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18 November 2021

Dear Shamima,

Audit Firm Governance Code consultation: KPMG UK Response

I am pleased to have the opportunity to respond to the Financial Reporting Council's consultation on proposed revisions to the Audit Firm Governance Code ("AFGC" or "the Code").

The profession is at an important place in terms of building public trust. For the larger firms, operational separation is one of the measures being implemented to achieve this. It is therefore of great importance that the AFGC promotes consistent and high-quality standards of governance. We welcome the FRC's intent to provide clarity with regards to the emerging arrangements for oversight, from a public interest perspective, of both an operationally separate audit practice and its relationship with the multi-disciplinary firm in which it sits.

We are also pleased that audit quality has remained a primary objective within the Code. We recognise the need for audits to be of consistently high quality and we continue to take action within our own business with a focus on audit quality.

In our response, we have identified areas where we believe further consideration or additional guidance will be necessary to ensure that the Code matches the intent, is consistently applied to the high standard required and achieves the right outcomes. In particular, we suggest greater clarity and precision is needed with respect to:

- the respective roles of the Independent Non-Executives (INEs) and the Audit Non-Executives (ANEs);
- how the roles of INEs and ANEs inter-relate and how the concept of mutual reliance between them will work in practice;
- how the roles of INEs and ANEs differ from the role of a non-executive director of a public company; and
- how the public interest lens, applied by both INEs and ANEs, is understood on an appropriate and consistent basis.



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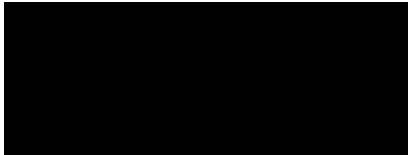
Audit Firm Governance Code consultation: KPMG UK Response

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The consultation often refers to the Code as a “requirement”; we consider the AFGC to be more than this. It is a hallmark of good governance, and we adopt the Code not because we are required to, but because it is the right thing to do in the public interest. That said, we strongly believe that a code, with which firms comply, or explain circumstances for not complying, is the right approach to promoting effective, proportionate governance within professional service firms with different legal structures, rather than adopting a more rigid rules-based or regulation-based approach.

If you would like to discuss any of the issues we raise, please do not hesitate to contact me.

Yours faithfully,



Bina Mehta
Chair

We set out below our responses to the questions posed in the consultation document.

1) How appropriate do you feel that the revised purpose of the proposed 2022 Code is?

Overall, we are supportive of the revised purpose of the AFGC.

Specifically, we agree that promoting audit quality should remain a primary objective and ensuring that public interest is taken into account in the firm's decision making.

We agree with the proposal to replace an objective focused on reducing the risk of "firm failure" by one focused on safeguarding "sustainability and resilience", which we believe is more appropriate. Not only does the objective become more tangible, but it also aligns more closely to the types of area of oversight and challenge that INEs are equipped to provide. Although the proposed objective does not rule out consideration of protection against events that might lead to the failure of a firm, it is clearly much broader than that and therefore likely to gain more traction in serving the public interest of ensuring a resilient audit market.

In our view, the objective in relation to reputation could have remained within the revised AFGC as a separate explicit objective, especially given its importance within the sphere of ensuring high levels of public trust in the profession as well as being key to resilience. However, we appreciate that it is covered by implication within the revised objective of safeguarding sustainability and resilience.

2) What are your views on the proposed thresholds for application of the proposed 2022 Code?

We are supportive of the proposal to have a higher threshold for Firms to start to apply the AFGC to bring stability in its application. We do however believe there should be harmonisation with the thresholds used by the FRC to determine level of firm supervision / firms in scope for public report of their AQRs.

We are supportive of the a "comply or explain" approach which will mean that smaller firms can consider whether some requirements could be scaled down to suit the size and scale of their firm (for example by having fewer independent non-executives if appropriate), while being transparent about their reasons for such a choice. We would encourage an open dialogue between the FRC and firms to enable firms to implement proportionate and effective governance models within the spirit and flexibility afforded by the 'comply or explain' principle, without concern that they will be negatively impacted.

