

CONSULTATION ON PRACTICE NOTE 10 (REVISED 2020): SUMMARY OF RESPONSES AND PROPOSED AMENDMENTS

INTRODUCTION

The consultation on the exposure draft of the 2020 revision of Practice Note 10 *Audit of Financial Statements and Regularity of Public Sector Bodies in the United Kingdom* closed on 31 August 2020. 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 13 responses to the consultation, from the following interested parties:

BDO
Chartered Institute of Public Finance and Accountancy (CIPFA)
Deloitte¹
Ernst and Young
Grant Thornton
Healthcare Financial Management Association (HFMA)
Institute of Chartered Accountants in England and Wales (ICAEW)
KPMG
Mazars
Police and Crime Commissioners Treasurers' Society (PACCTS)
Public Sector Audit Appointments Limited (PSAA)
PwC
South Yorkshire Police

SUMMARY OF RESPONSES BY CONSULTATION QUESTION

Question 1: This version of Practice Note 10 includes extensive changes to the section on ISA 570 *Going Concern*. **Do you consider the revised draft provides appropriate and useful guidance on applying the revised standard? What changes should be made, if any?**

The most extensive responses to the consultation related to the new proposed guidance on going concern. Several respondents welcomed the new guidance in relation to the 'continued provision of service approach'.

One respondent felt that the difference from the private sector and the funding and decision-making roles of central government should be further emphasised in the introduction to the section on ISA (UK) 570 and in paragraph I-170, now I-171 (in addition to the existing discussion in paragraph I-155, now I-156).

PAF response: We consider that paragraph I-155 adequately addresses the distinctive circumstances that apply to the financing of public sector bodies.

¹ Deloitte did not provide a full response but expressed support for the observations of the ICAEW.

The same respondent requested examples of a proportional approach to going concern, noting that there is currently variation in the approaches taken by different auditors.

PAF response: The ‘continued provision of service approach’ as set out in the section on ISA (UK) 570 is intended to be proportionate to the circumstances applying where the financial reporting framework’s treatment of the going concern basis is straightforward. Where it is not straightforward, ISA (UK) 570 and the guidance in the remainder of this section in PN 10 set out the appropriate approach. We have expanded on the key principles underlying this approach at the top of the ISA (UK) 570 section in the amended draft PN 10, under the new *Key principles* paragraph.

Two respondents suggested expanding on the examples given in paragraph I-149, now I-150 of situations where material uncertainty relating to going concern could arise in the public sector, such as covering bodies that obtain significant funding from service users or where there is a lack of certainty over future funding arrangements.

PAF response: The contents of this paragraph is quoted directly from the application guidance in the standard. We have added a sentence at the beginning of the paragraph to make this clearer.

Respondents requested further examples or clarifications relating to particular judgemental areas, such as:

- what evidence would be sufficient to support the entity’s expectations of ongoing funding (including when budgeting cycles are not aligned to the future period assessed for going concern);
- the impact of significant events such as the issuing of a Section 114 notice by a local authority or events causing major increases in demand for local services;
- whether the auditor is required to report by exception on the robustness of management’s going concern assessment (as per paragraph I-150, now I-151) when the auditor is able to conclude on going concern without a full assessment by management (as per paragraph I-161, now I-162);
- required disclosures and modifications to the auditor’s report that may be required when the auditor is aware that the reporting entity will cease to exist immediately after the year-end or on a set date during the period of the going concern assessment and the entity’s services will continue to be provided by a successor public sector organisation;
- clarification of whether a material uncertainty paragraph ought to be included in the auditor’s report in relation to going concern when there is a possibility of the entity being dissolved due to merger or transfer of functions but the public sector will be able to continue to realise the entity’s assets and discharge its liabilities regardless;
- guidance on whether a material uncertainty paragraph ought to be included in the auditor’s report in relation to going concern if there is uncertainty regarding future funding arrangements or financial sustainability or the reporting entity’s cash flow forecasts indicate that it will be unable to realise its assets and settle its liabilities in the normal course of business (or whether enhanced disclosures on the basis of preparation would be sufficient).

PAF response: We consider that the matters listed in the bullet points above can be established by auditors' professional judgement with reference to ISA (UK) 570 and the accompanying section of PN 10 as drafted, as well as ISA (UK) 500 when the matter relates to the adequacy of audit evidence.

A respondent requested clarification on whether the relevant period of assessment for whether the entity is a going concern is solely the twelve months following the date on which the financial statements are authorised for issue.

PAF response: We consider that that ISA (UK) 570 is clear that the relevant period of assessment is the period for which management have made their assessment, which management makes according to the requirements of the relevant financial reporting framework (where the financial reporting framework includes such a requirement) as per paragraph 3 of ISA (UK) 570.

