CONSULTATION ON PRACTICE NOTE 10 (REVISED 2022): SUMMARY OF RESPONSES AND PROPOSED AMENDMENTS

INTRODUCTION

The consultation on the exposure draft of the 2022 revision of Practice Note 10 *Audit of Financial Statements and Regularity of Public Sector Bodies in the United Kingdom* (PN 10) closed on 16 September 2022. This document summarises the responses to the consultation and the amendments the Public Audit Forum (PAF) proposes to make to the final draft as a result.

LIST OF RESPONDENTS TO CONSULTATION

We received 14 responses to the consultation, which have been published on the PAF website, from the following interested parties:

- Association of Chartered Certified Accountants
- Audit Scotland
- Chartered Institute of Public Finance and Accountancy
- Deloitte LLP
- Ernst & Young LLP
- Grant Thornton LLP
- Healthcare Financial Management Association
- Ichabod's Industries
- Institute of Chartered Accountants in England and Wales
- KPMG LLP
- Local Government Association
- MacIntyre Hudson LLP
- Maldon District Council
- Public Sector Audit Appointments Limited

OVERALL COMMENTARY

Part 1 of PN 10 provides guidance on applying auditing, quality management and ethical standards in the public sector. It is important to consider potential changes to PN 10 in the context of PN 10's status as a Statement of Recommended Practice (SORP): a set of sector-driven recommendations on (in this case) auditing practices for the public sector which guide auditors on how to apply the underlying standards, including International Standards on Auditing (UK) (ISAs (UK)), in the specialised context of the public sector. The PAF has no role in determining the principles or requirements which are included in the ISAs (UK). The PAF also has no direct role in setting the financial reporting frameworks for public sector entities (although member bodies of the PAF maintain dialogue with the framework setters).

As set out in the summary of responses below, respondents commented on a range of issues faced by auditors of public sector entities. By far the most-cited issue was the current situation in local audit in England and current delays in completing audits of local authorities. A number of respondents suggested various ways in which the consultation draft of PN 10 might be amended so as to ameliorate some of these issues by reducing the audit effort in particular areas. There were suggestions that the proposed changes to the guidance on applying ISA (UK) 320 *Materiality in planning and performing an audit* may have a significant impact on local auditors' approach to materiality judgements.

Whilst recognising the difficulties faced in financial reporting and audit for local authorities, the PAF wishes to emphasise its view that the scope for PN 10 to influence significantly auditor workload in performing an audit under ISAs (UK) is limited. The enhanced guidance on applying ISA (UK) 320 in the consultation draft outlines options for determining materiality for the financial statements as a whole and a materiality level to be applied to particular 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. The PAF presents these examples in PN 10 as options that are consistent with approaches already allowable under ISA (UK) 320. It remains the case that auditor judgement is required to ensure any approach taking to setting materiality is appropriate in the context of the circumstances applicable to the particular audited entity, its environment and the financial information needs of users of the financial statements – no assertion is intended, for example, that illustrative Example 5 in Box 1 is necessarily applicable to local authority audits. Some drafting changes have therefore been made to this section in the final version in order to avoid a misleading view that PN 10 is advocating a significantly novel approach to materiality.

It may be that some of the areas commented on by respondents to this consultation could be addressed by revisiting certain provisions of the financial reporting frameworks for public sector entities. The PAF does not endorse any particular changes to these, but it intends to bring relevant comments raised by correspondents to the attention of framework setters where this may help to inform their future considerations.

SUMMARY OF RESPONSES BY CONSULTATION QUESTION

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?**

The most extensive responses to the consultation related to the new proposed guidance on materiality. The majority of respondents broadly welcomed the new guidance in relation to the determination of the materiality level or levels to be applied to particular 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, in addition to overall account materiality, in accordance with paragraph 10 of ISA (UK) 320 (Revised June 2016) (Updated May 2022).

There was a common view that auditors' current approach to materiality led to overly onerous levels of work in certain areas, driving the balance of audit effort towards areas that they perceived to be of low practical interest to users of financial statements (for example, work on infrastructure/property assets held by local authorities). Arguments were advanced to the effect that auditors' current level of work on such areas is disproportionate to the actual level of influence of this type of balance on decisions made by users on the basis of public sector financial statements. Many respondents cited the approach to materiality in these areas as a significant factor leading to delays in local authority audits.

