



PRACTICE NOTE 10: AUDIT OF FINANCIAL STATEMENTS OF PUBLIC SECTOR BODIES IN THE UK

ICAEW welcomes the opportunity to comment on the *Practice Note 10: Audit of financial Statements of public sector bodies in the UK* published by Public Audit Forum on 17 June 2016, a copy of which is available from this [link](#).

This response has been prepared by the Public Sector Team of the 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 94 key audit partners under the Local Audit and Accountability Act 2014.

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INTRODUCTION

1. ICAEW notes the delegated authority that has been passed to the Public Audit Forum by the Financial Reporting Council to amend and update Practice Note 10 to bring it into line with the current public sector audit environment. ICAEW welcomes the opportunity to comment on the Public Audit Forum's *Practice Note 10: Audit of financial Statements of public sector bodies in the UK*.

MAJOR POINTS

FRC's wider objectives in relation to public sector auditing

2. It would be helpful to include within PN10, reference to the FRC's wider objectives in relation to public sector. There is an assumption within the paper that the reader knows what these are, but it would perhaps be better to provide this information in the paper for clarity. ICAEW's view is that PN10 should apply to all parts of the public sector and this could be more explicit in the paper.

Reflect the current environment

3. We appreciate that the guidance is intended to be relevant for the long term, but it may be useful to reflect the current public sector environment and the context in which auditors are now working. For example, there is a much higher political profile, austerity is in place therefore increasing the risk environment and whilst auditors are already using professional scepticism, our view is that these factors will be pertinent for the foreseeable future, certainly for the medium term. This addition could therefore helpfully be made in the introduction.

Principles v rules

4. There is a balance to be struck between principles and rules based. In line with other practice notes, ICAEW's view is that it is important for PN10 to remain principles based allowing auditors to use their judgement on their engagements.

Going concern

5. ICAEW welcomes the revised section on going concern. Our most significant comments are in respect of paragraphs 156 and 157 (confirmation of support). Paragraph 156 notes that, where auditors judge that the going concern basis is appropriate for the preparation of a public sector entity's financial statements substantially on the basis of third party confirmations received then they will consider whether this is a matter of such significance that the confirmations are referred to in the financial statements and the auditor's report as being relevant to a proper understanding of the basis of the opinion. It is not clear how this relates to the ISA 570 requirements for assessing disclosures and whether there is a material uncertainty by way of an emphasis of matter paragraph (assuming such matters are adequately disclosed in the financial statements).
6. The confirmation of support in itself would not automatically require disclosure in the accounts or the auditors' report. Instead our view is that the PN10 should emphasise the importance of ensuring there are detailed disclosures relating to the basis of preparing financial statements on a going concern basis. These disclosures would refer to a range of factors which may include (but not be restricted to) the need for and confirmation of support. Auditors would then consider whether to modify their audit report if bodies have not included sufficient disclosures relating to the basis of preparing the accounts.
7. In Para 157 we are not convinced that failure to obtain confirmation of support should be dealt with as a limitation of scope requiring a modified opinion or a fundamental uncertainty. As there is Government reluctance to formally confirm support for individual bodies, eg NHS Improvement has indicated that from 2015/16, it will no longer provide letters of support for

NHS Trusts. This reference to scope limitation is not contained in ISA 570. We consider that the position relating to support should be covered by accounts disclosures referring to the need for external support where relevant and whether this has been formally confirmed. Auditors would then draw attention to this uncertainty through an emphasis of matter in the audit report, where they considered this to be a material uncertainty. The wording of this emphasis of matter would depend on the extent of support required and whether there are any factors indicating that support would not be provided.

Regularity

8. We note the reference to regularity within PN10. There needs to be clarification that where the regularity opinion is part of the statutory audit engagement, then the work required is reasonable assurance because of the wording of the legislation.
9. There also needs to be clarity that the requirements for schools and colleges which require regularity opinions fall outside the scope of statutory audit and therefore other forms of assurance engagements are acceptable.

Materiality

10. The note in paragraph 85 of the draft PN10 that 'where a public sector entity has custody of public assets, assets may be an appropriate benchmark' is a change from the previous PN10 requirements, which could cause confusion in the current climate. In view of the current sensitivity on materiality for property valuations and implementation of the Highways Network Asset we suggest that more emphasis should be placed on seeking clarification on the reason for the change. Our view is that it is a stretch to shoehorn the income/expense based application that is used by all the firms into balance sheet testing and this is a legacy that goes back years and there is no change because of the optics of higher materiality. Our recommendation therefore, is for there to be a more intelligent use of specific materiality to meet expectations on income/expenditure areas.

11. We have made further detailed comments in response to the specific questions.

RESPONSES TO SPECIFIC QUESTIONS

Q1: To reduce duplication, detailed information that is already included in relevant auditing standards (apart from the objectives and public sector interpretations retained for context), financial reporting frameworks and legislation have been taken out and referred to in the document. Do you consider it is appropriate to remove this material and include only public sector specific guidance on the application of the ISAs (UK and Ireland) and the audit of regularity? If not, please describe in broad terms what other contextual information and guidance you would like to see and why such content would be an improvement?

12. We agree that it is helpful to decrease the duplication. The PN now appears to be more focussed and succinct, thereby making it more accessible to users.

Q2: The information on local audit and devolved administrations arrangements was updated to reflect changes in legislation and to refer to relevant Codes of Audit Practice. Do you consider that the guidance in Part1: Application of International Standards on Auditing (UK and Ireland) is appropriate, sufficient and relevant to all parts of the public sector? If not, what changes would you like to see made and why?

13. We believe the information in part 1 is appropriate and sufficient to all parts of the public sector. We have the following specific comments regarding going concern.

