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Dear Susan,

Draft Minimum Standard for Audit Committees: KPMG LLP response

I am pleased to respond to the FRC's Consultation Document on the Draft Minimum Standard for Audit Committees on behalf of KPMG LLP ('KPMG'). As stated within our response to the Department of Business, Energy and Industrial Strategy's Consultation 'Restoring trust in audit and corporate governance' ('BEIS Consultation'), we believe that all participants in the corporate reporting ecosystem, including Audit Committee Chairs, have essential roles to play to deliver reliable corporate reporting and high quality audits, which are vital to well-functioning financial markets, business investment and growth.

Audit Committees have an important role in the governance of companies and in our experience FTSE 350 Audit Committees generally take their responsibilities seriously and discharge them diligently. However, the quality and effectiveness of Audit Committees does vary across the listed company market (even within the FTSE350) and a lack of confidence in an Audit Committee and those charged with governance can have an impact on the quality of the financial reporting as well as the willingness of an audit firm to accept, or continue with, an audit engagement.

For this reason, we are supportive of the Government's intention to introduce a Minimum Standard for Audit Committees. We understand that currently the powers proposed for ARGAs, as a result of the Government's response to the BEIS consultation, are limited to appointment and oversight of auditors, however as stated within our response to the BEIS Consultation, we question why such standards would be limited to just these aspects of the Audit Committee's role. Audit Committees have a vital role to play in selecting and overseeing the performance of auditors to ensure they maintain professional scepticism, challenge management, and thus deliver high quality audits. But oversight of the auditor and the audit process is only one aspect of the Audit Committee's role. To single out this responsibility without regard to others places undue emphasis on it, to the potential detriment of other important areas.

In its current form, we are concerned that the proposed Standard does not provide the precision, objectivity, or clarity, necessary to hold Audit Committees to account for failing to discharge their duties. Furthermore, various paragraphs of the proposed Standard are inconsistent with each other; and in other places the proposed Standard appears to be inconsistent with the Companies Act and CMA Statutory Audit Services Order 2014. In the Appendix to this letter, we set out our views on the proposed Standard in more detail.

Precision, objectivity, and clarity

In our response to the BEIS Consultation, we recommended that any minimum Standard for Audit Committees should not inhibit the exercise of Audit Committee discretion and professional judgment, nor constrain the development of innovative best practices. We also believe that standards should have a degree of precision and clarity that allows them to be implemented in an objective way. Without this, it will be challenging to monitor and enforce the Standard.

The proposed Standard, as set out in the Consultation Document, draws heavily from the 'UK Corporate Governance Code' and the FRC's existing 'Guidance on Audit Committees' ('the accompanying guidance'). As a result, the proposed Standard reads like best practice guidance rather than an objective standard. We believe only the objective 'minimum requirements' should be included in the Standard and any subjective provisions should be transferred to the best practice guidance.

Consistency

There are instances where the proposed minimum Standard uses different terminology to articulate the same Audit Committee duty. This should be changed to make it consistent. Furthermore, part of the proposed Standard appears to contradict existing law and regulation. We have provided examples within our detailed response in Appendix 1.

Business decisions

Finally, while we are supportive of greater choice within the audit market, we are concerned that in seeking to encourage diversity in the audit market, the proposed Standard strays beyond the appointment of auditors into wider business decisions. For example, by law directors (and Audit Committees) are required to act within the best interests of the company, and therefore whether or not an Audit Committee wishes to exclude eligible firms that refuse to tender for the audit from bidding for non-audit services work should be a matter for each Audit Committee and the Board.

* * *

If you would like to discuss any of the issues we raise, please do not hesitate to contact me or our Audit Committee Institute lead, Timothy Copnell.

Yours sincerely,



Cath Burnet
Head of Audit, KPMG

Appendix 1

We have set out further detailed views on the proposed Standard below.

Scope and authority

There are no requirements for FTSE350 companies to have an Audit Committee – only a requirement that entities listed on the Main Market have a body or bodies responsible for performing the functions generally associated with an Audit Committee – i.e., FTSE350 companies might have an Audit Committee or a body performing equivalent functions (which could be the board itself). To reflect this unlikely, but potential, scenario, consideration should be given to extending the scope of the Standard to all bodies performing the functions of an Audit Committee.

Responsibilities

Paragraph 4

Paragraph 4 requires that the Audit Committee “conduct the tender process” whereas paragraph 6 requires that the Audit Committee “leads the tender process” and paragraph 8 talks in terms of the Audit Committee having “oversight over the auditor selection process”. The different phrases imply that the Audit Committee leads, conducts and has oversight over the audit tender process, which we consider to be three unique roles.

Furthermore, paragraph 4 requires that the Audit Committee approve the remuneration of the external auditors. This is inconsistent with Part 5 of the CMA’s Statutory Audit Services Order 2014, which requires (as does paragraph 6 of the Standard) that the Audit Committee negotiates the audit fee.

