

Date: 11 October 2016

Item: Local Audit and Accountability Act 2014 – Appointment of External Auditors

This paper will be considered in public

1 Summary

- 1.1 This report updates the Committee on changes to the arrangements for appointing external auditors for TfL and its subsidiaries. The paper considers the options available under the Local Audit and Accountability Act 2014 and makes a recommendation for compliance.

2 Recommendation

- 2.1 **The Committee is asked to approve the proposed arrangements for establishment of a new, independent Audit Advisory Group with responsibility for the selection and appointment of the external auditor to TfL and its subsidiaries commencing with the audit of the 2018/19 financial year.**

3 Background

- 3.1 The Local Audit and Accountability Act 2014 (the Act) abolished the Audit Commission and established transitional arrangements for the appointment of external auditors and the setting of audit fees for all local government and NHS bodies in England. This includes the GLA, TfL and the other functional bodies. On 5 October 2015 the Secretary of State for Communities and Local Government determined that the transitional arrangements for local government bodies would be extended by one year to also include the audit of the accounts for the 2017/18 financial year.
- 3.2 TfL's current external auditors are Ernst & Young LLP, who were originally appointed to undertake the audit for the financial years 2015/16 and 2016/17. This contract has since been extended by one year to 2017/18 by Public Sector Audit Appointments Limited (PSAA), the successor body to the Audit Commission. When the transitional arrangements come to an end on 31 March 2018, TfL will be required to appoint its own auditor.
- 3.3 Under the previous regime, the Audit Commission, and more recently PSAA, only had responsibility for the appointment of an auditor for the TfL Corporation and TfL Group financial statements (as their remit extended only to the Local Authority). Transport Trading Limited (TTL) and its subsidiaries

were obliged to undergo a separate tender and appointment process for the appointment of their auditor. Under the new arrangements, a single, combined tender and appointment process for both the TfL and TTL Groups is preferred.

4 Options for Local Appointment of External Auditors

4.1 The Act sets out four broad options for the appointment of an auditor. These are:

- (i) to opt-in to a Sector Led Body appointed by the Secretary of State under the Act;
- (ii) to set up a Joint Auditor Panel together with other local authorities responsible for auditor selection;
- (iii) to ask another authority's Auditor Panel to carry out the functions of the authority in question; and
- (iv) to make a stand alone appointment through a TfL-only Audit Panel.

4.2 Our views on the advantages and disadvantages of each are considered below.

5 Option (i): Opt-in to a Sector Led Body

5.1 PSAA, the company operating the existing transitional arrangements for auditor appointments, has been specified as an appointing person under the Local Audit (Appointing Person) Regulations 2015 (the Regulations). This gives it the power to make auditor appointments from 2018/19 on behalf of bodies who opt in, in accordance with the regulations. It is envisaged that the process for appointing auditors to individual local authorities would be much the same as under the previous regime. There would be no fee levied directly by the PSAA to the local authorities for appointing auditors or for managing the arrangements. It is instead proposed that these costs will be recovered through audit fees set by the PSAA.

5.2 As is currently the situation, the PSAA would only be able to appoint an auditor for the audit of the Corporation and the TfL Group financial statements. The TTL Group and individual subsidiaries are not covered by the Regulations and would therefore still need to tender separately for their audit. This has proved problematic in the past, as from a practical perspective it would be highly inefficient and costly to have different auditors for the TfL and TTL Groups. The auditor for the TfL Group would not be able to place reliance on an audit of TTL companies performed by an unrelated firm and would need to re-perform much of the same audit work. The alternative would be for the TTL Group to appoint the same auditor as had been appointed by the PSAA. However the PSAA would not involve itself in agreeing fees for the TTL Group audit. These fees would need to be negotiated separately by TTL whose ability to secure value for money would therefore be compromised.

- 5.3 In addition, TfL is significantly different in terms of size and nature of activities to the generality of local authorities. The PSAA, being a distant, completely independent body, is unlikely to consider TfL's needs separately from those of other local authorities in its auditor selection process. This option is not therefore recommended.

6 Options (ii) and (iii): Set up a Joint Auditor Panel together with other local authorities responsible for auditor selection; or to ask another authority's Auditor Panel to carry out the functions of the authority in question

- 6.1 TfL differs in terms of both size and nature of activities to other eligible Local Authority bodies to such an extent that its considerations and priorities in selecting an auditor are also significantly different. It is therefore not considered generally beneficial or appropriate for TfL to set up a Joint Auditor Panel with unrelated local authorities or to ask another authority's panel to carry out its Auditor appointment duties.
- 6.2 There is scope for investigating the possibility that a Joint Auditor Panel could be established between TfL and other functional bodies of the Greater London Authority. This would have some cost saving advantages in terms of reducing the duplication of effort in tendering separately for audits for each of the constituent bodies and also the costs of running separate Auditor Panels. It would be necessary to consider how any Joint Panel would be suitably constituted and empowered to be able properly to take into account TfL's particular circumstances, risk profile and audit requirements. It would also require the scope of the Joint Auditor Panel to be extended to include responsibility for the appointment of an auditor to the TTL Group of companies to avoid the issues highlighted in section 5.2 above.

