The Chartered Institute of
Public Finance & Accountancy

CIPFA

Public Audit Forum

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

Response from the Chartered Institute of Public Finance and Accountancy

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

CIPFA is pleased to present its comments on this exposure draft, which has been developed with input from members of CIPFA's Accounting and Financial Reporting Forum with audit experience.

Practice Note 10 plays an important role in setting out how ISAs (United Kingdom) are applied to public sector audits having regard to:

- the substantially different nature of most public sector activity providing services to the public in a non-commercial framework
- the very different formal frameworks through which government and public sector organisations are constituted
- the wider stakeholder base with a legitimate interest in public sector financial reporting, encompassing citizens in general, voters, elected representatives at various levels, and service beneficiaries
- the diverse risk profiles of public sector organisations, with less emphasis on commercial performance, and exposure to political and other pressures which differ from their commercial counterparts.

Guidance is therefore necessary so that the ISAs and other relevant requirements are properly applied to public sector audit, and that the work is appropriately tailored to the areas of greatest interest to users of public sector accounts and the relevant risks.

In CIPFA's view, the proposed amendments provide a helpful update to the Practice Note which reflect changes to the underlying ISAs.

In particular, CIPFA strongly supports the expansion of the section on ISA (UK) 320 to provide additional guidance on determining materiality including examples for situations where it is appropriate to apply more than one materiality.

Our comments on the questions in the Invitation to Comment are provided in an attached annex. While we have considered the proposed revision having regard to the UK public sector, these include some areas where we feel the Practice Note could be improved to better reflect or improve applicability to the circumstances of local government.

I hope this is a helpful contribution to the development of this guidance.

ANNEX

Question 1: This version of Practice Note 10 includes changes to the section on ISA (UK) 320 (Revised June 2016) *Materiality in planning and performing an audit* concerning the determination of materiality for the financial statements as a whole and the materiality level(s) to be applied to specific classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the decisions of users taken on the basis of the financial statements. Further guidance is also provided in Part 2 on the determination of a separate materiality threshold for the regularity opinion. **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?**
While Practice Note 10 does not seek to provide examples to cover all circumstances, CIPFA has had concerns for some time that the examples provided in relation to ISA (UK) 320 are not sufficiently comprehensive. We welcome the inclusion of an example where both an asset/liability based materiality and a flow based materiality are considered and used. When initially reading the proposals, we were concerned that the reasons set out in ED PN 10 for choosing both the higher and lower materialities might be too specific, and may set an expectation that these are the only circumstances under which this might occur. 1-88 reflects on assets/liabilities being much larger than expenditure and mentions major infrastructure assets or pension obligations. Our initial reading was that this mainly encompasses government bodies such as Highways England, and bodies with balance sheets dominated by pension obligations. However, we note that infrastructure assets and pension obligations are listed as examples rather than as requirements, and having read over Example 5 more carefully, we can see that this might encompass a wider variety of bodies. These could include many local authorities with significant assets and liabilities compared to gross expenditure, particularly but not necessarily those with substantial pension obligations or managing infrastructure assets such as highways networks or flood defences. CIPFA therefore strongly supports the inclusion of the additional example and guidance. We have previously been concerned that while gross expenditure is clearly of significant interest to users of local authority financial statements, a materiality based on expenditure may often result in disproportionate verification effort being required for balances where stakeholder interest is lower, and the risks around misstatement are both low in probability and such misstatements as might occur may have little effect on the financial position or service potential of the local authority. On balance, we suggest that it would be helpful to have two examples on this matter, in relation to: • a body whose function is principally managing assets on a long term basis, but where nevertheless stakeholders also have an interest in day to day basis; and • a body which is generally thought of as a service provider, but which holds and manages substantial assets and/or liabilities. Notwithstanding our strong support, we would note that this approach to determination of primary and secondary materialities may be slightly novel, and one of the auditor members of CIPFA’s Accounting and Financial Reporting Forum disagreed with the proposal on the basis that this might increase risks to the audit or have other unforeseen consequences. CIPFA considers that it should be possible to apply the proposed guidance in a way that is proportionate to the relevant risks while being fully compliant with ISAs (UK). However, the Public Audit Forum and other groups relevant to monitoring the quality of audits may wish to consider whether additional safeguards are necessary in the application of this new guidance.
Question 2: The previous section on ISQC (UK) 1 has been replaced by guidance on applying ISQM (UK) 1 in the public sector, including for contracted-out audits. **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?**

High-quality public audit and effective review is a fundamental component of effective public financial management. Recent issues experienced in the audit of local authorities in England have highlighted the importance of aspects of quality control referred to in ISQM (UK) 1, such as resourcing and engagement performance, to the local auditor. CIPFA therefore supports the inclusion of tailored, public sector specific guidance on ISQM (UK) 1 in Practice Note 10.