In bullet 3, there appears to be an expectation that Audit Committees engage with shareholders on the scope of the external audit but we believe this should be put beyond doubt by removing the term ‘where appropriate’. We would encourage the FRC/ARGA to provide best practice guidance – within the accompanying guidance- on how Audit Committees might approach this task. As stated within our response to the BEIS consultation, we believe there is merit in a formal mechanism to enable Audit Committees to gather shareholder views on the audit plan. This should encourage shareholders to engage with the audit process at an early stage, and to raise concerns they may have about the company’s operations or the accounting that may inform the auditor’s planned areas of focus or planned level of materiality. This would also have the added benefit of reinforcing to all parties involved that the ‘client’ of an audit is the shareholders as a body.

With respect to non-audit services policies (bullet 8), we note the proposed Standard does not set out who, or what body, should be approving non-audit services. We suggest that this is amended to make it clear that the Audit Committee must give prior approval to all non-trivial non-audit services provided by the external auditor.

“developing and implementing policy on the engagement of the external auditor to supply non-audit services, ensuring there is prior approval by the Audit Committee of all but ‘clearly trivial’ non-audit services, considering the impact this may have on independence, taking into account the relevant regulations and ethical guidance in this regard, and reporting to the Board on any improvement or action required.”

Paragraph 7

Paragraph 7 of the Standard states that the tender process should not preclude the participation of 'challenger' audit firms "*without good reason*" whereas section 489A(4) of the Companies Act 2006 states that the Audit Committee must carry out the selection procedures in accordance with Article 16(3) of the Audit Regulation, which states that the tender process *cannot* preclude the participation of non-Big 4 firms. "*The organisation of the tender process does not in any way preclude the participation in the selection procedure of firms which received less than 15 % of the total audit fees from public-interest entities ... in the previous calendar year,*".

We therefore believe that "*without good reason*" should be deleted, so that the Standard becomes:

"The tendering process must not preclude the participation of "challenger" audit firms"

Furthermore, we note that the term 'challenger firm' is not defined and those firms that are generally considered to be challenger firms today may change over time. We suggest that the Standard either defines 'challenger firm' or is aligned to Article 16(3) of the Audit Regulation which refers to audit firms which received less than 15% of total audit fees from Public Interest Entities in the previous calendar year.

Paragraph 9

We agree with the intent of Paragraph 9, but as drafted, it implies that price and perceived cultural fit should play no part in the choice of audit firm. In some instances, for example where two or more tendering audit firms are perceived to have equal standards of quality, other factors such as price and perceived culture fit will be taken into account. We therefore suggest replacing the first sentence of paragraph 9 with:

"In choosing the auditor, the Audit Committee must prioritise quality, including independence, challenge and technical competence, over and above price or perceived cultural fit."

Within the FRC's feedback statement on Firm-level Audit Quality Indicator (AQI) Consultation there is an aim to deliver users of audit services additional sources of information which will enable detailed and robust conversations about audit quality with firms. We consider that there is an opportunity to explicitly reference these AQIs within the Standard. This could be done by amending the final sentence of paragraph 9 to state:

"Audit Committees must also review audit quality indicators published by firms and/or the FRC"

Paragraph 11

This paragraph should be amended to clarify the Audit Committee's duty (not the company's):

"Audit Committees must manage their relationships with audit firms to allow them sufficient choice in a future tender"

and remove:

“to take account of the need to expand market diversity and any market opening measures that may be introduced”

In our view it is the Audit Committee’s role to recommend the appointment of the best possible auditor - based on independence, challenge, and technical competence as stated in Paragraph 9. As currently drafted, it could imply that expanding market diversity is also a requirement for Audit Committees, which is primarily the responsibility of the Government and regulators.

Paragraph 13

As drafted, it is unclear whether an Audit Committees should run price-blind tender processes or not. If it is just a matter for the Audit Committee’s discretion, then we consider it would be more appropriate to include this paragraph in the accompanying guidance rather than the Standard.

Paragraph 14

As stated with the cover letter, the proposed Standard strays into business decisions beyond that of appointing and overseeing the external auditors. By law directors and Audit Committees are required to act within the best interests of the company. Whether or not an Audit Committee wishes to exclude eligible firms that refuse to tender for the audit from bidding for non-audit services work is a matter for each Audit Committee and the Board of directors. We therefore suggest the deletion of the final sentence in paragraph 14, *“The Audit Committee should remind eligible firms that refuse to tender that they may as a result be ineligible to bid for non-audit services work”*.

The determination of whether or not to exclude a firm from bidding for non-audit services work due to the audit firm’s decision not to participate in a tender, should be considered in the context of s172 of the Companies Act, taking all relevant stakeholders into account. This could be included within the accompanying guidance.

We also suggest that if the sentence *“The Audit Committee should also consider asking those firms how such action is in the public interest”* is amended to:

“The Audit Committee must ask firms not willing to participate in the tender to provide the reasons for not doing so.”

This amendment would require audit firms to share their reasons for not participating within an audit tender, providing the Audit Committee with a better understanding of their rationale. Audit firms may have numerous reasons for not tendering for an audit, for example insufficient resource to be able to deliver a high-quality audit.

Oversight of auditors and audit

Paragraph 16

We believe that standards should have a degree of precision and clarity that allows them to be implemented in an objective way, which will enable them to be monitored and enforced effectively.

