KPMG LLP
15 Canada Square
London E14 5GL
United Kingdom

Bill Michael
UK Chairman and Senior Partner
Tel +44 (0) 207 3115 292
bill.michael@kpmg.co.uk

Darren Jones, MP
Chair Business, Energy and Industrial Strategy Committee
House of Commons
London
SW1A 0AA

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Dear Mr Jones,

Business, Energy and Industrial Strategy Committee Inquiry into Delivering Audit Reform

Thank you for the opportunity to contribute to your Committee's inquiry into *Delivering Audit Reform*. I am writing on behalf of my firm, KPMG LLP in the UK (KPMG).

We are supportive of your inquiry's stated aim: to help map out a path for implementing meaningful reform of the UK's audit industry following the various recent inquiries. This is a once in a generation opportunity to reset our profession and we believe that the time is right for reform.

The Reviews[1] that are the focus of both this inquiry and the Committee's previous future of audit inquiry share a common goal: to ensure that the UK has a well-functioning, world-class corporate reporting ecosystem, with a resilient audit market which meets stakeholder expectations and operates in the public interest.

We support the general direction of the Reviews and want to see the main elements turned into firm proposals for audit reform as soon as practically possible. But there is important work to do in order to get there. Each review has considered audit through a different lens, focussing on different elements of the overall landscape. Collectively they have proposed over 150, sometimes overlapping, recommendations which need to be assessed, synthesised and prioritised to produce a cohesive package of proposals.

We face a complex challenge, exacerbated by the backdrop of the Covid-19 pandemic and the UK's exit from the EU. It is vital that we and the other affected stakeholders work closely together towards our common goals and we welcome your inquiry as a forum in which to do this, as well as a mechanism to maintain the momentum for reform.

[1] The Reviews comprise Sir John Kingman's Independent Review of the FRC (Kingman Review), the CMA's Market Study on Statutory Audit Services (CMA Market Study) and Sir Donald Brydon's Review on the Future of Audit (Brydon Review)

Taking action now, recognising and responding to stakeholder concerns

Since I appeared before your committee and wrote to your predecessor in January 2019, my firm has introduced a number of changes, often unilaterally, which we believe will help achieve the ultimate goal of improved audit quality and increased public confidence in audit. These include:

- Moving substantially towards achieving the ‘operational separation’ envisaged by the FRC in the principles it recently published, through the introduction of a range of measures around enhancing our governance and partner performance management focused on audit quality;
- Continuing to learn and develop, investing heavily in audit quality through our Audit Quality Transformation Programme. By the end of 2020, we will have made a cumulative investment of £200 million, transforming our audit practice over a three-year period. To put that into context, we have added more than 2,000 people to our audit practice since 2017;
- Discontinuing the provision of non-audit services to FTSE350 companies we audit ahead of the FRC’s new Ethical Standard mandating a similar approach industry-wide; and
- Seeking to make our audit reporting more useful to stakeholders offering “graduated findings” in our audit opinions and a new type of independent report for inclusion in preliminary announcements.

Whilst these are important steps, which in our view go a long way in addressing concerns over auditor objectivity and independence, we recognise that more needs to be done both within our own firm and across our profession to restore the public’s trust and we are committed to continuing to work towards this.

Further consultation and legislation

We remain determined to make changes ourselves where we can. But there are many wider measures which require multi-party action, further consultation and refinement prior to enaction and / or regulatory or legislative initiatives. For example where some of the individual proposals are concerned (especially around complex areas such as the Internal Controls Framework and fraud), there is a need to address a lack of specificity which will require further thought and / or consultation in their design.

It is also essential to recognise there needs to be a fair division of responsibility and legal accountability between each of the parties in corporate governance and reporting; it is not only auditors, but management, directors and regulators who have a responsibility here. There is a risk that audit reform will never be completely successful if we only focus on audit without considering the whole financial reporting and corporate governance environment.

