Think Ahead ACCA

Practice Note 10: Audit of financial statements and regularity of public sector bodies in the United Kingdom

Consultation issued by the Public Audit Forum in 2022

Comments from ACCA
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GENERAL COMMENTS

ACCA welcomes the opportunity to respond to the Public Audit Forum's (PAF) consultation draft on Practice Note 10 (PN10). We commend the PAF on a comprehensive implementation of updated International Standards on Auditing (ISAs) and the International Standards of Quality Management (ISQM) as issued and amended by the Financial Reporting Council (FRC). We are pleased to note extensive application guidance that will assist public sector auditors in the United Kingdom.

We believe that the updates proposed generally reflect the updated UK ISAs to the letter and spirit intended by the FRC and International Auditing and Assurance Standards Board (IAASB), although we suggest an example is revised to comply with the spirit of ISA (UK) 320 in our response to question 1 below.

We encourage the PAF to do more to recognise the considerable challenges that certain public sector entities, particularly local authorities, can experience in obtaining timely sign-off from their external auditors. The cause of these delays has been subject to debate, with some local authority CFOs referencing onerous scrutiny of balance sheet valuations. As noted in our response to Sir Tony Redmond's Independent Review[1], we believe that there are a variety of reasons that could lead to a delay in audit certificate and report issuance, but disclosing the reasons for delay could be one approach to consider.

We suggest the PAF should encourage external auditors to consider the information needs and expectations of users of public sector entities' financial statements, and adopt a pragmatic approach that considers both qualitative and quantitative aspects of materiality in arriving at an opinion on whether the financial statements provide a true and fair view. We have provided further detail in our response to question 1 below.

We were encouraged by the International Public Sector Accounting Standards Board's (IPSASB) recent consultation paper, *Advancing public sector sustainability reporting* and note that the CIPFA Local Authority Accounting Code Board (CIPFA LASAAC) proposes to adopt sustainability reporting as a future agenda item. We recommend that the PAF consider adopting appropriate guidance for auditors in this area as a priority, given the strong likelihood of greater public sector disclosure in this regard.

We encourage the PAF to consider the most recent definition of Public Interest Entities (PIEs) announced by the Department for Business, Energy and Industrial Strategy (BEIS). It is likely that a number of central and local government bodies, together with certain NHS organisations, will meet the PIE threshold; we encourage the PAF to update PN10 to reflect this reality as soon as possible.

Recent section 114 notices in local government have elevated the vital importance of auditing compliance with laws and regulations, particularly in relation to trading subsidiaries and commercial ventures established by local authorities, financial support provided, and the extent

[1] *Independent review into the arrangements in place to support the transparency and quality of local authority financial reporting and external audit in England,* a call for views issued by the former Ministry of Housing, Communities & Local Government, led by Sir Tony Redmond (September 2019)

of off-balance sheet commitments a public body may have in relation to those subsidiaries and commercial ventures. We also note the growth of investment by NHS foundation trusts in trading subsidiaries and joint ventures, sometimes located overseas. We encourage the PAF to develop additional content to support public sector auditors. We have suggested specific enhancements in our response to question 6 below.

SPECIFIC COMMENTS

ISA (UK) 320 (Revised June 2016) ***Materiality in planning and performing an audit***

1. **Do you consider the revised draft provides appropriate and useful guidance on applying materiality to the audit of public sector financial statements and regularity? What changes should be made, if any?**

   We agree with the changes proposed in the revised draft, which will provide appropriate and useful guidance. Examples 1-4 in Box 1 *Illustrative examples of applying different benchmarks for setting materiality* provide a valid basis for determining materiality. We are concerned however at Example 5, which appears inconsistent with the requirements of ISA (UK) 320, under which an auditor determines materiality in context of what could be material to the primary users of the financial statements, before determining materiality for specific balances, accounts or disclosures. We recommend that Example 5 is revised to provide specific examples where an amount lower than performance materiality could reasonably be expected to be material to the primary users of the financial statements under ISA (UK) 320, paragraphs 10-11.

   We encourage the PAF and external auditors to recognise that many users of public sector financial statements have different information needs and expectations compared to those in the corporate sector. As stated in our response to Sir Tony Redmond's Independent Review[1], we consider the primary users of public sector financial statements to include any individual or organisation who:

   - Has been involved in funding the services, to align with investors in a private sector setting; and/or
   - Receives or uses services, whether they have funded them or not (the rationale being that for many public sector services the recipient/user does not have a choice); and
   - Legislators and regulators.

   We note that some local authority CFOs have blamed audit sign-off delays on challenges associated with balance sheet valuations; we believe that delays in the audit process can arise from a myriad of factors and hesitate to support this view. While it is important for auditors to obtain sufficient appropriate audit evidence in forming their conclusions, we believe that it is also important to understand that the primary users of these financial statements are unlikely to consider unrealised valuation movements but would instead be focused on the organisation's expenditure priorities and its overall financial health. Given that many such valuation movements could be regarded as more of a 'paper' accounting adjustment than a reflection on the public sector entity's financial performance, we suggest the PAF reinforces the importance of considering the primary users' information requirements in determining material financial statement balances under PN10.