This regime may also encourage greater voluntary adoption of certain provisions for firms which do not fall into scope to comply with the AFGC.

3) Should the proposed 2022 Code apply to any firm that audits a FTSE 350 company? Please suggest alternatives.

Given the concerns raised within the Department of Business, Energy and Industrial Strategy's (BEIS's) consultation on "Restoring Trust in Audit and Corporate Governance" around choice within the audit market, particularly for the FTSE 350, we note that this scoping requirement

could add an additional barrier to entry for smaller firms. However, investors will ultimately expect the same high audit quality (and therefore governance of audit firms) from firms auditing listed entities and therefore we agree that the Code should apply to all firms which audit a FTSE 350 entity.

If this recommendation is taken forward, clarity will also need to be given as to how this might apply with BEIS's proposals for managed shared audits for FTSE 350 entities. We think these firms should be brought into scope as it is in the public interest for these firms to deliver high quality audits, and therefore have appropriate governance structures in place.

4) What are your views on the proposed effective date of the proposed 2022 Code?

We consider the proposed effective date (i.e. accounting periods starting on or after 1 January 2023) to be appropriate in principle, for the reasons set out in the consultation document. We also believe early adoption should be permitted, particularly as the large firms are changing their governance structures already in the context of preparing for operational separation. However, for smaller firms it may be appropriate to adopt a transition period where they are moving from not having been subject to the Code, in order to allow them to implement any necessary changes to their governance or to recruit INEs.

5) What are your views on the priorities for engagement with investors, audit committee members and other external stakeholders and how could we encourage interaction with INEs?

We see great benefit in INEs and ANEs engaging with investors, audit committee members and other external stakeholders. It helps support their public interest responsibilities and also helps raise awareness of their role with our key stakeholders. Our INEs also receive regular updates at the Public Interest Committee on activities within our investor engagement programme.

We agree that a coordinated effort across firms, investors and audit committee chairs is likely to generate greater engagement. We therefore support the proposal to remove Principles F.2 and F.3 with a view to consulting on tackling this in the next revision of the UK Stewardship Code and the introduction of standards for audit committees.

Our INEs have welcomed the opportunity to interact with the Audit Committee Chairs' Independent Forum (ACCIF) and historically have also had an annual meeting with the Company Reporting and Auditing Group (CRAG). However, following their last meeting with the CRAG in September 2019, after which we were notified that CRAG would no longer hold annual meetings with audit firms.

In April 2020, we launched our first Audit Annual Review to strengthen dialogue between our firm and our key stakeholders. This annual event, where our INEs have presented in the past, is an opportunity to share views on changes to our profession as well as reforms underway in corporate governance and reporting. Our key stakeholders are invited including investors, audit committee members, finance directors, regulators, and other key external stakeholders.

We believe engagement facilitated by the regulator and/or stakeholder organisations (such as ACCIF) would generate more valuable interactions. It will be important in such interactions for the distinction between the roles of INEs and ANEs to be made clear, as discussed below.

6) To what extent do you support the changes proposed in the areas of partner oversight and accountability to owners?

We are supportive of the proposed changes in their overall direction. However, it is important for the large multidisciplinary firms, the Code does not confuse the ultimate responsibility of the main board for ensuring audit quality and the sustainability of the audit practice within that firm, with the oversight roles of the Public Interest Committee and the Audit Board. Furthermore, it should not be implied that governance oversight of audit quality is the exclusive domain of the INEs and/or ANEs. This could be addressed in Section A of the revised AFGC.

Having recognised the need to provide additional checks and balances in our own corporate governance, we separated the roles of Chair and Chief Executive in April 2021. This has helped enable the distinction between the Board and the Executive Committee (management) to be more clearly defined. In our view, it is critical that the Board has genuine authority to approve strategy and hold management to account for its delivery. This implies that there are meaningful checks and balances within a firm's governance arrangements so as to ensure Board members, who are line partners in a firm, feel free to challenge their executive leadership without fear of consequences for their own careers.