One respondent noted that the statement in paragraph I-155 that local government entities have the possibility of recovering losses over time is not necessarily true in all cases.

PAF response: We have amended the drafting of the relevant sentence to state that local government entities *may* have this possibility.

The same respondent stated that the reference in paragraph I-171 to reporting under paragraph 21-1(d) of ISA (UK) 570 needs clarification as that paragraph refers to entities reporting under the UK Corporate Governance Code rather than auditor reporting requirements.

PAF response: We consider that the current drafting of that sentence in paragraph I-171 is clear that it relates to matters to be included in the auditor's report in the circumstance where the reporting entity is a public interest entity, other listed entity or reports on how they have applied the UK Corporate Governance Code.

One respondent stated their view that the continued provision of service provisions (where the financial reporting framework includes such a presumption) would not obviate the need for the auditor to review and challenge the entity's cash flow forecasts, because they considered that it would be necessary for the auditor to include a material uncertainty paragraph in the auditor's report in relation to going concern if the reporting entity's cash flow forecasts indicate that it will be unable to realise its assets and settle its liabilities in the normal course of business, even though the financial reporting framework allows for the financial statements to be prepared on a going concern basis. This view was expressed particularly in relation to local authorities that may not be in receipt of a guarantee from central government to assist with cash flow difficulties.

PAF response: The 'continued provision of service approach' only applies where the financial reporting framework allows the reporting entity to adopt the going concern basis in particular circumstances. Where these circumstances apply, there is no material uncertainty related to going concern and management's use of the going concern basis is clearly appropriate, in which case ISA (UK) 570 does not require a material uncertainty paragraph to be included in the auditor's report.

Any issues that would be indicated by the entity's cash flow forecasts showing an inability to realise assets or settle liabilities in the normal course of business would, in these circumstances, be relevant to the entity's financial sustainability rather than going concern. We have sought to further emphasise the distinction between financial sustainability and going concern issues in the amended draft PN 10, through the new *Key principles* paragraph in the ISA (UK) 570 section.

One respondent suggested that paragraph I-163 on the auditor's evaluation of management's assessment under the 'continued provision of service approach' could be better presented using a tabular presentation.

PAF response: We have experimented with presenting the information in tabular or flowchart form, but we consider the steps as set out are easiest to follow.

The same respondent indicated that the reference in paragraph I-168 to letters of financial support from central government could be interpreted as stating either that only letters specific to a particular entity can be relied upon by the auditor, or that sector-wide letters could be relied upon, and suggested this should be clarified.

PAF response: If a reporting entity were to receive a letter of financial support then, as with any other piece of audit evidence, the auditor would evaluate this against the requirements of ISA (UK) 500 Audit Evidence. The drafting in PN 10 is not intended to express a view either way as to whether entity-specific or sector-wide letters are capable of providing relevant and reliable evidence, as the effect of any letter will depend upon the particular circumstances of the reporting entity and the party issuing the letter, as well as other factors.

One respondent expressed the view that the auditor's focus when reviewing going concern ought to be cash flow and financial sustainability rather than income and expenditure metrics.

PAF response: Matters that are relevant to the auditor's consideration of going concern are set out in ISA (UK) 570 and in the accompanying section of PN 10.

One respondent requested clarification of the last sentences of both paragraph I-180 (on references in the auditor's report to considerations of necessity for a public service to continue to be delivered) and paragraph I-182 (on the explanation in the auditor's report that the conclusions on going concern do not provide assurance over the entity's financial sustainability).

PAF response: We consider that the meaning of these paragraphs as drafted is clear.

Some respondents raised matters that would need to be addressed outside of Practice Note 10, such as:

- the provision by the national public audit bodies of guidance on going concern supplementary to the Code of Audit Practice for auditors of local government and health bodies;

PAF response: Guidance on these matters will need to be considered by the relevant bodies who set the Code of Audit Practice in due course.

- suggested amendments to public sector financial reporting frameworks, such as:
 - the inclusion of a rebuttable presumption of the going concern assumption being appropriate, and material uncertainties do not need to be disclosed, in the absence of any evidence that the reporting entity's services will cease to be provided; and

- the general need to clarify going concern requirements across both auditing and financial reporting frameworks; addressing disparities between the requirements of ISA (UK) 570 and public sector financial reporting frameworks and annual budgeting cycles.

PAF response: These are matters to be addressed by the setters of the relevant financial reporting frameworks, rather than through guidance to auditors.

