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Sir John Kingman
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9 November 2018

Dear Sir John

Arrangements for auditor procurement and remuneration

Thank you for writing to us with the opportunity to contribute to your consideration of the above in response to the additional question posed for your review by the Secretary of State for Business, Energy and Industrial Strategy.

As with many aspects of the current debate relating to the nature of audit and the structure of the audit market, we believe that the primary consideration should be audit quality. Care should be taken in making any changes so as to avoid unintended or unforeseen consequences. Further, any changes should not be to the detriment of audit quality (and ideally should enhance audit quality).

There are two themes to your questions, firstly the arrangements for the appointment of the auditor and secondly the remuneration of the auditor.

Appointment of the auditor

We believe that the Audit Committee (AC) is best placed to determine the firm which will deliver the highest quality audit but that it also needs to properly and demonstrably perform this task.

Any proposals which would result in the Board not being directly accountable for the appointment of auditors would run the serious risk of "moral hazard" and undermine the concept of the joint stock company governed by a unitary Board. The consequences of this would be very likely to outweigh any benefit.

However it is fair to say that the quality and effectiveness of ACs varies across the listed company audit market, including how they interact with the investment community and other interested stakeholders.

We believe that ensuring high quality standards for ACs (and Boards more generally) that are both consistently and demonstrably applied and transparent to broader stakeholders should be under the explicit and clear stewardship of a corporate regulator. We have made suggestions in relation to this in our previous submission to you.

In that response, we also suggested that the Corporate Governance Code could be enshrined in UK law and underpinned by more detailed standards (such as the US' Sarbanes-Oxley regime and a proportionate monitoring and enforcement regime). If such changes were introduced, these would clearly also be relevant to the activity of Boards and ACs in discharging their responsibilities in respect of the auditor.

In addition, we specifically noted that under current law there is a difference in the extent to which the FRC can hold directors to account depending on whether or not they are members of professional bodies. In our original submission to your inquiry, we suggested that this anomaly should be removed.

We also believe that some straightforward changes can be made that could have a significant, positive impact on how auditor procurement is viewed:

- Firstly, enhanced disclosure might include a requirement for the Board to publish, as part of its recommendation to shareholders, more extensive details as to the execution of a tender and the rationale behind its decision to propose the appointment for a specific firm and its remuneration.
- Secondly, greater dialogue between ACs and institutional shareholders around the process of auditor selection would be desirable. Larger companies might be encouraged or required to seek the views of the largest shareholders, and this process might form part of the enhanced disclosure referred to above.

In summary the quality, consistency and transparency of how ACs appoint an auditor including the quality and extent of engagement with shareholders should be monitored by a corporate regulator as part of its "macro-prudential" responsibilities in overseeing corporate Britain.

Remuneration of the auditor

We believe that it is important that auditors receive a fair fee to perform a high quality audit. The primary and overriding goal is the latter and the skills and resources to deliver it should determine the fee level. There is at least a perception that this may not always be the case.

This is difficult to prove and we believe large audit firms such as KPMG can and should do more to develop greater transparency in the performance management of its audit capability.

At an individual engagement level we do not believe that audits are cross-subsidised by other work and note that the extent of non-audit services to audited companies has been reducing over the years. At KPMG we have recently announced that we are working towards discontinuing the provision of non-audit services (other than those closely related to the audit) to the FTSE 350 entities we audit. This should further help improve transparency at an engagement level.

We acknowledge that individual audits have different levels of profitability reflecting normal operational and commercial pressures, although we do not believe that the level of profitability on any individual engagement (even if at the lower end of the range) would be a barrier to seeking to perform a high quality audit. This historically has been primarily due to the consequences for individuals (and the firm) of audits found to have fallen short of the expected standards being severe in terms of both financial sanctions and, whilst difficult to quantify, reputational damage.

We also note that some companies have adopted, as part of their tender processes, “fee blind” arrangements where the selection decision is made initially without access to proposed fee information. Such a practice might be further encouraged or mandated to reduce concerns about whether pressures on audit fees lead to lower quality audits.

Where there are pressures which reduce profitability to unacceptable levels, we believe that there should be a clear avenue to the audit regulator to discuss the challenges of the situation. In addition, the audit regulator might review circumstances where an auditor is replaced between mandatory rotation dates to satisfy itself that this was driven by quality rather than pricing (or other inappropriate) considerations. This could be part of that regulator’s overall monitoring responsibilities of audits of public interest entities.

Further, as part of its overall monitoring, the audit regulator might be tasked with considering firms’ approaches to pricing in audit tenders to ensure that both in individual tenders and in the round appropriate consideration has been given to the work (and therefore the resources) required to deliver a high quality audit rather than “low-balling” simply to win work at any cost. Whilst we do not believe such practices are prevalent, this additional scrutiny might provide confidence in this aspect of the tender process.