Many respondents welcomed in particular the addition of Example 5 to Box 1 ("illustrative examples of applying different benchmarks for setting materiality"). Some respondents felt this material should be re-worded or expanded further to be more explicit or prescriptive on how this approach should be applied in practice, or to advocate this as a preferred approach for audits of local authorities, or to suggest specific percentage thresholds to be applied to materiality benchmarks, in order to achieve changes in auditors' approach to materiality which they felt to be desirable.

Three respondents expressed concern that Example 5 may not be compliant with ISA (UK) 320 in certain respects.

One of these expressed this view because PN 10 does not explicitly state that ISA (UK) 320 does not allow (for example) determination of materiality for the financial statements as a whole using a revenue benchmark and then a higher materiality level for balance sheet items.

Another respondent recommended that Example 5 should be stated as not applicable to a local authority, based on their view that assets would not be an appropriate benchmark for determining materiality for the financial statements as a whole for local authorities other than pension funds. Their analysis of the guidance in paragraph A4 of ISA (UK) 320 indicated that users' attention and funding considerations are focused on service expenditure and delivery of services, with asset valuation a secondary concern and more volatile than expenditure.

The third dissenting respondent felt that Example 5 does not reflect the requirement in ISA (UK) 320 for the auditor to determine 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. They recommended that Example 5 be 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.

One respondent suggested that Box 1 include separate examples covering firstly 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 secondly a body which is generally thought of as a service provider, but which holds and manages substantial assets and/or liabilities.

One respondent asked that PN 10 clarify whether the setting of a higher materiality for particular classes of transactions, account balances or disclosures than materiality for the financial statements as a whole would be an acceptable approach.

One respondent expressed the view that PN 10 gives undue weight to the selection of a benchmark as a factor in the auditor's approach to materiality.

The same respondent recommended changes to paragraph 1-88 to reflect their view that, for entities where the value of gross assets and/or liabilities is much higher than the value of total expenditure and income, the auditor should consider the different levels of sensitivity that users give to different transactions and balances and that an appropriate technical approach would be to set materiality for the financial statements as a whole based on the least significant item of substantial size in order to avoid an amount being set that could lead to properly immaterial misstatements being defined as material.

This respondent also recommended that Example 4 within Box 1 be either removed or amended, as they felt it is a less detailed exposition of the circumstances applicable in Example 5, but with a different outcome.

One respondent felt that a plan should be made to inform audited entities about changes in auditors' approach to materiality as a result of these changes and the resulting impact on their preparations for audit.

One respondent recommended that the examples given in paragraph 1-87 of the 2020 revision of PN 10 of classes of transactions, balances or disclosures where a lower materiality threshold might be set where appropriate in the context of the audited entity and the expectations of the users of the financial statements, which have been removed in the 2022 consultation draft, be reinstated.

One respondent proposed that PN 10 state that in determining performance materiality, the auditor should consider the risk of manipulation of financial statements to achieve a higher financial health grading from a sector regulator.

One respondent suggested that PN 10 include further guidance on materiality in the context of errors that affect whether the audited entity achieves a break-even position (such as NHS bodies).

PAF response: **Paragraph A3 of ISA (UK) 320 is clear that a primary influence on materiality judgements for public sector entities is the financial information needs of legislators and the public in relation to public sector programmes. As outlined in the 'Overall commentary' section above, auditors of public sector entities need to use their professional judgement to identify these needs and determine how they influence financial statement materiality. ISA (UK) 320 provides a framework that is already in place for applying tailored materiality levels to particular classes of transactions, account balances or disclosures to take account of the differing interests of a range of users of financial statements.**

Some limited drafting changes have been made to the ISA (UK) 320 section of Part 1 to emphasise the continuing importance of auditor judgement and considering the financial information needs of users in setting materiality, as well as the need to apply fully the wider principles already set out in the standard. However, the PAF's view, having considered the range of comments made by respondents to the consultation, is that the substance of the guidance in the consultation draft remains appropriate.

Where respondents have requested guidance on setting materiality in the context of particular sectors, we have brought these comments to the attention of those responsible for writing the relevant audit codes for those sectors.

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?**

Respondents generally welcomed the inclusion of guidance on applying quality management standards.

One respondent recommended that PN 10 refer auditors to guidance from the relevant Auditor General on the making of external reports in the public interest.

One respondent suggested that paragraph 1-6, in addition to referring to situations where an auditor may be prevented by statutory requirements from withdrawing or resigning from an engagement, should also refer to situations where the auditor may be required by law to accept an engagement.

