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**Private & confidential**

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Contact David Matthews  
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Dear Susan

**Feedback on the FRC's consultation paper on audit firm governance**

I am writing in response to the FRC's request for feedback on its consultation paper "*Audit Firm Governance Code - Review of its Implementation and Operation*" (the "Consultation Paper").

Our firm was represented on the Audit Firm Governance Working Group (the "Working Group") which drafted the Audit Firm Governance Code (the "Code") and we have sought to implement the letter and spirit of the Code in a considered manner since its issuance (and, in respect of many elements of the Code, before its issuance). We believe that the timing of this review is appropriate and welcome the opportunity to provide feedback.

*The importance of principles*

We would start by noting that The Working Group "sought to discharge its responsibilities in a proportionate way that secures wide support for the Code and demonstrates a practical application of evidence-based public policy making". We believe this to have been a sensible approach. The principles based approach of many UK codes (for example the UK Corporate Governance Code) fosters evolution reflecting best practice rather than providing a constraint which results from prescriptive requirements.

The Consultation Document points out that there are important differences in the approach of the firms in their implementation of and reporting on the Code (in particular the positioning of Independent Non-Executives ("INEs") introduced by the Code in the governance structures).

Whilst the current consultation may well result in changes to the Code, we believe that it is important that flexibility is maintained through the continued use of principles rather than fixed rules and the option for firms to "explain" the approach taken rather than being forced into

“compliance”. The transparency of any explanations will clearly enable stakeholders, including investors and regulators, to assess the extent to which (and indeed whether) individual firms follow the spirit of the Code.

#### *Purpose of the Code and the public interest*

The Consultation Paper asks whether the purpose of the Code and its intended benefits remain valid (paragraph 15). Generally we believe this to be the case, although in so far as the objectives underlying the purpose (paragraph 29) are concerned we believe the objective to increase competition and choice has arguably, and perhaps unsurprisingly, been less successful in so far as choice is concerned. Whilst we have views on this point, given the public debate which has taken place in the UK in recent years (principally in the Competition and Markets Authority's review of the statutory audit market in the UK) we do not seek to deal with this further in this response.

The Consultation Paper notes that the Code refers to the *public interest* without being clear what that (ie the *public interest*) is. We acknowledge this point, and believe that this lack of clarity has become more significant in recent years as the term has been used interchangeably in different circumstances, thereby creating the potential for confusion. Since *public interest* is referred to elsewhere, for example in the ICAEW Code of Ethics, it would appear unwise to use this term unless its meaning is identical to that intended (and generally understood) by that other usage. The potential for confusion is clear, since the Consultation Paper itself states that “...the public interest also arises in other types of regulated work undertaken by the firm's....”: in fact, firms regulated by the ICAEW are obliged to consider the public interest under the ICAEW Code of Ethics in all (not just regulated) work undertaken<sup>1</sup>.

This is not to say that we disagree with the FRC's suggestion that the Code should be clear that its purpose should lie primarily in the promotion of high quality statutory audit in the interests of shareholders and in accordance with law and regulation (paragraph 16). Indeed, we believe that this is the primary concern of investors and therefore we would support articulation of the purpose of the Code in that way. It seems clear, however, that the concept of the *public interest* is broader than that intended by this revised purpose of the Code.

Our responses to the specific questions in the Consultation Paper are included in the Appendix hereto. Please do not hesitate to contact me if any elaboration on, or discussion of, the contents of this letter would be helpful.

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<sup>1</sup> Paragraph 100.1 of the ICAEW Code of Ethics provides that “A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest” and “In acting in the public interest, a professional accountant shall observe and comply with this Code.”

Yours sincerely



David Matthews  
*Head of Quality and Risk Management*



**Do you agree that the Code's purpose should be redefined in this way?**

Whilst we believe the purpose and intended benefits of the Code, in general, remain valid, we believe there would be benefit in providing greater specificity. Therefore we would support the proposed emphasis on audit quality as being of the greatest importance and, secondly, the firm's reputation, and therefore oversight of the firm's non-audit business.

However, as explained in the covering letter, we would be cautious about referring to the public interest, unless this was clearly linked in a consistent way to other use of that term, for example in the existing ICAEW Code of Ethics.

As a small point, we note that the FRC refers to "non-audit" and, to be accurate, it may be appropriate to refer to "non-statutory" audit.

**Should there be separate governance arrangements for audit? What might such arrangements look like?**

In considering culture and tone at the top, we believe it is important to remember that the provisions of the ICAEW Code of Ethics apply to the firms, their partners and staff regardless of skill set. At our firm, which we believe is likely to be the case for many firms, all staff undertake regular training on ethics and independence and many of the partners and staff will have qualified as Chartered Accountants, and will therefore have benefitted from rigorous professional training, even though many may no longer provide statutory audit services. Indeed, we believe that the success of the firms in growing services other than statutory audit in large part is due to the standards and professionalism that are embodied in the training which individuals receive during their professional training and within the firms on route to becoming Chartered Accountants. In part this is because the skills which underpin the Chartered Accountant qualification and audit quality are also essential to many other services provided to the firm's clients.