We also believe that current trends in strengthening the performance management and governance of audit practices as individual components within multi-disciplinary firms will increasingly highlight the profitability of those firms’ audit activity relative to that of the firm overall.

We set out our responses to your questions in the Appendix to this letter.

I hope our views are helpful to you and would be very happy to meet and discuss the content of this letter.

Yours sincerely

Bill Michael
UK Chairman and Senior Partner

Appendix – responses to individual questions

Are the present arrangements sufficiently responsive to the needs of consumers of accounts?

We believe they are.

The current position

The current position in the UK (for listed companies) may be summarised as follows. The Audit Committee (AC) is responsible, *inter alia*, for (i) overseeing the quality of the audit and the independence of the auditor and (ii) overseeing a tender process and making a recommendation to the Board on the auditor to be appointed (and the level of auditor remuneration). In turn, the Board makes a recommendation to the shareholders for their approval.

At the outset it is worth saying that our recent outreach to institutional investors has demonstrated that there is still a belief by some that it is executive management, in the form of the Chief Financial Officer, who holds the relationship with the external auditor and who makes the decision in audit tenders. Our experience is that this is not the case. Whilst usually executive management are involved in the tender process and their views taken into account by the AC and the Board, ACs (particularly at the larger end of the listed market) take control of the process and make the final decision on which firm to appoint. It would be helpful for market confidence for this to be clearer to all.

A number of observations might be made in relation to the current process:

- Firstly, the oversight and appointment of the auditor is but one area for which the AC has responsibility within a much broader remit of ensuring that the interests of shareholders are properly protected in relation to financial reporting and internal control. There would appear to be no obvious reason as to why the AC should be trusted to undertake these wider responsibilities in the best interests of the shareholders but not those in relation to the external audit / appointment of the auditor. It follows that if there are concerns about ACs discharging their responsibilities, this should be addressed by measures which enhance the capability and / or accountability of ACs more generally. We comment further on this below.
- Secondly, following on from this, dissatisfaction with the current arrangements in the UK appears to arise from a perception that the incentives of the AC (or indeed the Directors more generally) may not be aligned with those of the shareholders. In our view this ignores the strong incentive, in particular the maintenance of personal reputations and credibility, for non-executive directors to procure a high quality audit in order to avoid unidentified issues which might reflect badly on the company, its Board and themselves as individuals.

- Thirdly, at present shareholders have the opportunity to vote against the resolution to appoint the auditor recommended by the Board. That they frequently choose not to do so might suggest that, in practice, they support rather than do not support the recommendation by the Board. Alternatively, current voting practice may reflect the fact that shareholders believe that they do not have sufficient information in order to challenge the appropriateness of the Board's recommendation. The recent development of proxy advisers providing more differentiated recommendations on auditor appointments may change this.
- Finally, the approach taken in other jurisdictions with significant capital markets is broadly similar to that in the UK. This does not mean that this approach is "right" but rather that a more preferable appointment mechanism has not been identified.

Alternatives

It is worthwhile considering challenges to identifying a preferable alternative. In our view, the fundamental point is that the AC is best placed to make an informed decision. Companies are complex and varied in their businesses, business models, organisational structures, systems and controls, cultures, etc. The skills (both technical and "soft") and experience required to deliver a quality audit of any particular company are likely to differ and those inside the company will have far more knowledge of the specific features of the organisation to make an informed decision on the shareholders' needs than those outside even if it were possible for them to gain the same detailed knowledge of the company.

We believe, therefore, that the AC is best placed to determine the firm which will deliver the highest quality audit but that it also needs to properly and demonstrably perform this task.

Any proposals which would result in the Board not being directly accountable for the appointment of auditors would run the serious risk of "moral hazard" and undermine the concept of the joint stock company governed by a unitary Board.

Overall the question becomes whether the potential risk of an inferior auditor appointment decision being made is outweighed by the potential benefit of increased stakeholder confidence arising from the separation of the appointment decision from those within the company. We do not believe that it would be.

Focus on strengthening Boards and Audit Committees

Rather than introducing separate and specific arrangements for the appointment and setting remuneration of the auditor, the focus should be on ensuring high quality

standards for ACs (and Boards more generally) that are both consistently and demonstrably applied and transparent to broader stakeholders.

We believe this should be under the explicit and clear stewardship of a corporate regulator. We have made suggestions in relation to this in our previous submission to you.

In that response, we also suggested that the Corporate Governance Code could be enshrined in UK law and underpinned by more detailed standards (such as the US' Sarbanes-Oxley regime and a proportionate monitoring and enforcement regime). If such changes were introduced, these would clearly also be relevant to the activity of ACs in discharging their responsibilities in respect of the auditor.