In relation to the scenario envisaged in paragraph 1-9 where a contractor auditor may agree to provide the statutory auditor with a report on the system of quality management within their firm (a 'service provider report'), one respondent noted that audit firms typically do not need to provide such reports, and suggested that there are already arrangements in place around contracted-out audits to allow public sector audit bodies to obtain the information required from contractor audit firms without significant additional information requests, noting that decisions about the attractiveness and pricing of work as a contractor auditor would be affected by the extent of information required and cost of reporting.

There was a request to clarify the section on quality management for engagements on an "appointment by" basis to cover appointments of local auditors made by Public Sector Audit Appointments Limited (PSAA), where the firms appointed have responsibility for implementing quality management standards but PSAA does not oversee audit quality.

One respondent requested further guidance on how an auditor would determine whether an audited entity should be treated as "significant for the purposes of expanded quality control procedures" for the purpose of paragraph 1-17.

One respondent suggested that it should be clarified whether paragraph 1-18 refers to the Financial Reporting Council's Revised Ethical Standard 2019 or to the related section in PN 10 and that paragraph references to ISQM (UK) 1 be included in the section on Confidentiality.

The same respondent also recommended that PN 10 include public sector-specific guidance on the application of ISQM (UK) 2 *Engagement quality reviews* and ISA (UK) 220 (Revised July 2021) *Quality management for an audit of financial statements*, including guidance on determining which public sector audits should be subject to engagement quality review. This respondent expressed their view that it is impractical to mandate that all engagement quality reviews for local audits be carried out by a limited pool of Key Audit Partners.

One respondent suggested that the statement in paragraph 1-23 that in most cases large public sector entities do not meet the definition of Public Interest Entities (PIEs) be revisited as pronouncements from the Department for Business, Energy and Industrial Strategy (BEIS) may lead to a significant number of large public sector entities' being re-classified as PIEs. This respondent expressed the view that any public sector entity of sufficient quantum to meet the proposed PIE criteria would merit an engagement quality review.

PAF response: **In relation to the making of external reports in the public interest, auditors' powers to do so are dependent upon their legal and regulatory framework. Audit codes relevant to specific parts of the public sector provide guidance on reporting in the public interest (for example, Section 3 of Auditor Guidance Note 07 *Auditor reporting* issued by the National Audit Office to local auditors under the Local Audit and Accountability Act 2014).**

Paragraph 1-6 has been amended to clarify that it also applies to situations where the auditor may be prevented by law from declining to accept an engagement.

In relation to service provider reports that may be provided by contractor auditors, as described in paragraph 1-9, the provision (or not) of such a report would be subject to agreement between the contractor auditor and the statutory auditor.

In relation to engagements on an "appointment by" basis where PSAA is the appointing body: paragraph 1-12 has been amended to clarify that the guidance in that section is not relevant to audits where PSAA is the appointing person; paragraph 1.13 has been amended to clarify that a national audit agency may not be the appointing body; and paragraph 1.14 has been amended to clarify that the appointing body's responsibilities for quality listed in that paragraph only apply where the appointing body has responsibility for the oversight of, or quality assurance for, the audit assignment.

In relation to how an auditor determines whether an entity should be treated as "significant for the purposes of expanded quality control procedures", paragraph 1-17 already sets out that such significance may arise from "size, complexity or public interest aspects".

Paragraph 1-18 has been amended to clarify that the public sector considerations referred to are in the Revised Ethical Standard.

Paragraph 1-19 has been amended to include a reference to paragraph 34-1(m) of ISQM (UK) 1 on confidentiality requirements.

In relation to ISQM (UK) 2 and ISA (UK) 220 (Revised July 2021), where guidance is not currently included in PN 10, although the PAF endorses the FRC's recommendation on audit firms to early adopt these standards, it is the PAF's view that there is nothing in these standards preventing auditors adopting these without further public sector-specific guidance. The PAF will consider including guidance on these standards in the next iteration on PN 10 based on auditors' experience of applying these in practice.

In relation to the suggestion that a significant number of large public sector entities may be reclassified as PIEs based on pronouncements from BEIS, it is the PAF's understanding that it will continue to be the case (in the absence of further policy changes) that most large public sector entities will not be classified as PIEs. The existing wording of paragraph 1-23 has therefore been retained.