Accordingly we believe that it would be unhelpful to have a separate governance structure for audit. We believe that it is important that all staff have the same attitude to both the fundamental principles which underlie the ICAEW Code of Ethics and the quality of services provided to our clients. Any segregation risks suggesting that a lower standard is acceptable for services other than the statutory audit which we do not believe is in the interests of a professional firm or the accountancy profession as a whole.

Notwithstanding our comments above, redefining the purpose of the Code as proposed by the FRC and therefore providing the particular focus for INEs on audit quality would, we believe, enhance investor confidence in the quality of audit.

**Should the Code include more detail and impose more requirements on tone at the top and professionalism more generally?**

We agree that firms should have an appropriate tone at the top and a strong culture of ethics and professionalism. Since these are behavioural matters, we are not convinced that more detail and more requirements would be beneficial.

Rather, there is a danger that greater detail encourages focus on simple compliance with a checklist rather than thoughtful consideration of the broader principles at which such requirements would be aimed. We therefore believe it is for the firms to articulate how they strive to achieve the right culture and seek to demonstrate the success (or otherwise) in their reporting. We recognise that culture is often observed more easily than it can be described. In this regard, those with closer insights into the behaviours of the partners and staff of the firms - including INEs, audit committees and regulators - all have contributions to make. Consideration might be given as to how these views might be gathered - for example direct reporting by and discussion between the FRC and INEs and surveys of Audit Committee chairs.

**Do you agree that the concept of the Code should be spread more widely in the world? How might this be achieved?**

We recognise that there might be elements of the Code which would be applicable in other jurisdictions, particularly those with large public capital markets. However, it is important to bear in mind that the nature of capital markets and the role of audit in other jurisdictions may differ to that in the UK. The fact that audit firms are privately owned should also be taken into account.

It follows that whilst elements of the Code may be relevant for consideration in other jurisdictions, this may not be the case universally.

In particular, the concept of “comply or explain” is well understood in the UK and provides flexibility of approach for firms to apply the principles of the Code in a way which best meets their specific circumstances. In some jurisdictions, such a concept is less well understood, with the danger that even a principles based code becomes seen as a simple checklist for regulatory compliance purposes.

We also note that the FRC states that it would not wish for any reduction in the quality of governance at national level (paragraph 40). Where networks choose to apply the Code at a global level, we are not convinced that mandating similar, and potentially duplicative, structures (for example INEs) at a national level would in that case be necessary. We note that this would generally not be consistent with the corporate world, where (for example) the UK Corporate Governance Code (UKCGC) applies only at the parent company level.



### **How might the independence of the INEs be protected and demonstrated?**

We believe that INEs have an important role to play in ensuring confidence in audit. In order to do so, actual and perceived independence is essential. In that regard the Code refers to independence of INEs in relation to (a) the firm and (b) audit clients of the firm.

In relation to the former, we believe that independence is achieved if INEs have no other direct relationship with the audit firm other than under their contracts as INEs of the firm. We also believe that a perceived lack of independence would arise if an INE had a recent direct association with the audit firm of any significance. We do not believe that independence would be impaired by virtue of an INE holding a NED role at a non-audit client of the firm, although a similar role at an audit client should be precluded, if only to avoid a perceived threat to independence.

On the latter, particularly to the extent that INEs are accountable outside of the firm itself, a perceived (or actual) loss of independence would be safeguarded by applying similar restrictions to INEs in terms of family, business and financial relationships with audit clients as would be the case for partners in the audit firm. However, from a practical point of view, this might have a negative impact on the number of individuals willing put themselves forward for INE roles.

Consistent with our comments above on culture best being observed, we believe that the independence of INEs can similarly be gauged to an extent by virtue of direct interaction between INEs and the FRC and investor representatives. The extent of such interaction by INEs has evolved and increased over the period since implementation of the Code and we believe that there would be scope and benefit for this trend to be allowed to evolve naturally without regulatory intervention.

In terms of whether other provisions of the UK the UKCGC might enhance the perception of independence of INEs, we believe that term limits on the appointment of INEs would avoid any threat of over familiarity. We are less convinced that transparency around the remuneration of INEs would be relevant in contributing to this objective.

### **Should the firms follow a standard process in appointing INEs, including all such positions being publicly advertised? What engagement, if any, should investors in audited entities have into an audit firm's appointment of INEs?**

Generally we are not supportive of mandating a "standard process".

