

Auditor Regulation - Implications of the EU and wider reforms

**Department for Business Innovation & Skills
(BIS)**

The Audit Commission's response

Introduction

- 1 The Audit Commission is pleased to respond to this discussion on reform proposals arising from the new European Directive on Audit. Our experience comes from appointing auditors to local public bodies in England. We hope that by drawing on that experience we can contribute to the government's thinking about how to implement the Directive and how the wider framework for auditor regulation could be improved in light of these changes.
- 2 The Audit Commission will close on 31 March 2015. However, its statutory functions around auditor appointment and the setting of audit fees will transfer to Public Sector Audit Appointments Limited (PSAA).
- 3 Our response focuses on the questions in section 4.3 of the discussion document which are about audit fees and non-audit services and the issues raised in section 4.4 concerning the duration of auditor engagements.

Answers to specific questions

4.3 Audit fees and non-audit services

Question 18: Do you agree that the provisions of Article 4 of the Regulation on the cap on non-audit services should be included in amendments to the FRC's ethical standards for auditors?

- 4 Yes. It should be noted that auditors in the Audit Commission regime have wider responsibilities, including concluding annually on an organisations' arrangements for securing efficiency, economy and effectiveness in the use of resources ('Value for money'), and so are not currently directly comparable with private sector audits, including audits of PIEs. The Audit Commission currently applies its own requirements on its auditors based on the ethical standards, but modified to take account of these additional responsibilities.
- 5 Once new arrangements for auditor appointments described in the Local Audit and Accountability Act 2014 ('the Act') commenceⁱ local public auditors will be regulated by the FRC and a Recognised Supervisory Body.

ⁱ Scheduled changes in the Act to the statutory process of auditor appointment to local public bodies in England will come into force subject to Commencement Orders. The changes are expected to come into force during 2017. The government does, however, retain the option to extend the contracts, and the current regime, for up to three years. Any announcement about extension will follow the 2015 general election.

- 6 The Commission actively assists auditors in preserving independence by acting as an independent appointment authority and thereafter monitoring actual or perceived threats to auditor independence. The Commission defines a de-minimis threshold for non-audit work, above which auditors must seek Commission approval.
- 7 Guidance also informs auditors that the Commission will not normally approve applications to carry out non-audit work where the total value will exceed 50 per cent of the annual audit fee.

Question 19: What issues, if any, do you consider arise from the application of the provisions on the cap on non-audit services?

- 8 The Commission believes that audit firms would need to strengthen internal monitoring systems to ensure compliance with the cap. The FRC and other supervisory bodies will need to maintain the increased focus on this area that has been seen in recent years.
- 9 There is a sufficiently robust consultancy market in this country to allow purchasers of non-audit services of a value that exceeds the cap to source quality advice without difficulty.

Question 20: Do you agree that the Member State options in Article 4, to set more stringent requirements on the cap and on the auditor's independence where the total fee income from a PIE exceeds 15% of their total fee income overall, should be capable of being applied by the FRC in its ethical standards for auditors?

- 10 We agree that this should be capable of being applied by the FRC in its guidance to auditors.

Question 21: Do you agree that the FRC should have the ability to exempt an audit firm from the 70% cap for up to two financial years on an exceptional basis and on application by the firm?

- 11 We agree there may be special circumstances where exemption is appropriate. Our experience is that a documented process by which applications are made for exemption would help ensure consistency.

Question 22 Do you agree that the subject matter of Article 5 of the Regulation on the blacklist of non-audit services, including the possibility of setting more stringent requirements, should be included in amendments to the FRC's ethical standards for auditors?

- 12 Yes.

Question 23: What issues, if any, do you consider arise from the application of the provisions on the blacklist of non-audit services? If there are any, how do you consider these should be addressed?

- 13** The Commission's guidance stresses that checking against any 'blacklisted services' should not be the sole test when considering non-audit work proposals against ethical standards and risks to independence.
- 14** It needs to be made clear in guidance that any 'blacklisted services' are not the only kinds of work that can compromise auditor independence.

Question 24: Do you agree that implementation of the revised requirements on ensuring and documenting auditor independence in the 2006 Directive should be implemented primarily via the ethical standards, with amendments to the existing legislation as necessary only to:

- underpin the standards? And,
 - introduce simplifications for audits of small non-PIEs?
- 15** Yes. We believe a single source of guidance provides less possibility of error, mistake, misinterpretation or misapplication.

Question 25: Do you agree that the existing framework on disclosure by PIEs in notes to their accounts of the audit and non-audit fees they paid their auditor should be adapted, to ensure public disclosure of the information the auditor is required to provide to the competent authority under Article 14 of the Regulation?

- 16** Yes, in our view auditors, regulators and the users of accounts will all benefit considerably from this.

4.4 Tendering and duration of audit engagements

Questions 27-34:

- 17** The Commission, in its role as the appointing authority, has always been mindful of the need for auditor independence. A key part of this has been through a strategic rotation programme.
- 18** There are changes to auditor appointment arrangements for local public bodies arising from the Local Audit and Accountability Act 2014, which may be relevant in this context.
- 19** From financial year 2017/18 (or possibly 2020/21 if the government decide to extend the current Audit Commission contracts) local public bodies will take over responsibility for appointing their auditors.
- 20** Local public bodies will select from one of three options for auditor appointment:

- independent appointment, overseen by independent auditor panels;
- participation in collective procurement arrangements, overseen by a single auditor panel; or
- opting into audit appointment arrangements provided by a 'specified person' approved by DCLG, entry to which scheme removes the requirement for an auditor panel.

21 The various relationship possibilities between auditor panels, a specified person and audit committees is a matter still being considered in the relevant government departments. A significant number of local public bodies will be major audits. Developments around policy in this area may therefore be relevant to your current discussions in respect of auditor regulation and the implications of EU and wider reforms. It is for this reason we draw this to your attention.