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?**

Respondents made a number of suggestions for additions or amendments to the list of example inherent risk factors, including the following:

- *Complexity*
  - Inclusion of local authorities as an example of the size and scope of a public sector entity's activities creating complexity as these can provide a diverse range of services, are administratively complicated, hold specialist assets and have responsibility for place-making activities.
- *Subjectivity*
  - 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.
  - Re-wording the reference to "the extent to which public bodies recognise liabilities for possible obligations" in the third sub-bullet point to refer to "probable obligations" to be

    - consistent with IAS 37 *Provisions, contingent liabilities and contingent assets* and adding a reference to whether these bodies disclose sufficient detail on these obligations.
    - Stating that subjectivity in the valuation of property assets often arises from the choice of an appropriate valuation methodology.
- *Change*
    - Reflecting regular changes to statutory guidance and legislation with significant areas of interpretation.
    - Adding an additional example inherent risk factor for the delivery of new services.
- *Uncertainty*
    - Further detail in relation to uncertainty surrounding funding arrangements and allocations.
    - Reflecting examples of late notifications of allocations of funding within the NHS.
    - Reflecting uncertainty caused by fragmented and short-term funding schemes often dependent on the outcome of bids, resulting in weaknesses in financial management.
- *Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk*
    - Including a specific reference to the need for public sector entities to break even or meet annual limits, particularly in relation to NHS audits.
    - Adding an additional example inherent risk factor for the need to maintain accurate ringfencing of funding in large or complex organisations with multiple functions.
    - Reflecting the risk of manipulation of adjustments between figures in the performance statement and outturn against budget.
    - Reflecting the effect of budgetary controls on the risk of bias in estimates or aggressive and complex revenue-generating schemes.
    - Adding an additional example inherent risk factor for the possibility of manipulation by management to achieve performance or other targets set internally, externally or by a regulator.
    - Reflecting a greater likelihood of the existence of conflicts of loyalty in public sector entities than for commercial organisations.
    - Cross-referencing to paragraph 1-42 in the final sub-bullet point.
    - Expanding the reference to “incentives or pressures arising in the private sector [being] more focused on information about the profitability and solvency of the entity” to state explicitly that audits of public sector entities may be less focused on these areas, and more widely avoiding the need to apply both private sector- and public sector-related risk factors.
- *Other inherent risk factors*
    - Adding an additional example inherent risk factor for direction from controlling bodies, particularly in relation to local audit and directions from government departments in order to manage national positions.
    - Clarifying why a closely-regulated regime increases inherent risk, including whether susceptibility to misstatement is always increased by the requirement to meet targets.
    - Explaining the meaning of a breach of Parliamentary control totals.
    - Referring to “financial statements” rather than “final form of accounts” in the final sub-bullet point.
    - Amending the reference to “a wide range of stakeholders who may have disparate interests and needs as users of financial statements” and the references to entities’ being wound up, merged, sold or privatised, on the basis that these may not be relevant to local authorities.

PAF response: **As shown above, many respondents made suggestions for additional inherent risk factors that may be relevant to public sector entities, over and above those already outlined in the consultation draft.**

It is not the intention of this section of PN 10 to set out a comprehensive list of inherent risk factors that might be relevant to the public sector – given the range of the sector's activities, this would be impossible and the list in PN 10 is for illustrative purposes only. The PAF has therefore decided not to add additional examples which might make the list in PN 10 too unwieldy. However, the examples provided by respondents as outlined above will remain in the public domain via this document on the PAF website and auditors are free to draw upon these as desired. The PAF has also brought those examples relevant to particular parts of the public sector to the attention of those responsible for setting local audit codes, with a view to their inclusion in relevant sector-specific guidance.

A few amendments have been made in response to suggestions by respondents where this would improve the drafting of existing examples.

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?**

Respondents generally felt that Part 2 of the exposure draft provides appropriate guidance on the audit of regularity.

Some respondents requested further clarification of the scope of entities where a regularity opinion should be given in accordance with the guidance in Part 2, with one respondent proposing that the information in paragraph 2-83 that a regularity opinion is provided "for the audit of central government (or equivalent) and some health bodies" should be provided earlier within Part 2.

One respondent requested examples of where a modified regularity opinion may be required for certain sectors, such as in relation to statutory duties on NHS bodies.

