



AUDITOR GUIDANCE NOTE 1 (AGN 01) GENERAL GUIDANCE SUPPORTING LOCAL AUDIT

ICAEW welcomes the opportunity to comment on the *Auditor Guidance Note 1 (AGN01) General Guidance Supporting Local Audit* published by NAO on 28 July 2016.

This response has been prepared by the Professional Standards Directorate of ICAEW and reflects the views of ICAEW as a regulator. ICAEW is the largest Recognised Supervisory Body (RSB) and Recognised Qualifying Body (RQB) for statutory audit in the UK, registering approximately 3,500 firms and 9,300 responsible individuals under the Companies Acts 1989 and 2006. ICAEW is also the largest RSB in England in respect of local public audit registering 8 firms and 95 key audit partners under the Local Audit and Accountability Act 2014.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the National Audit Office's consultation on the draft revisions to Auditor Guidance Note 1 (AGN01) General Guidance Supporting Local Audit.
2. Given the tight timescales, we are only providing high-level comments on key issues which we have identified. We would have provided further, more detailed and considered comments on the AGN if there had been more time within which to consult within ICAEW and with our member firms and provide a more detailed response.
3. We note that the NAO has asked for comments on a new section within the AGN01 on Integrity, Objectivity and Independence, however our view is that there are other elements within the AGN 01 which have an impact and therefore we have provided comments on the whole AGN.

MAJOR POINTS

Clarification of terms within AGN01

4. On page 3, in the first paragraph, we note the line that states, '*the term 'have regard to' means that the auditor is expect to comply with the guidance issued by the NAO or provide reasonable explanation within audit documentation as to why not*'. ICAEW's view is that the definition goes beyond what is acceptable in legislation. A recent English legal case of R on the Application of London Oratory School v The Schools Adjudicator¹ analysed the meaning of 'have regard to' in the context of a requirement to have regard to guidance. The judge reviewed relevant legal precedent and concluded '*'have regard' ... [means] take the ... Guidance into account and if they decide to depart from it, they must have and give "clear reasons" for doing so ... 'have regard to' involves a greater degree of consideration than merely to 'consult' ... but plainly does not mean ... 'follow', or 'slavishly obey'. I would add that the "clear reasons" referred to ... must in my judgment objectively be proper reasons, or legitimate reasons*'.
 5. The AGNs should have the same standing as the FRCs Practice Notes and Bulletins, which are intended to be 'persuasive rather than prescriptive and...indicative of good practice.'
 6. In light of this, ICAEW suggests the following amendment to the paragraph 'have regard to means that auditors **take the guidance into account**. If the auditors decide to depart from the guidance, then they need to provide a reasonable explanation within audit documentation as to how the engagement standards have been complied with.' In ICAEW's view this creates sufficient flexibility to allow for auditors to make a judgement, specifically in the application of the ethical standards.

Principles based approach

7. ICAEW was a representative on the Code of Audit Practice Stakeholder Group when the new regulatory framework was being developed. It was always the intention that both the Code of Audit Practice and the related guidance would maintain a principles-based approach. Our view is that the changes in AGN 01 in relation to the ethical standards come across as too prescriptive and are easily interpreted as a 'rules' based approach which we do not agree with.
8. The new regulatory framework includes the Financial Reporting Council (FRC) and the Recognised Supervisory Bodies (RSBs). The FRC is responsible for setting the auditing and ethical standards in the UK and both the FRC and the RSBs are responsible for monitoring

¹ https://www.judiciary.gov.uk/wp-content/uploads/2015/04/oratory_school-170415-final-2.pdf

audit firms compliance against these standards. ICAEW's view is that it is for these bodies to set the standards for audit firms as they do for auditors under the statutory audit regime.

