Panel site visit on 10 January 2012.

The confidential presentation contained 52 slides, of these:

- **Section 1 Introduction to KPMG** - 3 of the 11 slides have been removed for commercial confidentiality reasons.
- **Section 2 KPMG Audit** – 2 of the 17 slides have been removed for reasons of commercial confidentiality.
- **Section 3 Audit Case Studies** – 20 of the 24 slides have been removed for reasons of commercial confidentiality.