One respondent suggested that the references in paragraphs 2-34 and 2-34A to situations where the materiality threshold for the audit of regularity may be different to the materiality for the financial statements as a whole should be changed to refer to a lower materiality threshold for regularity (i.e., indicating that this would not envisage a situation where the materiality threshold for regularity would be higher than that for the financial statements as a whole).

Another respondent suggested that PN 10 state that assets or liabilities would only be used in rare and exceptional cases as a materiality benchmark for the regularity opinion, given that regularity is a concept relating to transactions.

The same respondent expressed the view that whether a transaction complies with the framework of authorities would almost always be a factual rather than a judgemental consideration and that this might be noted in PN 10.

This respondent also felt that Part 2 of PN 10 downplays the issue of the propriety of transactions and that, whilst propriety is not readily subject to objective verification, there are occasions where impropriety is of such significance that its effect on the regularity of transactions should be considered.

One respondent highlighted the difficulties caused by increased system working in the NHS and NHS organisations' working under different frameworks, which may impact auditors' access to financial and performance information relevant to their work on regularity.

One respondent suggested that paragraph 2-53, which refers to the examination of expenditure on schemes funded by the European Union, be considered for deletion when such schemes have been completed.

PAF response: **The PAF's view is that PN 10 cannot prescribe the circumstances in which a public sector entity should be subject to a regularity opinion. This is because most regularity opinions are required by statute, which is a matter for legislators to determine. Where not required by statute, management of an audited entity may agree with its auditor that they wish the auditor to provide a regularity opinion and this will be set out in the terms of engagement – the PAF does not wish to restrict the ability of auditors to be able to respond to any such requests from audited entities.**

The PAF also does not consider that PN 10 should prescribe specific circumstances where entities in individual sectors should be subject to a modified regularity opinion beyond those already included in the consultation draft. Paragraphs 2-85 and 2-86 are clear that "Where the auditor concludes that material financial transactions do not comply with the relevant framework of authorities, the auditor qualifies the regularity opinion [...] Where the impact of the non-compliance on the financial statements is pervasive, the auditor issues an adverse opinion on regularity [and] Where the auditor is unable to obtain sufficient evidence to reach an opinion, the auditor qualifies the regularity opinion as a limitation of scope or, if pervasive, the auditor issues a disclaimer."

In relation to situations where the materiality threshold for the audit of regularity may be different to the materiality for the financial statements as a whole, the PAF does not consider there is a need for a blanket requirement that materiality for the regularity opinion is the same or lower than that for the financial statements as a whole, although the example circumstances envisaged by paragraph 2-34A would imply the regularity materiality threshold's being lower.

In relation to the possible use of assets or liabilities as a materiality benchmark for the regularity opinion, whilst regularity is a concept relating to transactions, the PAF considers that it may be theoretically possible to use an asset or liability benchmark: for example, where the bulk of the entity's transactions in the year relate to the purchase of assets.

The PAF does not agree with the view that whether a transaction complies with the framework of authorities would almost always be a factual rather than a judgemental consideration. There are many cases where the application of the framework of authorities in particular circumstances is subjective (for example, ambiguous wording or novel circumstances).

In relation to the issue of propriety of transactions, Part 2 of PN 10 relates specifically to regularity rather than propriety, as the opinion given in the audit report is on whether the transactions in the financial statements are regular in all material respects. The PAF's view is that a transaction's being improper does not in itself have an impact on its regularity, as that is dependent entirely on whether the framework of authorities covers the particular scenario. If future statute were to require auditors of public sector entities to give an opinion on the propriety of transactions, the PAF would revisit Part 2 accordingly.

In relation to the impact on auditors' access to information of system working in the NHS, Part 2 does not deal specifically with access to information needed to give a regularity opinion, as this is a matter for statute or for auditors and audited entities when agreeing the terms of the engagement.

Paragraph 2-53 on to the examination of expenditure on schemes funded by the European Union has been retained for the time being, as there may be legacy EU-funded items in accounts still to be published.

Question 5: The consultation draft includes other changes, as outlined in the Annex below *[included within the published Invitation to Comment]*. **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?**

ISA (UK) 570 (Revised September 2019) (Updated May 2022) *Going concern*
Respondents overwhelmingly welcomed the additional guidance reiterating the appropriate approach to the audit of going concern for entities for which the financial reporting framework provides for the adoption of the going concern assumption on the basis of the anticipated continuation of the provision of a service in the future. One respondent noted feedback from accounts preparers that going concern attracts disproportionate attention from some auditors and expressed support for further educational material from the PAF in this area.