9. Whilst understanding the need for guidance to support auditors, the FRC's revised Ethical Standard 'applies to audits of financial statements and other public interest assurance engagements in both the private and the public sectors.'² Additionally, the Financial Reporting Council – Scope and Authority of Audit and Assurance Pronouncements³ notes that 'the heads of the national audit agencies in the UK have chosen to adopt the ethical, engagement and quality control standards issued by the FRC for audits as the basis of their approach to the audit of financial statements.'
10. For this reason, ICAEW accepts that there is a need for the guidance to clarify how the Ethical Standard should be interpreted for the public sector, but disagrees with it going as far as defining all public bodies as public interest entities (PIEs) for this specific purpose. What ICAEW does agree with is that there should be some differentiation within the sector, as there is in the Companies Act regime, and that it would be sensible for major local audits to be treated as equivalent to PIEs and subject to the additional requirements placed upon auditors of Public Interest Entities and Other Listed Entities within the Ethical Standard. Putting further guidance into place which goes beyond the FRCs requirements is onerous and could have unintended consequences (paragraph 12)
11. We therefore recommend that the AGN01 follows the original intention set out by the Code of Audit Practice and maintains a similar principles-based approach. Our view is that the ethical standard should be consistently applied across the public and private sector, with the AGN simply providing some clarification as to when it would be appropriate to apply the additional requirements placed upon auditors of Public Interest Entities and Other Listed Entities within the Ethical Standard, in a public sector context.

Unintended consequences

12. ICAEW's view is that any perceived over-prescription in the draft AGN01 has a number of potential unintended consequences:
 - 1.1. Gold-plating of one sector in England, going beyond that set out by the FRC and the other national audit agencies.
 - 1.2. Restricting the ability of firms to make the professional judgements that they currently do under ethical standards, when ensuring that the overarching principal of the ethical standard, namely that the firm, its partners and all staff shall behave with integrity and objectivity in all professional and business activities and relationships and remain free from conditions and relationships which would make it probable that an objective, reasonable and informed third party would conclude their independence had been compromised, is achieved.
 - 1.3. Duplicating safeguards that already exist at bodies such as Foundation Trusts, where they are expected to have their own policy on the procurement of non-audit services which will involve scrutiny by the Audit Committee and approval by the FT Council of Governors.
 - 1.4. Potentially undermining existing practice in other areas.
 - 1.5. Impact on judgements about what is included within non-audit services (e.g. limited assurance work on quality reports, grant claims, the audit of consolidated charities).
 - 1.6. Sufficiency of audit firms and KAPs in the market to enable mandatory auditor rotation every 5 years.
 - 1.7. Giving a role to both PSAA and local bodies, in relation to being charged with oversight of the auditors' independence, which was never intended under the regulatory regime, while

² <https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Revised-Ethical-Standard-June-2016.pdf>

³ [https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Scope-and-Authority-of-Audit-and-Assurance-pro-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Scope-and-Authority-of-Audit-and-Assurance-pro-(1).pdf)

making no mention, perhaps in error, of the role of the FRC and RSBs in monitoring auditor independence.

Definition of Public Interest Entities

13. During the development of the regulatory framework, we discussed at length the definitions of major local audits in relation to this framework. The AGN appears to suggest that all bodies are PIEs for the purpose of applying the ethical standards. In ICAEW's view, this was never the intention during the discussions of the regulatory framework. Our view is that applying the PIE definition to all local public bodies is a step too far. Indeed, taking such a view could well have ramifications for audit monitoring.
14. It was our understanding that the major local audit definition was introduced to recognise that there is differentiation within the sector (which in turn should surely be reflected in the ethical requirements).
15. We note that the revised ethical standard very specifically defines public interest entities, via the FRCs glossary⁴, and states that *'No other entities have been specifically designated in law in the UK as 'public interest entities'*. The preface to the Ethical Standard also states that it *'applies to audits of financial statements and other public interest assurance engagements in both the private and public sectors.'*
16. The AGN01 is drafted in such a way that it appears that the application of the caps in relation to non-audit services applies to all public bodies audits. However, such a cap does not apply to non-public interest entities. This maybe an error in the drafting, however, currently as drafted this is the implication. ICAEW's view is that it needs to be made clearer that the definition of PIEs in a public sector context, and therefore the application of the additional requirements in the ethical standards, only applies to those bodies that fall within the definition of major local audits.
17. We also note that the smaller bodies' assurance work has also been included within this framework. Given that the limited assurance work is not an audit, ICAEW is of the view that the ethical standards would not apply. Any guidance that the NAO wishes to apply to the smaller bodies' sector, would be better done as an appendix to the AGN, in the same way as the Code is drafted, to avoid any confusion.

