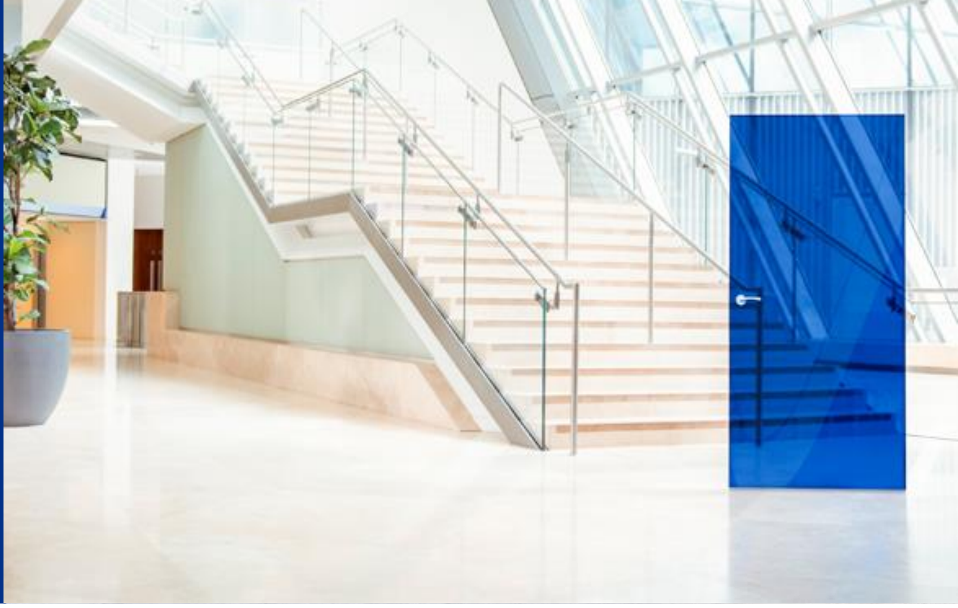
FRC principles for operational separation of audit practices

The Audit Committee Institute
Part of the KPMG Board Leadership Centre



The FRC has announced its principles for operational separation of the audit practices of the Big Four firms. The stated objectives of operational separation are to improve audit quality by ensuring that people in the audit practice are focused above all on delivery of high-quality audits in the public interest; and to improve audit market resilience by ensuring that no material, structural cross subsidy persists between the audit practice and the rest of the firm. The FRC note that in pursuing these objectives, they seek to ensure that audit remains an attractive and reputable profession and increase deserved confidence in audit.

The FRC's desired outcomes are

— Audit practice governance prioritises audit quality and protects auditors from influences from the rest of the firm that could divert their focus away from audit quality.

— The total amount of profits distributed to the partners in the audit practice should not persistently exceed the contribution to profits of the audit practice.

— Individual audit partner renumeration is determined above all by contribution to audit quality, taking account of the degree of difficulty and risk of the audits.

— Audit practice financial reporting is transparent to the regulator and public, allowing effective monitoring of audit practice performance and financial resilience.

— The culture of the audit practice supports audit quality and the public interest by encouraging ethical behaviour, openness, teamwork, challenge and professional scepticism/judgement.

— Auditors should act in the public interest and work for the benefit of shareholders of audited entities and wider society; they are not accountable to audited entities' executive management and are not (nor viewed as or considered to be) consultants.

The 22 principles - grouped under a number of headings: governance, scope, financial, remuneration, transparency, accountability, etc – are summarised below.

Firms should provide a transition timetable to ensure that each of these principles is implemented as soon as practicable and they are met implemented in full by 30 June 2024 at the latest.

Governance

— An Audit Board should be responsible for providing independent oversight of the audit practice, with a focus on improving audit quality. The firm's most senior governance body (the board) should be responsible for providing oversight with a focus on the pursuit of audit market resilience.

— The Audit Board and the management of the audit practice should establish and promote a culture supportive of the public interest.

— The Audit Board should be chaired by and have a majority of Audit Non-Executives (ANEs).

— At least one of the ANEs should not be a firm INE ('doubly independent'). The Chair of the Audit Board should be an ANE and may also be a firm INE but should not chair any other governance body in the firm.

— At least one ANE on the Audit Board should have experience of audit at an appropriate level of seniority, either as a former auditor or consumer of audit services.

— The Audit Board should oversee the firm's audit strategy to ensure that it is consistent with pursuit of the FRC's objectives and desired outcomes (see earlier). It should be able to require changes where it considers that the strategy is not consistent.

— The Audit Board shall be consulted by the Senior Partner of the firm with respect to the appointment of the CEO of Audit and have the opportunity to object to the appointment. The Audit Board may seek the removal of the Audit CEO.

— Remuneration of audit partners and audit partner promotion should be overseen by a sub-committee of the Audit Board comprising ANEs only. Admissions of partners will remain a partnership responsibility. However, the selection of candidates to be admitted to the partnership to practice as audit partners will be overseen by the Audit Board.

— Appointments of individuals to the Audit Board should be subject to a formal, rigorous and transparent procedure.

— The Audit Board should have the authority to commission reviews from Internal Audit to support their oversight role.

Scope of the separate audit practice

— Statutory audit should be provided by the audit practice. The audit practice may also provide:

  – permitted audit-related and non-audit services to PIE entities audited by the firm;

  – audit-related and non-audit services to non-PIE entities audited by the firm which are not prohibited; and

  – services to other entities not audited by the firm that are either included on the "white-list" in the Ethical Standard or are non-audit assurance engagements where the recipient of the assurance is a third party (e.g. a regulator, government or lender) separate from the client of the audit firm.

— Specialists supporting audit (and other permitted services provided by the audit practice) can be located elsewhere in the firm provided their services are supplied and charged to the audit practice on an arms-length basis.

— Partners and staff in the audit practice should spend the majority of their time on work in the audit practice. This does not preclude the secondment of staff to other areas of the business (in either direction) or the appointment of audit partners to firmwide leadership roles.

— Revenues from statutory audit work should make up the majority of the revenue of the audit practice.

Financial

— Transactions between the audit practice and the rest of the firm should be conducted and priced on an 'arms-length' basis.

— The audit practice should produce a separate profit and loss account with overhead absorption on an equitable basis.

— As part of its annual assessment, the FRC will assess whether the overall distribution of profits to the partners in the audit practice and to those in the rest of the firm is consistent with their respective contributions to firm profits, with no material, structural cross subsidy persisting in either direction.

Remuneration of partners

— Remuneration policies and practices for audit partners should be designed to reward good audit practice-related behaviours. Good audit quality, along with positive leadership and behaviours should be rewarded and the firm should have measures in place to reduce reward in cases of poor audit quality.

Transparency

— Firms should publish information about the governance of the audit practice and the terms on which transactions occur between the audit and non-audit business and the nature of these transactions.

— Firms should produce annually a separate profit and loss account for the audit practice. This should be assured by the firm's auditors.

Accountability

— Firms should appoint one individual (or a small number of individuals with clearly defined and non-overlapping responsibilities) from the Senior Management team to be responsible and accountable for ensuring the outcomes and principles for operational separation are delivered, embedded and monitored.

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