Another respondent suggested that PN 10 further clarify that a decision by an audited entity to discontinue providing some, but not all, of the services it previously provided (for example, discretionary services) would not, in itself, prevent the auditor from applying the continued provision of service approach to going concern.

The same respondent requested guidance on the scenario where the audited entity has a subsidiary, joint venture or associate whose own auditor has reported a material uncertainty related to going concern.

Another respondent suggested that PN 10 refer to defined benefit pension scheme liabilities and their impact on public sector entities' financial position, but acknowledged that these generally did not affect the assessment of going concern.

PAF response: **Based on the feedback received, the PAF is confident that the revised guidance on ISA (UK) 570 will provide an appropriate framework for auditors' approach to going concern.**

In relation to the continued delivery of discretionary services, the risk assessment for auditors applying the continued provision of service approach envisages the auditor concluding that "services [the audited entity] performs can be expected to continue to be delivered by related public authorities". There is no implication here that every service currently provided by the entity will continue to be delivered or that the discontinuation of discretionary services would prevent the auditor from applying the continued provision of service approach.

The situation where the auditor needs to consider the implications for the going concern status of the parent of a material uncertainty related to going concern in the audit report of a subsidiary, joint venture or associate is not unique to the public sector. The auditor of the parent would still need to take into account the circumstances of the audited entity and its financial reporting framework in assessing the parent's going concern position – the guidance in PN 10 can be applied to this scenario.

Similarly, the presence of defined benefit pension scheme liabilities (or any other liabilities) should be considered in the same way as for a private sector entity, subject to any provisions in the financial reporting framework on the anticipated continuation of the provision of a service in the future.

Revised Ethical Standard 2019

One respondent proposed that paragraph 1-232 be re-worded to state that it "would" (rather than "may") be in the public interest for public sector organisations to establish policies and procedures to promote compliance with the spirit of rotation of engagement partner responsibility.

PAF response: **The relevant sentence has been amended to be more consistent with the phrasing used elsewhere in PN 10, to read: "Nonetheless, for public sector entities considered significant, the auditor establishes policies and procedures to promote compliance with the spirit of rotation of engagement partner responsibility."**

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

Other suggestions made by respondents covered the following areas:

ISA (UK) 210 (Revised June 2016) (Updated May 2022) ***Agreeing the terms of engagements***

One respondent proposed that PN 10 should include material on the need to have an engagement letter for every audit engagement and to publish those engagement letters on the audited entity's website.

PAF response: **Practice relating to agreeing the terms of audit engagements and the status of engagement letters is not a public sector-specific issue. Paragraph 10 of ISA (UK) 210 already requires that "the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement". ISAs (UK) envisage that management's and the auditor's responsibilities are communicated to users of the financial statements within the audit report (see paragraphs 33 to 42 of ISA (UK) 700** ***Forming an opinion and reporting on financial statements*****).**

ISA (UK) 240 (Revised May 2021) (Updated May 2022) ***The auditor's responsibilities relating to fraud in an audit of financial statements***

One respondent proposed that the statement in paragraph 1-47 that auditors focus their consideration of the risk and fraud and error on expenditure should be qualified to state that this is only 'likely' to be the case.

This respondent also stated that that the examples of areas where the risk of external fraud may be particularly high could be extended: for example, to include the risk of fraud committed by a private sector business partner.

Another respondent recommended that PN 10 encourage auditors to consider the risk of manipulation of adjustments between figures in the performance statement and outturn against budget, as well as the risk of manipulation of outturn against other statutory measures such local authorities' Minimum Revenue Provision.

One respondent questioned why the objectives listed in paragraph 1-38 had changed from the previous version.

PAF response: **Paragraph 1-47 has been amended to state that "In the public sector, auditors typically focus their consideration of the risk of fraud and error on expenditure."**

The example given in paragraph 1-48 of an area where the risk of external fraud may be particularly high due to an increased risk of fraudulent activity by individuals or groups outside the immediate control of the entity is only intended to be illustrative. The PAF does not consider that the presence of a private sector business partner would necessarily lead to an increased risk of fraud – virtually all public sector entities have interactions with business partners or suppliers from the private sector.

Paragraph 1-45 already states that "A public sector auditor considers misstatements that may arise from fraudulent financial reporting where the audited body may manipulate its results to meet externally set targets" – this would encompass issues such as manipulation of outturn against budget and other statutory measures. Again, the examples given are only intended to be illustrative.