Blanket caps

18. Using a blanket threshold of 70% as the limit for non-audit services, whilst being higher than the current 50% threshold applied by PSAA, in our view treats all public bodies as PIEs that would be subject to the same restrictions. We do not believe that this is appropriate. Firms will have their own policies on designation of their clients that are PIEs within their public sector client base, which are typically the larger councils and NHS bodies. In ICAEW's view, we support the application of the same threshold (of 70%) as would apply to PIEs in the FRC's ethical standards, but only its application to major local audits and entities that audit firms designate as being PIE equivalents.

Terms of appointment

19. We are unclear why the existing terms of appointment are being cited as best practice in determining the future model (page 10). In implementing a new regulatory framework, the government's policy objective was to mirror, as far as possible, the Statutory Audit regime, rather than reintroduce elements of the previous Audit Commission regime. Additionally, any future terms of appointment issued by local public bodies or the specified person, should only

⁴ [https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Glossary-of-Terms-\(auditing-and-ethics\)-June-2016.pdf](https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Glossary-of-Terms-(auditing-and-ethics)-June-2016.pdf)

seek to apply the ethical standards, Code of Audit Practice and associated AGNs. Any implication that such terms of appointment could set lower caps only risks creating a number of sub-frameworks within the regime.

20. Page 10 also suggests that ‘those charged with governance of auditors’ independence are responsible for establishing and advising local bodies on policies and arrangements for ensuring compliance with the relevant ethical requirements.’ We are not sure if this will work in practice. Ethical standards are not for local bodies to ensure compliance with; they are for auditors to ensure compliance with, and for RSBs and the FRC to monitor. It is then the auditors’ role to notify those charged with governance (e.g. the audited body) of potential ethical issues and the safeguards they have implemented (not the other way round).
21. Appendix 1 discusses the auditor appointment process. We are unclear whether it is the role of the NAO to prescribe the auditor appointment process.

Definition of non-audit fees

22. The AGN makes reference to audit-related services and other assurance engagements such as assurance on grant claims or returns under the ‘tri-partite’ assurance arrangements that are not carried out under the Code. It then states that any such assurance engagements would count towards the cap on non-audit services. But it makes an exception for certification work on housing benefit subsidy claims which is required under transitional arrangements and there is a statutory obligation for this work. We would suggest that there is an analogous situation with respect to other certification or assurance work that was previously carried out under certification arrangements made by the former Audit Commission. This would include work on certifying housing capital receipts for DCLG and certifying Teachers Pension Returns for the Department for Education. Another assurance engagement that should arguably also be excluded from any cap would be work that auditors carry out to report on the Quality Accounts prepared by NHS trusts. Trusts are required to obtain assurance on their Quality Accounts under Department of Health guidance, and this was previously included as work to be carried out by auditors as it was specified as mandated work by the Audit Commission. There are some non-audit services that are required by law or by a rule (or other guidance or requirements) issued by a regulatory body (which in this context would include government departments and grant-paying bodies) and therefore, in our view, these should be exempt for the purposes of determining any cap on the provision of non-audit services.
23. It is clarification such as this on the application of the ethical standards in a public sector context that the AGN should seek to provide.

Relationships and political activities

24. We think that there may be some loose wording that needs to be tightened up around the paragraphs in relation to relationships and political activities where all the staff or all senior staff within the firm are brought into the requirements of the relationship or activity, rather than just the audit engagement partner, audit team and those directly involved with the audit client.