Our profession must continue to drive the UK's prosperity

We are proud of our profession. We believe that, collectively, accountancy firms, including the large multi-disciplinary practices such as our own, bring many strengths and benefits to the UK: through the support and advice we provide to both the private and public sectors; via targeted initiatives around social mobility; by directly employing tens of thousands of people across the country; and as a result of our providing training which provides the basis for successful professional careers for many thousands more.

We want to continue to play a full and active part in driving the future prosperity of our country. I believe that the reforms under discussion, if implemented sensibly and proportionately with support, co-operation and a constructive approach from all stakeholders, provide an opportunity to reshape our profession for the better. I welcome the opportunity your inquiry presents to progress this agenda.

* * *

We set out our responses to your questions in Appendix 1 below. In the interests of brevity, we have not sought to set out our views on individual recommendations from the Reviews as included in our responses to other consultations and inquiries. We've included a list of the submissions that we have made in Appendix 2.

Yours sincerely

Bill Michael
UK Chairman and Senior Partner

Appendix 1 – Responses to Committee's questions

About KPMG in the UK

KPMG LLP, a UK limited liability partnership, operates from 21 offices across the UK with approximately 17,600 partners and staff. It is the UK member firm of KPMG, a global network of professional firms providing Audit, Tax, Legal and Advisory services.

Responses to Committee's questions

1 Do the proposals from the three reviews of audit fit together as a coherent package that can deliver meaningful reform?

1.1 Although the Reviews address different aspects of the landscape, collectively they broadly share common goals; to ensure that the UK has a well-functioning, world-class corporate reporting ecosystem with a resilient audit market which meets stakeholder expectations and operates in the public interest.

1.2 We support the general direction of travel of the Reviews, which provide a once in a generation opportunity for meaningful reform. At a high level the reviews provide the basis for a coherent reform package and we hope the core recommendations becomes firm proposals as soon as practically possible. But there is a lot of work to do in terms of assessing the individual proposals and then sequencing, prioritising and implementing them over a long-term programme to ensure meaningful reform is achieved with no unintended consequences.

1.3 We welcome, and believe it is critical for a successful reform, that audit (or auditors) are not the sole focus of the Reviews, which place additional responsibilities on a variety of participants in the corporate reporting process and direct certain recommendations towards addressing governance and reporting as a whole (see Question 6).

1.4 The Reviews' recommendations sometimes overlap one another and there are a number where they are not sufficiently specific to enable implementation without further definition, and therefore appropriate consultation is important for the full benefits to be realised. For example, both the Kingman and Brydon Reviews made reference to the potential benefits of introducing reporting requirements around internal controls frameworks and business resilience, both of which we support but will need to be developed fully prior to implementation.

1.5 Additionally, the Reviews have conflicting views on the UK auditor liability regime. The BEIS Committee[2] recognised that it was a barrier for competition while the

[2] "The Future of Audit" report by BEIS Committee dated 26 March 2019
https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf

CMA Market Study[3] concluded that no change to liability framework is necessary. Further, the Brydon review recommended an extension of what an audit should cover, but with no clear recommendation on how auditor liability should change. We believe that changes in legislation should be made to the liability regime to remove some of the barriers to entry faced by challenger firms, in support of greater choice and potentially competition and increase the resilience of the audit market.

1.6 There is a need to establish clear priorities. In total, the Reviews have over 150 individual recommendations so the challenge is to identify those which will 'move the dial' in terms of enhancing audit quality and the confidence it engenders in stakeholders. This is separate to the question of a more general cost-benefit analysis of the overall package of reform addressing both audit and other areas of corporate governance and reporting.

1.7 Additionally, there are a number of areas with which we disagree in principle, generally because we consider they are likely to have a detrimental impact on audit quality (for example joint audits or Brydon's recommendation to publish Audit Committee minutes with a 12-18 months lag) or where we consider that any benefits of introduction are, at best, marginal making the introduction of the measures unwise. We discuss joint audits more in our response to Question 3.

2 Which reforms can be delivered without legislation and what progress has the FRC made in implementing such reforms ahead of future legislation?