The changes in paragraph 1-38 reflects amendments to the underlying standard, as this paragraph quotes directly the objectives of the auditor described in ISA (UK) 240 (Revised May 2021) (Updated May 2022).

ISA (UK) 250A (Revised November 2019) (Updated May 2022) *Consideration of laws and regulations in an audit of financial statements*

One respondent proposed that the guidance on applying ISA (UK) 250A should be updated to take account of recent Section 114 notices issued in local government and auditors' public interest reports, including guidance on support to trading subsidiaries and other non-routine transactions and their effect on the risk of non-compliance with laws and regulations.

PAF response: **The guidance on consideration of laws and regulations in PN 10 is intended to be generally applicable to public sector entities' circumstances. Given the wide scope of statutory requirements to which various public sector entities are subject, it would be impracticable for PN 10 to include extensive guidance on legal issues relating to specific entities or sectors. The PAF's view is that the section on ISA (UK) 250A, alongside the underlying standard, provides an adequate framework for auditors' consideration of laws and regulations. Sector-specific guidance applicable to local authorities may be found in the audit codes and related guidance that apply to local auditors in England, Scotland, Northern Ireland and Wales.**

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

One respondent suggested that paragraph 1-73 should develop further the concept of ownership in the public sector to encompass control or influence and their impact on audit risk (acknowledging that this is developed further in the section of paragraph 1-79 on susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk).

PAF response: **This paragraph is quoted directly from paragraph A58 of ISA (UK) 315.**

ISA (UK) 540 (Revised December 2018) (Updated May 2022) *Auditing accounting estimates and related disclosures*

One respondent suggested that paragraph 1-114, which discusses considerations relating to non-current assets in the public sector, be enhanced to include more guidance on the audit approach to address such considerations.

Another respondent also suggested expanding paragraph 1-114, specifically to encourage auditors to take a practical approach to the valuation of specialised assets where the reported value has little impact on service delivery or interest to users of financial statements.

PAF response: **Paragraph 1-114 is intended to highlight that the valuation of such specialised assets may be complex, which will have implications for the auditor's risk assessment in relation to accounting estimates. ISA (UK) 540 provides a framework for responding appropriately to risks and complexities identified within accounting estimates, which can be applied to specialised public sector assets.**

The effects of the impact on service delivery or interest to users of financial statements (or lack thereof) should be considered in the auditor's assessment of materiality, with reference to ISA (UK) 320 and the related section in PN 10. The PAF does not endorse a blanket assessment that specialised asset valuations are less material due to qualitative considerations – this should be judged on a case-by-case basis following the requirements of the standard.

ISA (UK) 620 (Revised November 2019) (Updated May 2022) *Using the work of an auditor's expert*

Two respondents proposed that PN 10 should include guidance on the use of auditor's experts for property valuations on local authority audits, from the perspective of concern from preparers of such accounts about implications for cost and timeliness of auditors' increasing use of external valuers. One of these respondents also requested guidance on making use of auditor's experts to enhance effective public financial management.

PAF response: **Paragraphs A4 to A9 of ISA (UK) 620 provide detailed guidance on determining the need for an auditor's expert.**

Paragraph A7 sets out circumstances where the auditor may be able to obtain a sufficient understanding of a relevant field other than accounting or auditing (such as property valuation) to perform the audit without an auditor's expert. The standard therefore already allows the auditor to make this judgement, depending on the skills required to audit the relevant balances, transactions or disclosures in the financial statements.

Nonetheless, paragraphs A8 and A9 are explicit that whether management has used a management's expert in preparing the financial statements influences the auditor's decision on whether to use an auditor's expert.

ISAs (UK) do not allow for property valuations on local authority audits to be subject to a different approach. Matters relating to the implications of valuation requirements embedded within the financial reporting framework for cost and timeliness of reporting are for framework setters to address rather than PN 10.

A new paragraph has been added to the ISA (UK) 620 section (paragraph 1-202) regarding the use of information that may be provided by auditor's experts to discharge auditors' wider responsibilities for public audit.

ISA (UK) 720 (Revised November 2019) (Updated May 2022) *The auditor's responsibilities relating to other information*

One respondent requested that PN 10 include further guidance to help auditors drive improvements in the quality of narrative reporting.