Going concern

14. ICAEW welcomes the revised section on going concern. Our most significant comments are in respect of paragraphs 156 and 157 (confirmation of support).
15. Paragraph 156 notes that where the use of the going concern basis is supported by third party confirmations of support then the auditor considers whether this is a matter of such that the confirmations are referred to in the financial statements and the auditor's report as being relevant to a proper understanding of the basis of the auditor's opinion. It is not clear how this relates to the ISA 570 requirement for the auditor to refer to matters giving rise to a material uncertainty by way of an emphasis of matter paragraph (assuming such matters are adequately disclosed in the financial statements). The same paragraph suggests that there may be a need for a reference to confirmations of support – even where this is not considered to give rise to a material uncertainty. We are unclear whether this is the intention here? If it is, how and where would this be referred to in the auditor's report? In the absence of a material uncertainty such a matter would appear more likely to meet the criteria for an 'other matter' paragraph than an 'emphasis of matter paragraph' as set out in paragraph 7 of ISA 706. The guidance in the proposed PN could be clearer in this respect.
16. We note that NHS Improvement has indicated that from 2015/16 it will no longer provide letters of support for NHS Trusts. Therefore, there could be a large number of emphasis of matter paragraphs required in next year's NHS Trust audits (in the same way as there are for Foundation Trusts).
17. In Paragraph 142, it would be helpful to remind auditors of the need to ensure there is adequate disclosure of the basis of preparing accounts on going concern basis as well as disclosure of any material uncertainties. This could either be done within paragraph 142 or as a separate paragraph. The reference to material uncertainties should highlight that these arise when there is a forecast shortfall of funds to meet operational plans (both revenue and capital).
18. In Paragraph 147 which relates to guarantees, it may be helpful to emphasise the responsibility of the entity to make an appropriate disclosure.
19. In Paragraph 149, in relation to the foreseeable future, it would be helpful to refer to the ISA 570 requirement. Namely, that if the period considered by management is less than 12 months from the reporting date auditors should "request management to extend its assessment period to at least twelve months from that date."
20. Paragraph 154 relates to the statutory break-even requirement. Whilst we agree there may be reporting implications for bodies who fail to break-even, this does not of itself indicate a going concern issue. A better way of phrasing this may be that 'auditor's work on other areas of the Code may help inform their understanding of an entity's ability to meet obligations as they fall due.'
21. In Paragraph 155, the link between forecasts / available resources / material uncertainties and the need to obtain evidence of support could be drawn out more clearly, for example at the start of Paragraph 155.

Q3: This Practice Note was updated to reflect recent changes to auditing standards. Do you believe that the appropriate guidance is included in Part 1: Application of International Standards on Auditing (UK and Ireland) in relation to the application of the revisions to ISAs (UK and Ireland)? If not, what changes would you like to see made and why?

22. Yes, an appropriate level of detail is provided.

Q4: The section on the audit of regularity reflects existing practice in the public sector. Do you consider that the guidance in Part2: The audit of regularity is appropriate, sufficient and

relevant to all parts of the public sector? If not, what changes would you like to see made and why?

23. We welcome the inclusion of a separate section on Regularity. The overall level of work outlined seems appropriate. On a point of detail, we note the reference to existing practice. It would be helpful to confirm that the PAF has considered the actual work that is necessary rather than relying only on existing practice.
24. One of the biggest challenges in auditing regularity is the inconsistency between the sectors. We appreciate that this can be a function of legislation, but it can also be confusing for readers. There would be benefit in further explaining within the PN10, why limited assurance conclusions are used for education, and where auditors can find further information.

Q5: Are there any other changes you believe would be appropriate? If so, what changes would you like to see made and why?

25. Yes, in our view, it would be helpful if the current public sector environment and the context in which auditors are now working is reflected in the introduction. For example, whilst auditors will always use professional scepticism in their work, there is now a much higher political profile, austerity is in place therefore increasing the risk environment. Therefore auditors will be required to exercise their professional scepticism even further.
26. We appreciate that the guidance is intended to be relevant for the long term, but it may be useful in some way to reflect this in the introduction.
27. Other more detailed points include the following:
 - Paragraph 46 highlights that the presumed fraud risk relating to revenue, may be rebutted in situations where revenue is immaterial. However, it then caveats this by warning of revenue manipulation in situations where achievement of net spending targets is important. In our view, this suggests that the ISA 240 presumption may ONLY be rebutted where revenue is immaterial (and even then with caution) – and not in other situations such as where revenue is effectively pre-determined or calculated according to a prescribed formula (eg Housing Rents, Council Tax etc).
 - Paragraph 47 then highlights the fact that manipulation of expenditure may also present a fraud risk that may be greater than the risk in relation to revenue. However, the PN does not explain how this paragraph 47 then ties in with previous paragraph. For example, is it suggesting that there should be a presumed fraud risk in relation to expenditure, and if so in what situations may this be rebutted?
 - Paragraph 48 covers the auditor's consideration of external fraud but the examples given suggest a level of detailed examination and understanding that will not be achievable in most audit situations. Perhaps this could be amended to make clear that the auditor is not expected to identify benefit or prescription fraud at the individual transaction level – but only consider the risk that such fraud may occur on a scale that could materially affect the financial statements.
 - Paragraphs 84 to 86 stated that in the private sector it is not uncommon to have specific materiality levels applicable to certain balances or classes of transactions. For example in property companies, investment companies and pension schemes, the materiality levels applied to property or investment assets and valuation adjustments thereto will often be significantly different from those applied to working capital balances and other transactions reflected in the income statement. ICAEW notes that, in the public sector this situation will arise in authorities with significant infrastructure assets, public sector housing, pension schemes etc. However, as drafted, the proposed PN does not consider this possibility or offer any guidance for the auditor in this respect.