7) What are your views on the proposals to underpin connectivity with the global network and monitoring of its potential to impact the UK Firm? Do you have other suggestions for how this could be addressed?

Given the nature of some UK audit firms' international networks, it is absolutely right for a UK firm to identify, assess and monitor risks to its reputation or resilience that could arise from other firms in the same network. Against this background, we believe that the Code could establish an expectation on a UK firm's leadership to assess and monitor risk associated with or emerging from the global network. A firm's transparency report could include a section on how this achieved to the satisfaction of the UK firm's board.

In our view, the role of the INEs should be characterised as an oversight role of the degree to which a firm has carried out such assessment and risk management activities for the board's satisfaction, rather than placing on the INEs a role of making the underlying assessments themselves.

We specifically highlight Provision 32, which suggests that the INEs would have a role in assessing global governance standards and the impact of the network on the UK firm and the public interest. We believe that this role of "assessment" should sit with leadership within the firm and the role of the INEs is to oversee this through challenge and enquiry.

As with many international professional services firms, KPMG's individual member firms are independent in terms of their decision-making and governance. However, they are members of an international network which is coordinated by KPMG International Limited, which itself does not provide any professional services. Given the nature of the global brand and reputation, as well as the need for consistent quality of work, member firms agree to adopt global policies that seek to protect the brand and promote quality. These international arrangements are described both in the UK firm's annual Transparency Reports and also in the annual Global Transparency Report published by KPMG International and many of the proposed transparency requirements of the AFGC would appear in those reports.

As regards some of the detailed proposed provisions of the revised AFGC, including Provision 28(g) regarding actual risks or threats to a firm's resilience arising from a global network, we do not believe transparency of the type envisaged is the most appropriate. Under current arrangements, when a firm becomes aware of such a risk, it will already consider its disclosure obligations to the FRC and such existing disclosure requirements benefit from customary confidentiality protections within the regulatory framework that are frequently essential depending on the circumstances.

8) How supportive are you of the approach taken to people and culture in section B of the proposed 2022 Code? Please include any suggestions for how we could improve it further.

We welcome the changes made to the approach to people and culture.

We reiterate the comment above on having a definition of the ANE and INE throughout the document, particularly with regards to Provision 17 and the expectation for 'INE's to have a close eye on whether the right behaviours are being incentivised in the audit practice in particular'. We believe this would also be applicable to ANE's - indeed, this may well be an area where the INEs are entitled to rely upon the ANEs. We have commented on the concept of mutual reliance in our response to Question 12.

9) Are there any matters you believe we should include in section C that do not currently feature and/or can you suggest other improvements to how the proposed 2022 Code approaches operational matters and resilience?

We are supportive of the recommendations on the whole but question the purpose of commenting on interaction with the global network to the extent this will achieve the purpose of the Code. We regularly interact with our Global network and set out in our annual Transparency Reports some of the forums in which we do that but specifically commenting in a public document on some of the risks and benefits posed by the network does not, in our mind, go towards achieving the purpose of the Code. It also poses problems in terms of the confidentiality one might expect if the matter is client-related.

The suggestion of establishing a partner-led audit quality committee where an Audit Board is not in place is a good one. Where possible, we believe these should have a degree of independence insofar as practical and possible from the firm itself.

10) Do you think that the proposed 2022 Code is clear enough about the role INEs play in the Firms?

We are concerned that the intended aim to provide greater clarity over the expectations for the role of the INEs is not satisfactorily achieved in the current drafting of the proposed AFGC.