2.1 We believe there are areas where progress can be made ahead of legislation. As a firm we have already implemented changes and will continue to do so. We outline below a number of relevant key areas of audit reform where both KPMG and other stakeholders (including the FRC) have made changes without legislation. These include the audit product and its quality; auditor objectivity, independence and financial sustainability; and choice and competition in the large audit market.

The audit product and its quality

2.2 We are committed to enhancing audit quality and our Audit Quality Transformation Programme is at the heart of this work, aimed at improving audit quality and the experience of our people. By the end of 2020, we will have made a cumulative investment of £200 million in transforming our audit practice over a three-year period. We have added more than 2,000 people to our audit practice

[3] "Statutory audit services market study" by the CMA dated 18 April 2019
https://assets.publishing.service.gov.uk/media/5d03667d40f0b609ad3158c3/audit_final_report_02.pdf

since 2017 – in the front line, in support, in project management and in technical functions.

2.3 We have sought to enhance the audit product we offer, making our audit reporting more useful to stakeholders by pioneering "graduated findings" in our audit opinions in 2014, which we are actively promoting with the companies we audit. More recently in 2019, we introduced a new type of independent report that companies can publish with preliminary announcements. However, while we have seen some uptake of these offers (as of May 2020 we had published graduated findings in the case of 14 companies we audit and three companies have engaged us to produce our independent report for inclusion within their preliminary results), there is a limit to what we can do without legislation to ensure consistency across the industry.

2.4 The Brydon Review contains numerous recommendations on how the audit product could be developed further to make it more relevant for stakeholders. We are looking to progress the following without legislation:

- Enhancing the fraud and climate risk training incorporated within our continuous learning
- Offering assurance to audited entities over alternative performance measurements, as well as KPIs used for calculating executive remuneration (including ESG metrics)
- Enhancing our audit report (beyond graduated findings) to be more meaningful for users.

2.5 There is also an opportunity for management and directors to make proactive changes within their companies to start driving reform without legislation. For example, companies could commence developing their internal controls further or enhance their reporting on going concern / viability in line with business resilience statements. Without changes made by the companies themselves (or legislation), auditors cannot effectively provide the additional assurance envisaged by the Reviews.

2.6 The FRC has also revised certain International Standards of Auditing (ISAs) in relation to going concern and laws and regulations, which places additional responsibilities on auditors in their assessment of a company's ability to continue as a going concern or of its areas of non-compliance. Given the public interest in audit quality, we believe that the FRC could provide greater transparency over what it regards as good audit practices as suggested by the Brydon Review[4].

Auditor objectivity and independence and firms' financial sustainability

2.7 An important way in which there has been progress in auditor independence and objectivity is in relation to non-audit services. KPMG was the first firm to commit to discontinuing the provision of non-audit services (other than those closely related to the audit) to FTSE350 entities which we audit. Subsequently the FRC released their Revised Ethical Standard which prohibits the provision of non-audit services to a much larger population of companies than the previous Ethical Standard, which KPMG has adopted.

2.8 Another recommendation made by the CMA Market Study was operational separation, which addresses not only auditor objectivity and independence, but also the financial sustainability and resilience of the UK audit market. The FRC has made significant progress in this area and has published objectives, outcomes and principles for operational separation, on which we have engaged constructively.

2.9 We support operational separation as a piece of a wider programme aiming to reform audit and corporate governance and ahead of the final principals being published, we took the following steps:

- Created a separate Audit Board
- Ensured closer alignment between the renumeration for audit partners with audit quality
- Enhanced the degree of segregation of our audit business, bringing specialists into the audit function or charging on an arms-length basis where specialist services are required from elsewhere within the firm
- Increased transparency around engagement with key stakeholders, notably shareholders, regulators and audit committees with, for example, the introduction of our Annual Audit Review.

Choice and competition in the large audit market

2.10 The recommendations in relation to competition are harder to achieve without legislation. None of the steps we have taken to date addresses the concern relating to the level of concentration of the large audit market amongst a small number of firms as we believe that this is not something that any firm individually (or indeed firms collectively) can address.