In terms of the content of Practice Note 10 on ISQM (UK) 1:

- ISQM (UK) 1 makes reference to use of an external expert in the context of ensuring the appropriateness of resources. Through its work with local authority accounts preparers, CIPFA has received informal feedback suggesting concern from some accounts preparers that auditors are making increasing use of external valuers to support the audit of property valuations. CIPFA accepts the need for the appropriate use of external experts to support the audit of high risk, specialist areas where this is necessary to reduce detection risk to an acceptable level. However, noting that the cost of auditors' experts is met using public money, CIPFA would welcome guidance from the Public Audit Forum that supports auditors in determining how to make best use of auditors' experts in a public sector context. Such guidance could refer to specialist technical areas of the financial statements considered most susceptible to manipulation or misstatement in a public sector context. Further, guidance on making use of auditors' experts to enhance effective public financial management would be welcomed. CIPFA would be pleased to assist in the development of any such guidance. CIPFA notes that the additional guidance on determining materiality in a public sector context as contained in the draft Practice Note 10 and discussed in our response to question 1 above is likely to be relevant in the context of use of auditors' experts to audit property valuations.
- As a minor drafting point, paragraph 1-6 of the draft Practice Note refers to the situations in which the requirements of law, regulation or statute to accept or continue an engagement may prevent a public sector auditor from withdrawing or resigning from the engagement where auditing or ethical standards would otherwise have led them to do so. CIPFA suggests that this paragraph could also refer to situations in which a public sector auditor is required to ***accept*** an engagement where auditing or ethical standards would otherwise have led them not to do so, in addition to considering withdrawing or resigning from an engagement.
- ISQM (UK) 1 covers the communication of relevant information to external parties. Public auditors may be required to report externally in the public interest. CIPFA recommends that Practice Note 10 refers auditors to guidance from the relevant Auditor General, and as it relates to the relevant sector on public interest reporting.
- Paragraph 1-17 refers to situations in which an auditor may consider a public sector entity to be "significant" for the purposes of expanded quality control procedures. However, there is no further guidance on how an auditor might determine if the audited entity is "significant". CIPFA notes paragraph 1-23 which, in our view, provides helpful guidance and references for a public auditor when determining whether an engagement quality review is appropriate. CIPFA is of the view that additional guidance on what is meant by a "significant" entity in the public sector similar to the guidance and cross references provided in 1-23 would be useful to public auditors.

Evidence presented to the House of Commons Committee of Public Accounts[1] indicates that local auditors might view quality and timeliness of reporting separately where, the quality of audit work is prioritised over deadlines. CIPFA advocates for effective public financial management and supports both local authorities and local authority auditors in their efforts to ensure the high quality of both financial reporting and auditing. However, CIPFA is of the view that, to support accountability and the decision-usefulness of local authority accounting information, the timeliness of the completion of audits and the subsequent publication of audited financial statements is a key component of audit quality. Where the publication of audited financial statements is subject to significant delay the usefulness of the financial information is called into question and the confirmatory nature of the audit process is significantly less effective. CIPFA is of the view that delays adversely affect quality. The current delays in local audit in England would call into question the prioritisation of audit quality and timeliness.

[1] https://committees.parliament.uk/publications/6672/documents/71757/default/ paragraph 11

As the issue of audit delays adversely affecting audit quality is currently specific to the public sector, CIPFA would support the Public Audit Forum providing guidance on the relationship between quality and timeliness. While Practice Note 10 might not be the suitable place for such guidance, a comment piece outside Practice Note 10 may be useful.
Question 3: The section on ISA (UK) 315 includes additional examples of inherent risk factors that may be particularly relevant to public sector entities. **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?**

CIPFA would bring the Public Audit Forum's attention to the first bullet point under 'Complexity' in paragraph 1-79. In this bullet point, government departments are provided as an example of complexity due to the size and scope of the entity. CIPFA would recommend inclusion of local authorities as an appropriate example of complexity. Like some government departments, local authorities can be of a size that inherently increases complexity. Furthermore, local authorities can provide a diverse range of services, are administratively complicated, hold specialist assets and have responsibility for place-making activities. Additionally, the interaction of both proper accounting practice and statutory prescriptions for local authority accounts increases both complexity and inherent risk.
 	