7 Option (iv): Make a Stand Alone Appointment through an TfL-only Audit Panel

- 7.1 Given the limitations of options (i) to (iii), it is recommended that TfL make a stand alone appointment of an auditor. This would give TfL the scope to select panel members with an appropriate skill set and understanding of TfL's particular circumstances that will enable the panel to make an informed choice as to the most suitable audit firm for the TfL Group. It also provides TfL the flexibility to set up a panel with the authority to combine both the TfL and TTL audit tenders into a single exercise - thus maximising the efficiency of the selection process whilst minimising the risk of incurring unnecessary audit fees.

- 7.2 In order to make a stand-alone appointment. TfL would need to set up an Auditor Panel, to be formally known as the 'Audit Advisory Group' (AAG). Under legislation, the minimum number of members that the AAG must have to be quorate is three. However, as there must be a majority of independent members as well as an independent chair, and for a meeting to be quorate there must be a majority of independent members present, it is proposed that the AAG be comprised initially of a minimum of five individuals to allow for unavoidable absences etc. Three of these appointees are to be independent.
- 7.3 Independent members for this purpose specifically exclude board members, officers or employees of the local authority or any entity connected with it (which for TfL includes all constituent bodies of the Greater London Authority and any entity with a key contractual relationship) and close families and friends thereof. It also specifically excludes anyone who would have been considered connected at any point within the previous five years.
- 7.4 AAG members should have a certain level of specific knowledge and experience to ensure that the panel carries out its duties effectively. The Auditor Panel regulations state that the authority may therefore pay an allowance and "reasonable expenses" to panel members to attract candidates with the appropriate skills and experience.

8 The functions of the AAG

- 8.1 Under the Act the AAG must advise the authority on:
- (a) the selection and appointment of the auditor;
 - (b) the contents of TfL's policy on obtaining non-audit services from the auditor;
 - (c) any proposal by TfL to enter into a liability limitation agreement;
 - (d) maintaining an independent relationship with its auditor; and
 - (e) the outcome of any investigation of an auditor's resignation from office, if this occurs, or on any proposal to remove an auditor from office.
- 8.2 The AAG is also included under legislation in any discussions and receipt of relevant documents in relation to public interest reports.
- 8.3 There is no specific mention under legislation of an Auditor Panel carrying out oversight of contract management for the life of the auditor appointment, but guidance issued by the Department for Communities and Local Governments suggests it would be helpful for the AAG to be involved in this role.

9 Relationship with the Audit and Assurance Committee

- 9.1 The AAG and the Audit and Assurance Committee (AAC) should have a close working relationship. There are three overlaps between the duties of the AAG and the AAC – being in respect of:
- (a) the quality and effectiveness monitoring role undertaken by the AAC which will feed into the AAG's contract monitoring;
 - (b) the AAC should be able to express an opinion on the selection and rotation of the auditor; and
 - (c) the AAC is responsible for reviewing TfL's policy on non-audit work carried out by the external auditors, whereas the AAG has to advise TfL on the contents of the non-audit work policy.
- 9.2 The terms of reference of the AAC will need to be reviewed in detail as part of the process of drafting terms of reference for the AAG to ensure the respective responsibilities of each body are clearly defined.

10 Financial Implications

- 10.1 The annual audit fee for TfL Group and Corporation for the year ending 31 March 2017 has been set at £155,925. This excludes the fee for the audit of TTL and its subsidiaries, currently £750,000 per annum. It should however be noted that current fee levels for the TfL audit are based on discounted rates offered by audit firms in return for substantial market share. When the contracts were last negotiated nationally by the Audit Commission they covered NHS and local government bodies and offered maximum economies of scale. This would not be the case going forward. An increase in the level of fees for the TfL Group element of the audit is therefore anticipated, although until the tender process is underway the quantum of this increase cannot be determined. It is also hoped that this increase would be mitigated by a reduced fee for the audit of the TTL Group. There will also be additional costs incurred in setting up an Auditor Panel. This will include the cost of recruiting independent appointees, servicing the Panel, and, as indicated in section 7.4, paying members fees and allowances.
- 10.2 As set out in section 3.3 TfL is currently obliged under the existing auditor appointment regime to run a separate tender process for the appointment of auditors to TTL and its subsidiaries. It is anticipated that the new appointment will allow both tender processes to be combined. Incremental costs of running a bidding and tender evaluation process and letting a new contract for the combined TfL Group are therefore anticipated to be kept to a minimum.

11 Next Steps

- 11.1 Although the first year for which an auditor needs to be appointed under the new regime is 2018/19, under Section 7 of the Act TfL has until December 2017 to appoint an auditor. In practical terms this means that the AAG will need to be established by spring 2017 at the latest in order that the contract can be awarded during 2017. It is therefore proposed that the terms of

reference for the new AAG be prepared with the selection and appointment process getting underway by December 2016. This is with a view to the AAG being in place by April 2017.

- 11.2 It is proposed that the AAG be set up initially with five members, including an independent chair. A recruitment process should be entered into to select the three independent members; and it is proposed that the Chairman of the Audit Committee and TfL's Chief Finance Officer be appointed as the non-independent members.

12 Conclusion

- 12.1 The Committee is asked to approve the establishment of an Audit Advisory Group by April 2017, with responsibility for the appointment of an external auditor to TfL and its subsidiaries for the audit of financial year 2018/19 and future years.

List of appendices to this report:

None

List of Background Papers:

None

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