2.11 We are aware that the FRC has developed thinking on mandatory managed shared audits, which will enable 'challenger' firms to participate in the audits of

[4] Section 26.1.2 of the Brydon review.

larger companies. We will continue to engage constructively with BEIS and the FRC on ideas for how to build capacity in the large audit market. See response to Question 3 which includes our considerations of shared audits.

Areas where legislation is necessary

2.12 While progress has been made as noted above, there are areas where we believe legislation is necessary in order to make consistent and effective progress and we would welcome its introduction as soon as practically possible. These include, but are not limited to, the following:

- The new statutory body conceived by the Kingman Review (ARGA), and to provide it with the powers felt necessary for that role
- A wider scope and purpose of audit beyond the financial statements, for example assurance over other areas within a company's Annual report and a wide range of corporate behaviours. This will also need careful consideration on issues such as auditor liability (see Question 1)
- New types of company reporting as recommended by the Brydon Review, including public interest statements, fraud, internal controls and business resilience.

3 Will the reforms proposed by the audit industry itself address the failings that were identified by the reviews and the BEIS Committee's Future of Audit Report?

3.1 The "failings" identified by the Reviews in relation to audit may be summarised as the audit product and its quality; auditor objectivity and independence; and choice and competition in the large audit market. We believe that in some areas, industry movements have already started to address these concerns (as set out in Question 2), but there are areas which still require further consultation and/or legislation.

The audit product and its quality

3.2 We believe the initiatives that have been implemented to date (see Question 2) go some way to address concerns over the audit product and its quality. The Brydon Review as a whole and the individual proposals it contains need further definition and subsequent consultation before the industry moves forward in relation to a number of recommendations. Key areas include:

- Clearly defining the purpose and scope of an audit
- Development of a UK internal controls framework. We welcome the introduction of this; however, we believe mandatory assurance should be provided over statements made by management on their internal controls operating

effectiveness as there is little incentive for management to report any control deficiencies identified. This would increase stakeholder confidence over the accuracy of such statements

- Clarity in relation to management and auditor's responsibilities in relation to detection and reporting of fraud
- Broader KPI assurance and how these could be consistently reported across different companies in the same industries to allow comparability
- Development of resilience statements and clear expectations to avoid unnecessary "boiler plate" language

Auditor objectivity and independence and firms' financial sustainability

3.3 Again, progress has been made to date as commented on within Question 2 in relation to auditor objectivity and independence.

3.4 We have made good progress towards operational separation (see Question 2), engaging constructively with the FRC as to the design of our governance and operating structure to align with their principles, objectives and outcomes for operational separation. We will continue our open dialogue with the FRC and contribute to industry discussions to agree the details around implementation.

3.5 It is essential that there is a level playing field on which the firms operate and that the process results in sustainable arrangements that are achievable, transparent, comparable and consistent across the firms. Subject to this being achieved, we believe this model should allow us to continue to deliver high quality audits in the UK whilst continuing to benefit from the specialist knowledge and greater financial resilience derived from a larger, multi-disciplinary organisation.

Choice and competition in the large audit market

3.6 We have always maintained that competition in the large audit market is fierce, notwithstanding that there are a small number of active and successful participants. Equally, we have acknowledged that it would be desirable if there was greater choice with more active participants - but that the current market structure has arisen through market forces. Early indicators suggest that the smaller firms are starting to take on more listed audit engagements, indicating that the audit market may not need regulatory intervention. However, if the pace of change is not considered fast enough, the challenge is to identify the most effective mechanism to drive change more quickly; it is important in our view, however, to recognise that each of the recommendations to date have drawbacks and limitations as set out below.

3.7 We do not agree with the CMA's recommendation for joint audits as a mechanism by which to enhance choice and competition. We believe it presents significant risk to audit quality and gives rise to practical and cost challenges. Many other stakeholders have also expressed this concern.