Paragraph 16 states the Audit Committee should obtain evidence of the effectiveness of the external audit and the auditor from those impacted by the audit/auditor – but then goes on to

outline seven individual approaches that “may be suitable” and that “should be documented if used”. This suggests that the seven individual approaches are optional – and if the Audit Committee employs a different approach, there is no requirement to document it.

We also suggest the use of ‘should’ is revisited throughout the Standard. ‘Should’ suggests that any action/duties/responsibilities are best for a particular situation and lends itself to best practice guidance such as that within the accompanying guidance. By contrast, we believe Standards should use ‘must’ to convey the compulsory nature of the minimum requirements, aligning to the hierarchy of authority within the [FRC’s Framework for Developing Standard, Statements of practice, Codes and Guidance](#).

We suggest that paragraph 16 could be amended to:

“The Audit Committee must obtain evidence of the effectiveness of the external audit and the auditor from those impacted by the audit/auditor, and document the approach used.”

This could then be cross-referenced to the accompanying guidance which provides examples of how this can be achieved. This approach is also supported by the reference in paragraph 1, that this Standard should be read in conjunction with the accompanying guidance and the UK Corporate Governance Code; we believe for clarity, there should be limited duplication between these publications.

We note that within the guidance, the audit firm’s annual transparency reports are only referenced in relation to the appointment and tendering of the auditors; we believe it should also be used in the ongoing oversight of the auditors.

Paragraph 21

We suggest that phrases such as “where appropriate” or “without good reason” should be removed throughout the Standard. These do not provide sufficient clarity for Audit Committees or those seeking to hold Audit Committees to account for failing to discharge their duties.

We believe paragraph 21 should be amended as follows:

“Details of how effective oversight has been achieved throughout the year must be documented and reported on in the annual report.”

Reporting

Paragraph 22

We do not consider that the ‘Audit Committee report’ is the right place to explain the application of an entity’s accounting policies. As required by International Accounting Standard 1 (IAS 1), a summary of the significant accounting policies should be included in the financial statements. It is not clear to us whether, and how, the intended Audit Committee disclosures are different from those required by IAS1.

Further, given the Standard is limited to the Audit Committee’s role in relation to the oversight and appointment of auditors, we believe that the first three bullets of paragraph 22 should be removed as they do not relate to this limited role.

Omissions

While we recognise that the Standard is restricted to the Audit Committee's role in relation to the appointment and oversight of auditors, we believe there are some important omissions from the overall Standard including:

— *Skills and experience*

Effective oversight of audit starts with an 'audit competent' Audit Committee i.e., one with both financial literacy and appropriate experience in audit. We believe that the Standard should also address the independence, skills, and experience of the Audit Committee members.

— *Oversight of management*

Management, including the Chief Financial Officer and finance function, also have a role to play in ensuring a high-quality audit. We believe the Standard should address the Audit Committee's responsibility to ensure:

- management provides quality and timely information to the auditor during an audit.
- management are open to challenge during an audit and respond promptly to queries and information requests.
- management understand and fully promote the public interest purpose of the audit.

Furthermore, the Standard should make clear that the Audit Committee must review and monitor management's responsiveness to the external auditor's findings and recommendations.

— *Audit process*

While the Standard refers to the Audit Committee's role in reviewing the effectiveness of the external audit process, they are silent on the Audit Committee's role as part of the audit process. For example, we would expect the Standard to address the minimum requirements in respect of the Audit Committee's involvement in the planning stage of the audit.

As noted in the recent FRC paper, '[What Makes a Good... Environment for Auditor Scepticism and Challenge](#)', a well-planned audit reaps many benefits, including ensuring that audit efforts are directed at the most significant areas where there is an increased need for scepticism and challenge. We note that the current accompanying guidance clearly articulates the Audit Committee's role in ensuring that appropriate plans are in place for the audit, including consideration of whether the planned levels of materiality and proposed resources to execute the audit plan, are consistent with the scope of the audit engagement.

Consideration should also be given to addressing 'communication' by requiring Audit Committees to agree the formal and informal means of communication with the auditors at the start of the audit, including the plan for how any unexpected matters arising can be escalated in a timely manner. Communication provides a strong foundation for establishing an effective working relationship between the auditor, management, and the Audit Committee. There are requirements within Auditing Standards for the auditors to



communicate with Those Charged With Governance; the Standard could include a similar provision for the Audit Committee to receive/require such communications.

Additionally, as recommended within the 'What Makes a Good... Environment for Auditor Scepticism and Challenge' paper, the Standard could also require Audit Committees to set clear expectations and boundaries of what is desired of an auditor to deliver a good quality audit. The accompanying guidance could provide examples of the extent of constructive challenge that stakeholders expect to see between the audit firm and the audited entity's management, including how this would best be achieved and evidenced.

— *Foreword*

Finally, we believe that the Standard would benefit from a foreword, which includes a clear articulation of a high quality audit, as well as the Audit Committee's role in building and sustaining the environment for scepticism and challenge, drawing on the FRC paper, 'What Makes a Good... Environment for Auditor Scepticism and Challenge'.