

29 January 2010

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Dear Ms O'Sullivan

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Consultation Response – audit firms providing non-audit services to listed companies that they audit

The Audit Commission (the Commission) welcomes the opportunity to comment on the APB's consultation paper.

In submitting these comments, we recognise that the consultation focuses primarily on the provision of non-audit services to listed companies. However, the Commission hopes that its long experience in regulating the provision of non-audit services to local public service bodies by appointed auditors within the Commission's regime may help the APB. In this respect, however, it should be noted that the scope of audit in the Commission's regime is wider than that in the private sector, so we have to consider threats not only to the opinion on the financial statements but also to auditors' annual value for money conclusion.

As the regulator of the audit regime for local government and local NHS bodies, the Commission has developed and applied a clear framework on the provision of non-audit services by auditors. I attach the current version of this framework for information (appendix).

In our response we have addressed only those questions where we feel our own experiences may be of assistance to the APB.

Q1 (a)

Do you think the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?

Yes, we believe that there is a general perception that the provision of non-audit services may impair auditor's objectivity. Clearly, however, the profession has recognised this perception and has taken steps to address this by putting in place a robust framework of ethical standards, including prohibition in certain circumstances. The question for the APB now is whether these safeguards need to be strengthened.

Q1 (b)

Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have affected audit quality?

No. Within its own regime, the Commission is confident that the framework it has put in place for regulating the provision of non-audit services has mitigated effectively the threat to audit quality. While the Commission only considers formally requests from appointed auditors to carry out non-audit work where the fee is the higher of £30,000 or 20 per cent of the total audit fee, we estimate that the amount spent on non-audit services is very significantly lower than the 71 per cent of the audit fees of the FTSE 100 companies in 2008.

Q3

In the light of your answer to questions 1 and 2, do you think that there needs to be a change in the approach taken by the APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit? Please give reasons for your view.

The Commission believes that the APB's Ethical Standard 5 (ES 5) already provides a helpful framework to guide auditors through the decision making process about whether or not to provide non-audit services. The most common threats arising from the provision of non-audit services are:

- Self interest threat;
- Self review threat;
- Management threat; and
- Advocacy threat.

ES 5 has identified safeguards to reduce or eliminate these threats and identifies some specific types of non-audit services that auditors should not be undertaking.

The FRC's Combined Code, which applies to listed companies, imposes specific duties on Audit Committees including a requirement for them to develop and implement policies covering the engagement of the external auditor to supply non-audit services. The Combined Code also requires the annual report to include an explanation to shareholders of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

The mechanisms applied by the Commission to safeguard auditors' independence reflect the fact that within its regime it discharges some of the functions of an audit committee, for example in relation to the appointment of auditors and setting of fees.

The APB could consider whether it would be appropriate to apply the Combined Code's requirements in this area to apply to a wider range of entities.

Q4

If you think that there should be a change in the current arrangements what would you advocate?

The Commission considers that the Board and the Audit Committee are the 'first line of defence' in this area. So it may be appropriate to strengthen safeguards at this level, for example by requiring specific non-audit service engagements to be approved by an audited body's Board or Audit Committee (subject perhaps to a de minimis value).

We do not believe it would be appropriate to impose an arbitrary financial limit on the value of non-audit work, as this is a complex area and individual cases will need to be considered on their merits in the light of all the available evidence. However, intuitively there must come a point where the cumulative value of non-audit work may be so high relative to the audit fee that a perception that auditor independence has been compromised is difficult to counter. The practical problem is defining at what point this arises, but we suspect it is significantly above the 71 per cent current average.

We welcome the fact that the APB is looking at this issue and look forward to seeing its conclusions in due course.

Yours sincerely

Martin Evans
Managing Director, Audit

Extract from the Audit Commission's Standing guidance for auditors

Integrity, objectivity and independence

- 3.15 It is recognised that the appointed auditor may be well placed to carry out certain types of additional work for the audited body cost effectively. This is consistent with the Commission's strategic aim of bringing to bear the skills and resources of its appointed auditors to promote improvements in local services.
- 3.16 Additional work can be undertaken, without prior approval from the Director of Audit Policy and Regulation, if an appointed auditor is satisfied that:
- performance of such additional work will not compromise his/her, or the firm's, independence nor be reasonably perceived by members of the public to do so; and
 - the value of the work in total, in any audit year, does not exceed a *de minimis* amount.
- 3.17 The Commission has set the *de minimis* amount as the higher of £30,000 or 20 per cent of the total audit fee (excluding fees for the certification of grants and returns) payable by the audited body to the appointed auditor. If the value of the work in total for an audited body in any financial year would exceed the *de minimis* amount, the appointed auditor should obtain approval from the Director of Audit Policy and Regulation before agreeing to carry out the work.
- 3.18 However, it must be emphasised that the *de minimis* specified by the Commission is a threshold for reporting purposes only. Whether the value of the proposed work is below or exceeds the *de minimis* threshold should not affect the appointed auditor's judgement as to whether carrying out the proposed work would, or could reasonably be perceived to, compromise the independence of the auditor or the Commission.
- 3.19 Audit suppliers are required to establish procedures to identify and address promptly any potential breaches of these requirements.