3.8 We are aware that the FRC is developing its thinking on shared audits. We will contribute to this discussion and if a pilot scheme is launched, we would be happy to participate, recognising that this is an area worth exploring. We view shared audits as a less disruptive alternative to joint audits, although we recognise there are cost implications.

3.9 If shared audits are chosen as the most appropriate route, the shared auditor's role would need to be meaningful and significant and consider the following:

- *Extent and significance of allocated work* - this would need to be of relevance and interest to senior management and the Audit Committee of the audited entity to ensure visibility thereby providing the opportunity to build credibility and demonstrate capability and expertise
- *Location of allocated work* - there needs to be an appropriate level of "domestic" (UK) work that is shared if the purpose is to build capability and capacity in the UK market. Shared audits are more likely to be successful if a practical solution can be found, for example sharing the UK legal entities audited within a group.

3.10 Regardless of any "required" allocations of work to the shared auditor, the principal auditor would need to be satisfied with the work undertaken by the shared auditor. Clearly this will involve significant review by the principal auditor as well as potentially undertaking their own work. In either case, this will lead to an element of duplication and therefore increased cost. For this reason, we believe it will be necessary to legislate any changes as there is little incentive for a company to choose to have a shared audit.

4 When will the Government bring forward its proposals and the necessary legislation where required?

4.1 Whilst we are supportive of early legislation to implement an appropriate and proportionate package of reforms, the question of intended timing of legislation is one for BEIS. We hope legislation is introduced as soon as practical with sufficient time for appropriate consultation.

4.2 However, depending on the timescale envisaged, it may be worth considering whether separate legislation to establish the ARGA and provide statutory backing for its powers sooner would be beneficial and could allow progression of other areas of reform which ARGA could do without any further legislation.

Appendix 1 – Responses to Committee's questions

5 Will audit reform help track progress made by companies in meeting the UK's Sustainable Development Goal commitments and in particular Net Zero?

5.1 Overall, our view is that audit reform could help track progress in this area if assurance over ESG metrics was made mandatory (either provided by the statutory auditor or other independent auditor). This would help drive consistency and improve accuracy, as well as deliver outcomes across all industries recognising the widespread stakeholder demand for this. However, there is no legislation currently mandating this and reporting of ESG metrics is inconsistent across companies.

5.2 In the absence of legislation, we are taking a number of actions starting now and in the coming years, including the following:

- Encouraging audited entities to enhance the level of relevant ESG disclosures within their Annual Reports
- Mandating climate risk audit training for Responsible Individuals (RIs) and introducing supplementary guidance for audit teams
- Continuing to enhance our risk assessment procedures on how climate risk considerations are incorporated into our audit engagements from the planning stage
- Including climate risk considerations into reporting to those charged with governance or within audit reports where relevant

Additionally, we have recently announced[5] our commitment as a firm to become Net Zero by 2030, setting ambitious new environmental targets approved by the Science-Based Targets initiative, recognising the importance for action within our own firm, not just the entities we audit.

5.3 Many listed companies already provide information on ESG factors in their Strategic Reports which is useful to investors and other stakeholders in evaluating how companies are managing the risks and opportunities arising from a changing environment and society to drive long-term value creation and sustainable business models. However, this information differs across different companies and will likely differ from information required to track national progress.

5.4 In order to track progress, a reporting framework needs to be introduced, providing clarity on:

- which of the Sustainable Development Goals (SDGs) need to be tracked;
- how to measure performance against the relevant SDG by individual entities; and
- Directors' responsibilities in relation to ESG reporting

[5] KPMG announcement: https://home.kpmg/uk/en/home/insights/2020/06/environmental-performance.html

5.5 If reporting requirements were adapted to include incremental information to be disclosed, this would come with a financial cost. For example, taking only the climate component of the SDGs, the FCA in its consultation on the adoption of the Task Force on Climate-related Financial Disclosures (TCFD) framework estimated an aggregate one-off implementation cost for UK premium issuers of £120m and an annual cost of £50m thereafter[6]. This is not to say that such reporting requirements should not be introduced, simply that there should be proper consideration of the costs and benefits of doing so. This should also consider the reporting of (and assurance over) other voluntary disclosures, such as ethnic diversity, which are important to stakeholders.