PAF response: **The scope of the auditor's role in relation to narrative reporting in the annual report is set out in ISA (UK) 720 and the related section in PN 10. It is not within the remit of PN 10 to drive changes in the reporting framework or audited entities' approaches to their narrative reporting.**

Applicability of PN 10

One respondent suggested that PN 10 clarify its applicability, which is currently stated in the Preface as the audits of public sector bodies in the United Kingdom, as classified by the Office for National Statistics (ONS), to cover scenarios where the ONS changes its classifications – the respondent requested specific clarification on the applicability of PN 10 to the audits of train operating companies that have been reclassified to the public sector.

The same respondent recommended that the PAF work with the Education and Skills Funding Agency (ESFA) to ensure any changes to PN 10 are reflected, where relevant, in the ESFA's framework and guidance for the auditors of academy trusts.

PAF response: **PN 10 provides guidance and recommended practice on public sector audits. Whether to apply the guidance in PN 10 to individual engagements is a matter for auditors to determine and this will be informed by the statement in the Preface that PN 10 is suitable for application to ONS-classified public sector entities.**

Bodies providing sector-specific guidance on public sector audits are free to consider the guidance in PN 10 as they deem appropriate. However, the PAF will discuss the changes made in the 2022 revision of PN 10 with the ESFA and invite the Agency to consider how these may be reflected within its guidance and framework.

Sustainability reporting

One respondent recommended that the PAF consider providing guidance on the audit of sustainability reporting, in anticipation of future expanded requirements in this area.

PAF response: **PN 10 is focused on providing guidance on existing auditing, quality management and ethical standards. If standards are adopted in future on the audit of sustainability reporting, the PAF will consider whether PN 10 should provide guidance on implementing these in the public sector.**

Other guidance

One respondent provided feedback on the practical application of paragraph 53 of Auditor Guidance Note (AGN) 01 *General guidance supporting local audit* issued by the National Audit Office in September 2022, which relates to the cap on the fees for non-audit services provided by an auditor to certain audited entities that is provided for in the Financial Reporting Council's Revised Ethical Standard 2019, suggesting there are different possible interpretations of the prescribed method for the calculation of fees subject to the cap in relation to work being undertaken for an Integrated Care System.

PAF response: **The PAF has raised this matter with the Local Audit Code and Guidance team in the National Audit Office, which has the remit for issuing any further guidance in this area.**

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?**

No specific concerns were raised by respondents in relation to this question.

AMENDMENTS MADE (SUBJECT TO FRC APPROVAL)

Subject to approval of the final draft Practice Note 10 from the Financial Reporting Council, the PAF has made the amendments indicated in the *PAF responses* above to reflect comments received as part of the consultation and related discussions, in addition to the following changes (paragraph numbers relate to the consultation draft):

Amended paragraph 1-6 to clarify that it also applies to situations where the auditor may be prevented by law from declining to accept an engagement.

Amended paragraph 1.12 to clarify that the guidance in that section is not relevant to audits where PSAA is the appointing person.

Amended paragraph 1.13 to clarify that a national audit agency may not be the appointing body and amended paragraph 1.14 to clarify that the appointing body's responsibilities for quality listed in that paragraph only apply where the appointing body has responsibility for the oversight of, or quality assurance for, the audit assignment.

Amended paragraph 1-18 to clarify that the public sector considerations referred to are in the Revised Ethical Standard.

Amended paragraph 1-19 to include a reference to paragraph 34-1(m) of ISQM (UK) 1 on confidentiality requirements.

Amended paragraph 1-47 to clarify that it is "typically" the case that auditors of public sector entities focus their consideration of the risk of fraud and error on expenditure.

Amended the third sub-bullet point under *Subjectivity* in paragraph 1-79 to refer to "probable" rather than "possible" obligations recognised as liabilities.

Amended paragraph 1-80 to clarify the inherent risks that may arise from a closely-regulated regime and to refer to "the form of the financial statements" rather than "the final form of account".

Amended paragraph 1-88 and illustrative Example 5 in Box 1 and added new paragraph 1-89 to address feedback on the guidance given relating to setting materiality.

Added new paragraph 1-202 regarding the use of information that may be provided by auditor's experts to discharge auditors' wider responsibilities for public audit.

Amended paragraph 1-232 (now 1-234) to state that "for public sector entities considered significant, the auditor establishes policies and procedures to promote compliance with the spirit of rotation of engagement partner responsibility" rather than "it may be in the public interest" to do so.

Minor amendments to paragraph referencing.