We believe firms should explain the relevant qualities and skills of INEs and how identification and selection has been managed, but that this should not be based on a prescriptive approach defined externally. In so far as investor involvement is concerned, the challenge is seeking such input in a representative way recognising the increasingly diverse ownership of UK listed companies, although consideration could be given to soliciting investor views, even if this might be somewhat random and / or potentially non-representative.

**Should the FRC or any other regulator have a role in the appointment of INEs, perhaps a right of veto?**

We would support the FRC (being the most appropriate regulator given its role as the competent authority in the UK) having a right of veto over the appointment of an individual INE.

**Which of these, if any, should be incorporated into the Code? Are there any other aspects of the Corporate Governance Code which should also be considered?**

We have commented above on aspects of the UKCGC which might enhance the perception of INE independence.

**To who should the Boards, INEs and public interest committees be accountable? How should this accountability be discharged, including to the FRC?**

We believe that accountability can be achieved firstly through transparency of the activity of the INEs (for example through direct reporting in the firms' transparency reports (TRs)) and also through regular interaction with investor representatives and the FRC.

**Should the Code include specific provisions on the firms' boards and public interest bodies engaging with and disclosing certain matters to regulators?**

At present there is no restriction on the FRC seeking information from, or requesting a meeting with, the firm or any of its members, its Board or INEs. Similarly, there is no practical barrier for the INEs requesting a meeting with the FRC to discuss matters which it considers relevant (which we believe has historically happened in practice).

Accordingly, we see no great merit in introducing such provisions and would leave the need for such interactions to the judgements of the firm, its INEs and the FRC.

**Is greater transparency sufficient? What else can be done?**

Since the introduction of the Code, we have sought to provide full and transparent disclosure as to the governance of, and quality controls within, our firm. We have also been very open to feedback received on our TR, although we have not received extensive feedback. We will, however, continue to consider how we can improve our reporting.

The FRC comments that stakeholders consider that the firms' TRs contain a lot of "boilerplate". In part we believe that this follows from the fact that the firms have detailed quality control procedures which are difficult to summarise if disclosure is to be meaningful. Much of the information on quality controls is unchanged from year to year, and we would suggest that such boilerplate might be reduced or eliminated if information which is largely unchanged from year to year could be disclosed on the firms' websites, with TRs left to report key changes and other matters relevant to the year under review.



The FRC suggests (paragraph 86) that TRs could be enhanced by the inclusion of success measures or KPIs. We agree with this and note that in our own TR we already give KPIs not only for financial performance but quality (internal and external quality reviews, regulatory investigations, etc), as well as other areas such as CSR activities. We agree that TRs should (continue to) include a report by the INEs on activity during the year. We also agree that it would be reasonable for TRs to include a statement by the firm's Board that the TR is "fair, balanced and understandable".

However, we are less convinced that the case for the corporate statement of longer-term viability carries over to audit firms, or whether it would add much. After all, the driver in the corporate world was transparency for owners about the *risk of loss* through corporate failure, and (in our view this is the most valuable part) it is about what management is doing to identify possible failure scenarios and to plan to avoid them. In the case of audit firms the primary audience of the TR is not the firms' owners but others with interest in the wider confidence as to the firm's audit quality, choice and the risk of a firm exiting the market. In this regard, it might be argued that a statement that the firm remains committed to providing statutory audit services to listed clients for the foreseeable future would be more valuable than a long term viability statement. As to such a statement adding little, the most obvious threat to longer term viability arises from risks that are already well-known to all concerned – loss of confidence (and client exodus) and / or large and successful claims against the firms – and in many respects the detail in TRs (such as the description of quality controls) is already designed to explain how a firm manages to mitigate such risks.

#### **Should the Code be applied to a wider group of firms?**

We recognise the challenge that the FRC has in ensuring proportionality of regulation here. Conceptually, extending the requirements to any firm which audited a listed company would be sensible. However, this would undoubtedly carry with it some burden on firms with few listed audit clients, possibly to such an extent that one or more firms might consider withdrawing from undertaking audits of such companies. This would clearly be inconsistent with any objective of the Code to promote choice. We believe that the current position is a pragmatic approach to balancing these conflicting priorities, but in reaching a final decision the FRC might seek specific evidence from firms with fewer listed audit clients on the current costs and benefits of compliance.

#### **Do you have any comments on the role of the FRC in this context?**

We believe that the absence of "ownership" of the Code has not had a particular impact on the extent of implementation of the Code by the firms nor on the ability of the FRC to discuss with firms aspects of its implementation or compliance. In that sense, there is perhaps no burning platform for change. However, we recognise that ownership by the FRC might be an important factor in increasing public confidence and in that context would be supportive of ownership by the FRC if this was the consensus from the current consultation.

#### **Do you have any further comments on any of the issues raised in this report?**

Please see our overall comments in the covering letter.