5.6 Overall, audit reform has an important part to play, but there is need for wider discussion in relation to a common framework for companies to report against, as well as mandatory assurance, so that there is consistent measurement and reporting across companies to allow progress to be tracked accurately.

6 How will audit reform fit with wider corporate governance reform?

6.1 We believe it is key that reforms to audit fit into wider corporate governance reform. We have made the point in our responses to the Reviews that a variety of parties have important roles to play in corporate governance and reporting process. The failure of any of these parties to discharge their responsibilities diligently and effectively can undermine confidence in the governance, corporate reporting or audit of a particular company or in the capital markets more generally. It is therefore critical that reforms, especially to regulatory and governance frameworks ensure that all the players are held to account and they are progressed in a timely and co-ordinated way.

6.2 The Reviews recognise this wider landscape and they each include recommendations other than in respect of "audit reform". The Kingman Review focuses on reform of the FRC and includes its responsibilities in relation to corporate governance and corporate reporting; the CMA Market Study includes recommendations in relation to the responsibilities and conduct of audit committees; and the Brydon Review recommends new responsibilities for audit committees and corporate reporting.

6.3 The greatest causes of public concern generally relate to unexpected corporate failure or undetected fraud. We welcome the recommendations in relation to reporting on fraud and internal controls within the Brydon Review, which recognises the importance of the responsibilities management and directors have in the first instance. We believe this could be enhanced further by having, for example, a corporate "Fraud Officer" in companies who has the responsibility to

[6] CP20/3: Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations (see https://www.fca.org.uk/publications/consultation-papers/cp20-3-proposals-enhance-climate-related-disclosures-listed-issuers-and-clarification-existing).

implement and oversee effective fraud controls, as well as lead investigations into suspected misconduct and reporting to the regulator where necessary.

6.4 In our view, the risk is not so much that the other recommendations (i.e. those in relation to "corporate governance reforms") do not "fit" with audit reform, but rather that these other reforms are not progressed in a timely or meaningful way, resulting in over-reliance on audit and auditors for matters where responsibility is primarily with others.

6.5 On this point, the Reviews make recommendations in a number of areas where we consider that implementation in parallel with those recommendations in relation to audit is particularly important, including[7]:

- Consideration being given to a strengthened framework in relation to internal controls and reporting thereon by directors
- The extension of the FRC's enforcement powers to include any individuals in certain roles (for example directors or certain senior management) rather than such powers only applying to members of professional accounting and actuarial bodies. We believe the regulator should have responsibility to independently assess whether directors are fit and proper (similar to the PRA's Senior Manager Regime)
- Review of the UK definition of a Public Interest Entity
- Addressing various concerns in relation to the design and implementation of the UK's existing capital maintenance regime. Given the economic challenges faced by Corporate Britain following the Covid-19 pandemic, closer review by both the auditors and the regulator of companies under stress may be necessary, for example panel reviews ahead of results announcements could be introduced to give investors more confidence in the results

6.6 While recommendations in relation to audit are being advanced, there is no clarity on any of these other key areas at this time, without which there can be no plan for implementation. There is a risk that audit reform will never be completely successful if we only focus on audit without the whole financial reporting and corporate governance environment.

[7] The areas highlighted are illustrative and are not intended to be a complete listing of recommendations which we believe should be implemented in relation to areas other than audit.

Appendix 2 - Relevant KPMG submissions to reviews, consultations and inquiries

Our submissions to Sir John Kingman's review of the Financial Reporting Council, the Competition and Markets Authority's market study into the statutory audit market, the Business, Energy and Industrial Strategy (BEIS) Select Committee's inquiry into the future of audit, Sir Donald Brydon's review of the quality and effectiveness of audit and BEIS's initial consultations on the Kingman and CMA proposals are available on this page on the KPMG website (https://home.kpmg/uk/en/home/insights/2018/11/future-of-the-profession.html)