As minor drafting suggestions:
 	
• In the subsection of paragraph 1-79 that covers 'Subjectivity':
    o the second bullet point would benefit from clarity over how the ability of government to act contrary to its previously announced intentions and to alter the legal position in response to events might affect financial statements or auditors. CIPFA agrees that the overarching issue is an important one and agrees with its inclusion in the list, but, as a minor comment, is of the view that the paragraph could benefit from greater clarification of the link to subjectivity, or an example of the link to financial statements and audit.
    o the third bullet could benefit from re-wording. The final sentence of this bullet refers to "extent to which public bodies recognise liabilities for possible obligations". CIPFA would recommend use of "potential" rather than "possible" as, per IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as implemented in the public sector Manuals including the local authority accounting Code, possible obligations are not recognised as liabilities but disclosed as contingent liabilities.
• In the subsection of paragraph 1-79 that covers 'Uncertainty', the paragraph reference should be to 1-110 (rather than 1-116)
• In the subsection of paragraph 1-79 that covers 'Susceptibility to misstatement due to management bias or other fraud risk factors', CIPFA would recommend inclusion of a specific reference to the need for public sector entities to break even in the list of factors. CIPFA notes that the need to break even in the context of the NHS is mentioned in the cross-referenced content on ISA 240. However, CIPFA is of the view that explicit reference to the need to break even would be of use in paragraph 1-79, particularly to local (NHS) auditors in England who may have a background in commercial audit. Further, CIPFA is of the view that the Practice Note would benefit from further guidance on materiality in the context of errors that affect whether an entity achieves break-even.

Question 4: The section on the audit of regularity reflects existing practice in the public sector. **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?**
As not all audits will require work on regularity, clarity is required on the entities that fall within the scope of Part 2. Paragraph 2-83 indicates that regularity opinions are relevant to the audit of central government and some NHS bodes. CIPFA recommends that this detail is included earlier in Part 2.

Question 5: The consultation draft includes other changes, as outlined in the Annex. **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?**
CIPFA welcomes the additional material and guidance on the audit of the use of the going concern basis of reporting and audit of uncertainties around future funding. We have welcomed such clarifications in previous versions of Practice Note 10. However, despite previous changes to Practice Note 10 in this respect, CIPFA still receives feedback from accounts preparers on auditors' approaches to the audit of going concern, in particular that going concern seems to attract disproportionate attention from some auditors. As noted above, CIPFA has welcomed the previous clarifications in Practice Note 10 on going concern. CIPFA has been clear about the going concern basis of reporting in local authority financial statements and has included such guidance in our Bulletins. We have supported efforts to ensure audit attention to going concern and related uncertainties is therefore proportionate through those bulletins and training events. However, it appears that further guidance may be required to ensure auditors consistently achieve the correct balance. If the Public Audit Forum is of the view that this will not be achieved through further amendments to Practice Note 10, CIPFA would support the development of educational material from the Public Audit Forum for auditors to support a consistent, proportionate approach to the audit of going concern and related uncertainties. We will be happy to discuss the development of educational material further with the Public Audit Forum if required.
Question 6: Are there any other changes you believe would be appropriate? If so, what changes would you like to see made and why?

As minor drafting points:
• Several incorrect paragraph references appear to have been included. CIPFA has noted incorrect references as listed below, but does not suggest that this is an exhaustive list.
    o Paragraph 1-39 should refer to ISA (UK) 240 paragraphs A7 and 9 (rather than A6 and 3).
    o Paragraph 1-49 should refer to paragraph 44, rather than 43, of ISA (UK) 240.
    o Paragraph 1-50 should refer to paragraphs A69 and 44 of ISA 240 (UK) (rather than A67 and 43).
• In paragraph 1-47, CIPFA would recommend the inclusion of "are likely to" so the first sentence becomes "In the public sector, auditors ***are likely to*** focus their consideration of the risk of fraud and error on expenditure." Paragraph 1-46 discusses fraud in the context of revenue, which may be overlooked if auditors focus solely on expenditure. CIPFA is of the view that slight re-wording to paragraph 1-47 (as suggested) may reflect auditors' professional practice.
• Paragraph 1-48 provides benefit fraud and inappropriate prescription claims as examples of fraud external to the audited entity. Given the relatively low proportion of benefits estimated to be claimed fraudulently, CIPFA recommends that the examples of fraud by third parties could usefully be extended, perhaps to include the risk of fraud committed by a private sector business partner.

Question 7: The Auditor General for Wales and the Wales Audit Office are required to comply with Welsh Language Standards that provide for the Welsh language not to be treated less favourably to the English language in Wales and for individuals to be able to access public services in Wales though the Welsh or English languages. **Do you consider there to be anything in this consultation draft that undermines these requirements? Do you consider there is any revision that could be made to support the use of the Welsh language?**
CIPFA is not aware of any aspects of the consultation draft which undermine compliance with Welsh Language Standards that provide for the Welsh language not to be treated less favourably to the English language in Wales and for individuals to be able to access public services in Wales though the Welsh or English languages.