From an administrative perspective, we note that the cross-referencing of paragraphs 1-84 and 1-85 to ISA (UK) 320 may be incorrect and propose the following corrections:

PN10 ED paragraph	ED reference	Suggested reference
1-84	ISA (UK) 320, A2	ISA (UK) 320, A3
1-85	ISA (UK) 320, A9	ISA (UK) 320, A10

ISQM (UK) 1

2. Does this section provide appropriate and useful guidance on quality management arrangements for statutory and contractor auditors of public sector entities? What changes should be made, if any?

We commend the PAF for embedding ISQM (UK) 1 into the revised draft given the removal of certain public sector-specific paragraphs in the transition from ISQC (UK) 1 to ISQM (UK) 1.

We note that paragraph 1-23 states that public sector entities *'(in most cases)* [*…*] *do not meet the definition of* […] *Public Interest Entities*'. Given the most recent updates from BEIS on the future definition of this term, many larger public sector entities could be re-classified as PIEs. We recommend that the PAF update PN10 to reflect this status as soon as possible to minimise confusion, and that public sector auditors amend their audit approach to reflect this, if not reflected already. We believe that any public sector entity of sufficient quantum to meet the proposed PIE criteria merits an engagement quality review under ISQM (UK) 1, paragraph 34(f)(iii).

ISA (UK) 315 (Revised July 2020) *Identifying and addressing the risks of material misstatement*

3. Are these example inherent risk factors relevant to public sector audits and do they encompass the common areas of inherent risk that are particular to public sector entities?

As noted in our response to question 2 above, it is likely that many larger public sector entities will meet the proposed definition of a PIE audit. The range of inherent risks included in the ED are broadly relevant, appropriate and comprehensive. Considering the inherent risk examples provided in paragraph 1-79, we recommend the PAF include further detail under the *Uncertainty* bullet point, particularly in relation to funding arrangements and allocations. The uncertainty around future funding levels is a critical issue for many public sector entities and should be regarded a common inherent risk across the sector.

We note a cross-referencing issue under the *Uncertainty* bullet point in paragraph I-79 of the ED. We suggest that this bullet point should reference paragraph 1-110 of the ED, rather than paragraph 1-116 as drafted.

Part 2 ***The audit of regularity***

4. **Do you consider that the guidance in Part 2: *The audit of regularity* is appropriate, sufficient and applicable to all parts of the public sector? If not, what changes would you like to see made and why?**

   The complexity and diversity of authorisations in the public sector create a pervasive risk unique to public sector audits, and we commend the PAF on its comprehensive application guidance in this regard. We consider the revised ED to reflect the significant risks and provide relevant guidance on this matter.

   As public sector entities experience continued budgetary pressures, we note an increase in non-routine transactions to supplement established income sources, for example sale-and-leaseback transactions, where it is vital the external auditor evaluates both the audited entity's assessment of the transaction's substance, and the regularity of the transaction, in arriving at an audit opinion. Public sector entities are custodians of public funds, and it is important they conduct, and are seen to conduct, such non-routine transactions on an arms' length basis and in accordance with the relevant statutory framework. We encourage the PAF to specifically address non-routine transactions in this section of PN10.

   We note that paragraph 2-53 refers specifically to schemes funded by the European Union; we suggest this paragraph is considered for deletion when such schemes have been completed.

Other changes

5. **Do the other changes that have been proposed contribute to the objective of providing useful and appropriate guidance for public sector auditors? If not, how could these be improved?**

   We concur with the changes made elsewhere in the revised draft. We believe the changes made are proportionate, appropriate and adequately reflect the updated UK ISAs (where applicable).

6. **Are there any other changes you believe would be appropriate? If so, what changes would you like to see made and why?**

   Whilst we are mindful of statutory frameworks permitting national audit agencies to issue an appointment letter or Code of Audit Practice to determine the nature and scope of the audit engagement, we would highlight the critical importance of having an engagement letter for *every* audit engagement, and ensuring that such engagement letters are published on the public sector entity's website. In the interest of transparency, users of public sector entities' financial statements should be able to readily identify the audit scope and any scope limitations imposed, which may not always be readily understood from the audit report itself, or from statute. Audit engagement letters provide both the auditor and audited entity with clarity on respective responsibilities and scope. We do not regard such letters as being an 'optional extra' but a vital component in achieving a high-quality audit.

We encourage the PAF to update its guidance concerning ISA (UK) 250A *Consideration of laws and regulations in an audit of financial statements*, which is of particular relevance to the public, given recent section 114 notices issued in local government and auditors' public interest reports. Support (both financial and administrative) provided by London Borough of Croydon to its trading subsidiary, Brick by Brick Croydon Limited, may have been viewed by London Borough of Croydon as an internal or administrative matter, but was rightly flagged by Grant Thornton UK LLP via its reports in the public interest. We suggest that the PAF provides specific guidance on this type of transaction and other non-routine transactions, recognising that public sector entities can experience considerable funding pressures and, as they look to supplement their income from non-traditional sources, the risk of non-compliance with laws and regulations is likely to increase.

On an administrative point, we note that some cross-references may be incorrect, and propose corrections as follows:

PN10 ED paragraph	**ED reference**	**Suggested reference**
1-39	ISA (UK) 240, A6	ISA (UK) 240, A7
1-50	ISA (UK) 240, A67	ISA (UK) 240, A69