In addition, we specifically noted that under current law there is a difference in the extent to which the FRC can hold directors to account depending on whether or not they are members of professional bodies. In our original submission to your inquiry, we suggested that this anomaly should be removed.

Shareholder views

Notwithstanding our views above, we recognise that the audit opinion on company accounts is addressed to shareholders of the company and, therefore, the question of whether the current arrangements for the appointment and setting remuneration of the auditor are appropriate is best answered by shareholders or, as their representatives, large institutional investors.

Do the present arrangements risk auditors being too close to company management, and insufficiently incentivised to pose suitable scepticism, objectivity and challenge?

In practice we do not believe this to be the case, not least because current mandatory firm and partner / senior staff rotation requirements guard against this. Nor do we believe that the nature of the relationship with non-executive directors and executive management would be significantly altered were the appointment of the auditor to be by a party other than as at present (i.e. the shareholders on the recommendation of the Board following a process run by the AC).

We believe the professional training received by auditors instils the need for scepticism, objectivity and professionalism. Moreover, one key incentive which is overlooked is the potentially significant financial consequences of, and the stigma associated with, adverse findings from a routine quality review or from the enforcement process of a regulator (which is increasingly a matter of public record following investigations by the Competent Authority) and the consequential impact on individual careers which is considerable. This provides a powerful incentive – if any is needed over and above the

professionalism referred to above – for individuals and audit firms to avoid any suggestion of audit failure on any individual audit appointment.

Could present arrangements in practice contribute to a situation where audit work is under-priced, under-resourced or cross-subsidised from other work?

At an individual engagement level we do not believe that audits are cross-subsidised by other work and note firstly that, particularly for larger listed companies, the extent of non-audit work to an audited company has been reducing over the years and secondly that going forward there will be caps on fees following the of provisions of the Ethical Standard implementing the EU Audit Regulation[1].

That said, individual audits have different levels of profitability reflecting normal operational and commercial pressures – usually the level of the audit fee agreed with the AC in advance and the outcome of negotiations during or on completion of the audit in respect of time and costs representing variances from those planned at the outset.

Tender processes provide, particularly at the larger end of the market, an in-depth view of the company, its financial reporting processes, internal controls and finance functions and allow participating firms to price audit knowledgeably.

However, we do not believe that the level of profitability on any individual engagement (even if at the lower end of the range) would be a barrier to seeking to perform a high quality audit. As explained above, the consequences for individuals (and the firm) for audits found to have fallen short of the expected standards are severe in terms of financial sanctions and, whilst difficult to quantify, reputational damage.

Where there are pressures which reduce profitability to unacceptable levels, we believe that there should be a clear avenue to the audit regulator to discuss the challenges of the situation. In addition, the audit regulator might review circumstances where an auditor is replaced between mandatory rotation dates to satisfy itself that this was driven by quality rather than pricing (or other inappropriate) considerations. This could be part of that regulator's overall monitoring responsibilities of audits of public interest entities.

Further, as part of its overall monitoring, the audit regulator might be tasked with considering firms' approaches to pricing in audit tenders to ensure that both in individual tenders and in the round appropriate consideration has been given to the work (and therefore the resources) required to deliver a high quality audit rather than "low-balling" simply to win work at any cost. Whilst we do not believe such practices are

[1] See FRC's Ethical Standard, paragraph 4.34R.

prevalent, this additional scrutiny might provide confidence in this aspect of the tender process.

We also believe that current trends in strengthening the performance management and governance of audit practices as individual components within multi-disciplinary firms will increasingly highlight the profitability of those firms' audit activity relative to that of the firm overall.

Are there alternative arrangements which would be feasible and workable in practice?

As explained above we believe that any enhancements should be focussed on increasing the capability and consistency of ACs overall rather than on specific changes in the arrangements for the appointment and setting the remuneration of the auditor alone.

However, in so far as alternatives are concerned, there appear to be a range of alternatives and for completeness we provide our observations below.

Increased transparency

Increased transparency might include a requirement for the Board to publish, as part of its recommendation to shareholders, greater details as to the execution of a tender and the rationale behind its decision to propose the appointment for a specific firm and its remuneration. This increased transparency would be relatively easy to implement.

In addition, greater dialogue between ACs and institutional shareholders around the process of auditor selection would be desirable. Larger companies might be encouraged or required to seek the views of the largest shareholders, and this process might form part of the enhanced disclosure referred to above. That said, we know that some ACs have sought the views of the institutional investors with a large holding in the company being audited as part of planning audit tenders, though with little success. It seems to us that encouraging greater dialogue between ACs and institutional investors would provide more insight and trust in the tender process.

We are supportive of such measures which increase transparency of the existing arrangements.

Increased intervention.

