

Audit Firm Governance Code

The Independent Non-executive Directors (INEs) of KPMG LLP would like to offer the following response to the consultation on the Audit Firm Governance Code.

The INEs are Philip Augar, Laura Empson, David Pitt-Watson and Sir Steve Robson. Augar, Empson and Pitt-Watson have been INEs for almost 2 years and Robson for almost 5 years.

Purpose and Public Interest

We do see value in seeking to clarify the meaning of “public interest”. The purpose, and value, of an audit goes beyond the shareholders of a company. It is also of importance to creditors, employees, customers, suppliers and the general public who can all have an interest in the solvency and management of the company.

We consider that the matters covered in paragraphs 16-18 of the consultation document are indeed part of an appropriate expression of the public interest. But we believe that there is also a clear public interest in seeking to reduce the risk of any further concentration in the audit market. We note that it was a concern about this matter which led to the formation of the Market Participant Group. This important aspect of the public interest is missing from paragraphs 16-18

We note that in paragraph 58 of the consultation document there is a different expression of the public interest which includes prevention of firm failure. It is not clear that the public interest extends as far as “prevention” of failure. This could imply taking any measures needed to avoid failure, including possibly publically funded bail outs.

We would not go this far but we do consider that there is a clear public interest in the firms having governance arrangements, and being managed in a manner, which reduces the risk of failure. Subject to this point, we consider the approach in paragraph 58 to be correct. The chief mischief is the adverse impact on competition if a firm did fail, or even being seriously weakened. FRC might wish to consider whether there are other forces which could also have

an adverse impact on competition and what, if any, role the Code might have on mitigating them.

The promotion of audit quality is not, of course, a matter only, or even mainly, for INEs. There is, therefore, benefit in investors, corporates, audit firms and regulators all having a clear understanding of the public interest in this area. The FRC may wish to consider how such an understanding can best be established.

Application of the Code: Governance

We have had a number of meetings with investors and these have been productive. However it is not easy to get traction in this area and, on the investor side, it tends to be the same, relatively small number of firms, and individuals, who are prepared to engage.

It is difficult to establish whether the Code has achieved its purpose as so many other factors are driving change and behaviour. We do judge that the appointment of INEs has brought some new and different views into the discussions within the firm and, as with any organisation which tends to promote from within, this has a positive impact. We have also encouraged the development of the extended audit, and the outreach of KPMG to the investor community.

It is correct to say (paragraph 33) that the role of INEs differs from that of NEDs of a public company. While the role of NEDs is founded in legislation in contrast to that of INEs, it is important to recognise that there are important similarities in their activity. If it is agreed that part of the INEs role is to reduce the risk of failure of the firm, this will lead them to address similar issues to plc NEDs; for example, strategy, culture, incentives and risk management.

We share the view that INEs should regard themselves as accountable to the public. This seems almost self-evident as their role is to protect the public interest. This is best done through transparency. At KPMG we have given a report on our activities in the annual Transparency Report. It can get rather buried within that Report. An alternative would be to publish our report as a free standing document. To generate more awareness and interest, there might be simultaneous publication of the reports of the INEs of all the firms.

We share the views in paragraphs 38-39 on the issues surrounding the network issues. We consider that the transmission of risk through these networks to be a real and growing danger in a globalised economy. We have had a number of discussions within KPMG on this issue and on the firm's arrangements to mitigate this risk. We are surprised that national regulators are not taking a co-ordinated approach in this area. We agree that it would be desirable for firms' international governance be reviewed.

We welcome (paragraph 41) the FRC's intention to hold regular meetings with each firm's Board and public interest committee.

Application of the Code: competition

We agree (paragraph 46) that firms should give clear assurance that they have addressed risk and should make a longer term viability statement.

Application of Code: transparency

As mentioned above, consideration could be given to INEs reporting separately from the firm's Transparency Report.

Specific questions

Paragraph 59 – subject to the point above about “prevention”, we agree on the approach in paragraph 58 and not on that in paragraphs 16-18

Paragraph 65 – do not favour separate governance for audit for the reasons in paragraph 64. An effective organisation cannot serve two masters. As audit rests in firms alongside other professional services, it would not be appropriate to limit the Code to audit activities.

Paragraph 68 – agree on the emphasis on “tone at the top”. The “top” might be given explicit responsibility for culture and behaviour at all levels of the firm and in all functions. They might also be asked to report on what they believe the current culture to be and on what it should be.

Paragraph 70 – as mentioned above we attach importance to network risk being addressed effectively. Co-ordinated action by national regulators would be an important part of this. Spreading the Code in isolation might result in limited progress in important jurisdictions

Paragraph 80 – an INE should not be on the Board of an audit client or on the Board of a company which pays substantial non-audit fees to the firm (say where the non-audit fee received is equivalent to 33% or more of the fee the company pays for audit).

Appointments should be agreed between the lead INE and the Senior Partner. It would be hard to engage investors effectively (see comments above on traction in this area) and any process of soundings could leave many investors feeling left out. The FRC should have the right of veto.

Paragraph 82 – it is interesting that the FRC seems to view it as appropriate that the Code should be less demanding than the Corporate Governance Code. The nature of audit is that it is paid for by those who do not receive the benefit of the service. The same extent of externality does not apply to the products of companies covered by the Combined Code. Some might see this as a prima facie case for the Audit Firm Code to be the more demanding of the two.

The specific suggestions in paragraph 82 are unexceptional apart from two. First, we doubt if it is necessary for one INE to have had recent financial experience. The INEs are not responsible for the audit of the firm. Such a requirement could reduce choice of INEs in a way which would be unhelpful bearing in mind that INEs are usually fewer in numbers than NEDs in most plcs. Second, we do not understand the suggestion that the chairman of the INEs should be independent. It is hard to see how he or she could be anything else.

Paragraph 88 – as mentioned above, accountability should be to the public, possibly through simultaneously published free standing reports. INEs should be given discretion on deciding when to engage with regulators. Any attempt at codification in this area could get in the way of dialogue. The Senior Partner should confirm that the Transparency Report is “fair, balanced and understandable”. Similarly he, or she, should give a statement of viability concerning long term liquidity and solvency. The INEs should not have this responsibility. Putting these obligations on the Senior Partner is a proper recognition of the centrality of their role in the running of the business.

Paragraph 90 – no opinion

Paragraph 91 – the FRC alone should own the Code