We believe there is a risk of creating an 'expectation gap' in the public's mind and that of investors about what the role of a non-executive within a partnership is, in comparison to that of a non-executive of a corporate entity. The latter is part of an entity's unitary board and decision-making (including being able to vote) and can be held accountable for decisions made by the entity. This is not necessarily the case for INEs or ANEs within audit firm partnerships, and, indeed, is contradictory with their primary role of independent overseers, separate from a firm's main board.

This 'expectation gap' is not helped by the nomenclature adopted in the AFGC – admittedly, a nomenclature which has been in place for a number of years. We therefore suggest a review of the titles "Independent Non-Executive" and "Audit Non-Executive". By way of illustration, an alternative that might be more appropriate could be, "Public Interest Member" and "Audit Public Interest Member", to reflect that their role is in the public interest, and to reduce the risk that there may be an expectation that the INEs or ANEs are decision-making company directors.

We are concerned that some of the proposals within the proposed revised AFGC unintentionally bring the INEs into a management position as opposed to remaining independent outside the chain of command. For example, in Section 8, it is suggested that INEs "influence decisions".

We think there needs to be greater clarity in relation to the split between the role of Board and the INEs; there are instances where both the Board and the INEs are given the same responsibilities. For example, Provision 11, refers to both the Board and INE overseeing the compliance of the Code of Conduct by everyone within the firm. We do not think the INEs should be responsible for overseeing how everyone within the firm are in compliance with the Code of Conduct; they should however understand and challenge how the Board gains comfort that everyone is complying with the Code of Conduct.

We also note that Appendix A refers to the FRC's Ethical Standard definition for a "covered person". While this articulation is useful, in practice it is not only the UK definition but also, for example, the SEC definition of a covered person which has led to challenges with regards to non-executives and whether they are considered a "covered person".

11) What are your views on the proposals for strengthening the status and role of INEs? Please include any suggestions for other ways to increase their impact and effectiveness.

As stated in response to Question 10, we consider that the INE role should be to oversee, from a public interest perspective, decisions made by management and to provide challenge and consequently are not in the chain of command. Therefore, we do believe there needs to be greater clarity on the role of the Board compared to that of the INEs.

We are supportive of the proposals to require firms to appoint or establish a nomination committee for future INE and ANE appointments. At KPMG, the process for appointments of INEs and ANEs includes review and recommendation to the Board by our People Committee, functioning as a nomination committee.

We agree there should be transparency of disagreements, particularly if this has led to the resignation of an INE or ANE.

12) What are your views on the proposed boundaries between the responsibilities of INEs and Audit Non-Executives? Please give examples of any potential difficulties you foresee with what is proposed.

Overall, we are concerned that the role of the ANE has been included within the AFGC as a "bolt on" for the larger audit firms adopting the FRC's Principles of Operational Separation (the Principles), without fully reflecting on how the Code and the Principles need to work in conjunction.

We understand that where a firm is subject to the Principles, the proposed revised AFGC sets out a firm-wide perspective for the INEs and an audit practice focus for the ANEs. Both INEs and ANEs have an overarching responsibility to provide oversight from a public interest perspective.

However, there are examples throughout the consultation which create confusion of the different roles. For example, Principle R states that ANEs “will fulfil the responsibilities of independent non-executives under this Code in so far as these relate to the audit practice”; however, in some instances the ANEs are specifically referred to in addition to the INEs (for example Provision 31). We believe greater precision throughout the consultation would help to clarify the boundary.

In the context of the INE’s responsibility to oversee the whole firm, we believe there should be more clarity on the nature of the public interest that is intended to form the basis for their oversight. We also question whether the concept of an INE’s “accountability to the public interest” is sufficiently precise to be meaningful in terms of defining the actual scope and remit of the role and therefore extent of any fiduciary duty.

With regard to the concept of “mutual reliance” between the INEs and ANEs, there is a need for more precise guidance or clear expectations from the FRC on how this mutual reliance is intended to work in practice and how a consistent standard of good governance across the industry is achieved in relation to it. Examples on how the FRC see the interaction working in practice or good practice observed would promote this.