There are clearly degrees of intervention. At one end of the spectrum, this might be simply a requirement for recommendations on the auditor appointment to be approved by a regulatory authority. This could be the Competent Authority for audit (currently the FRC in the UK) albeit this could be regarded as a conflict with other regulatory responsibilities. However, clarity would be required as to the grounds on which the regulator would not give approval in circumstances where a valid recommendation had been made to, and approved by, shareholders.

As an alternative, it could be mandated for certain listed companies / PIEs (or a subset thereof) to include a third party on its auditor selection panel (the "independent expert approach"). This third party might, for example, be selected by the company or allocated by a regulatory authority from a panel of knowledgeable individuals established for this purpose. The nature of this role would also have a range of options. For example, the role might simply be as an observer to the process with access to all of the inside information available to the AC, possibly accompanied by a requirement to report externally (i.e. to shareholders) on the process. This would provide shareholders with increased and a more independent perspective on the quality and objectivity of the tender process. The role could be extended to attend key presentations alongside the AC (or even management). A further iteration might involve the third party meeting with key institutional investors along the lines described above.

Whilst for the reasons set out we do not believe that change in the responsibility for appointment of the auditor and setting its remuneration is necessary or desirable, were the outcome of your review to conclude otherwise we believe that the "independent expert approach" would nevertheless largely preserve the existing accountability of the AC.

However, there would be significant challenges to be overcome. These challenges might include (i) the initial selection of panel members; (ii) the basis of allocation of panel members to individual audit tenders; (iii) addressing potential confidentiality and inside information issues; and (iv) the remuneration of panel members.

Removal of the Audit Committee (and the Board) from the auditor selection process

This would be the most extreme of the obvious alternatives to the current arrangements and carry the highest risk of the selection of an auditor not best suited to undertake the audit with the consequent risk to audit quality.

The key questions to overcome would be firstly who would make the appointment (or recommendation to shareholders) and secondly how to ensure that those tasked with the decision (or recommendation) might have sufficient knowledge on which to base the decision. Whilst the first could be overcome relatively easily, albeit not without cost to implement, by placing the responsibility on the FRC or another body established for the specific purpose, it is harder to see how the latter issue can be addressed effectively.

We would therefore not be in favour of such an approach.

If auditors of some or all major companies of public interest were to be appointed in a different way, by whom could this be done in practice?

As outlined above, we do not believe that responsibility for the appointment (and oversight) of the auditor should be removed from the AC.

As we have set out above, if there are concerns as to discharging of responsibilities of ACs that this should be addressed by enhancing AC capability and / or accountability.

What capability would need to be built up to do this competently? How could this be properly governed?

Under the “independent expert approach”, individuals from a panel would supplement a company’s internal committee overseeing the tender process. To be effective, it would be essential that members of this panel had relevant skills – namely an in-depth knowledge of the corporate reporting and audit processes. It seems likely, therefore, that this panel would comprise experienced professionals currently serving as non-executives or recently retired from such roles, or recently retired senior auditors.

Appointment to the panel would be critical. Alternatives would be (a) by a nomination committee comprising representatives of major investors or (b) by a regulatory body (such as the Competent Authority for audit) based on nominations from investors. Either mechanism would need to be accompanied with appropriate transparency over the nomination and selection process.

In any case we consider that the ultimate decision should remain with shareholders.

How could this be done in a way which commanded the confidence of users of accounts, such as investors? How could investors' rights of approval over auditor appointments be protected in any new arrangement?

Under the “independent expert approach”, limited change would be needed in the form of investors’ rights. The Board of a company would continue to make a recommendation to shareholders, but this recommendation would be accompanied by a report on the tender process by the independent member allocated to oversee the tender process.

How would any alternative body take into account the views of Audit Committees?

Under the “independent expert approach”, the views of the AC would still form the basis of the recommendation put to shareholders.

What companies should any new arrangement apply to? Is there a case for piloting an alternative approach, for instance in relation to cases where deficiencies in audit have been identified?

We believe that any changes need to be proportionate. Clearly the larger the population of companies brought into scope for any revised arrangements, such as the

"independent expert approach", the greater the number of individuals who would be needed to form any panel to meet the demand.

One model, as the question outlines, would be to only apply alternative arrangements where "deficiencies in audit" have been identified. But it is not clear what this means, who would define whether there were deficiencies and whether this small subset would alleviate any shareholder concerns. One possibility would be for shareholders to be given the right to vote on whether such an appointment should be made at the time a tender is initiated.

Whilst the most experienced non-executives tend to be attracted to the largest companies, suggesting that any action might be more appropriate for smaller companies, another alternative would be to apply the "independent expert approach" to those companies with the greatest impact on the UK capital markets – for example those companies in the FTSE100 or FTSE350. On the basis that a company tenders its audit every ten years, this would amount to 10 or 35 tenders a year on average and the panel from which experts might be selected could be sized accordingly.