Question 2: Guidance is included for the case where the reporting framework requires the other information to be “fair, balanced and understandable” (ISA 720). **Does this paragraph set out an appropriate audit response for this circumstance?**

There were mixed responses to the guidance given in paragraph I-224 on the auditor’s approach when the reporting framework includes a requirement for the other information to be fair, balanced and understandable. Some respondents felt that the new paragraph provided appropriate and useful guidance.

One respondent felt that the guidance was too brief and additional information should be provided on how the concept of ‘fair, balanced and understandable’ applies to public sector entities.

PAF response: It is for the setters of public sector financial reporting frameworks rather than PN 10 to define what is meant by ‘fair, balanced and understandable’ in the public sector context.

This respondent noted that for most public sector bodies, audit requirements cover the consistency of the other information with the financial statements rather than the fair, balanced and understandable requirement, but that the direction of travel in the Redmond and Brydon reviews is for public sector financial reporting frameworks to move towards this being a requirement. Another respondent felt that this paragraph is not relevant because there is no explicit requirement in ISA (UK) 720 on the auditor to confirm that the other information is fair, balanced and understandable, other than as part of their consideration as to whether the other information is misleading. Public sector financial reporting frameworks indicate that this is the responsibility of the Accounting or Accountable Officer. This respondent stated their view that the auditor’s responsibilities relating to the other information should not vary according to the differing natures of reporting entities or applicable financial reporting frameworks.

PAF response: We do not agree with the suggested interpretation of the audit requirements. If the financial reporting framework requires the other information to be fair, balanced and understandable, then the auditor needs to consider whether it has been properly prepared in accordance with the applicable reporting framework, which in such a case would include the fair, balanced and understandable requirement. We have added an example (HM Treasury’s *Financial Reporting Manual* covering central government bodies) into paragraph I-224 as an indication of how this applies in practice.

One respondent felt that paragraph I-224 only addressed understandability rather than fairness and balance.

PAF response: Paragraph I-224 indicates that, along with understandability, the auditor considers the implications for their report of any issues with fairness or balance. The additional guidance on understandability in the following sentence is supplementary to that requirement.

The same respondent suggested that the reference to “a wide range of potential users with varying levels of financial expertise” could be expanded to note who these users are (giving the general public as an example),

but that the word “financial” could be omitted to avoid the implication that these provisions relate solely to financial information.

PAF response: As suggested, we have removed the word ‘financial’ in recognition of the fact that other types of expertise may have a bearing on the understandability of the information presented.

If further guidance were to be included in Practice Note 10 on this area, one respondent noted that this could draw upon the Financial Reporting Council’s Audit Quality Thematic Review on Other Information in the Annual Report.

PAF response: As indicated above, we have decided not to include substantial further guidance on this point.

One respondent commented that it would be helpful for the various public sector reporting frameworks to clarify whether they explicitly require the other information to be fair, balanced and understandable, as there are variations in the language used between them.

PAF response: This is a matter to be addressed by the setters of public sector financial reporting frameworks rather than in guidance for auditors.

Question 3: The guidance in the section on ISA 560 *Subsequent Events* has been re-ordered and clarified. **Do you consider the revised draft provides appropriate and useful guidance on applying the revised standard? What changes should be made, if any?**

Respondents generally welcomed the revised guidance.

Two respondents commented on instances of auditors taking longer to complete their work in recent years and thereby increasing the scope for possible subsequent events.

PAF response: The length of time taken to complete audit work is not a matter to be addressed in PN 10.

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.

Several respondents raised the topic of materiality in relation to regularity; for example, requesting guidance on how the materiality threshold applying to regularity should be set and examples of matters that might be considered material.

PAF response: The concept of materiality applies to regularity, as referred to in numerous places in Part 2 of PN 10. We have clarified the basis on which the auditor sets a materiality threshold for the regularity opinion (following the method set out in ISA (UK) 320) in paragraph 2-13.

Paragraph 2-91 sets out that auditors might consider it appropriate to draw the attention of the addressees of the auditor's report to certain immaterial irregularities – there was a suggestion that this paragraph should state the mechanisms by which auditors might do this.

PAF response: The auditor's reporting powers that might be used for this purpose are addressed in the preceding two paragraphs (2-89 and 2-90).

There was a request for clearer guidance on the situation when reporting entities are required to stay within income and expenditure limits voted by Parliament (as alluded to in paragraph 2-35) and how materiality applies when immaterial misstatements would, if adjusted, lead to a breach of these limits.

PAF response: Paragraph 2-35 establishes that the auditor may consider breaches of any of these limits to be subject to a lower materiality threshold. The treatment of the potential effect of immaterial unadjusted misstatements on outturn against these limits is an area where the national public audit bodies have made judgements in particular cases based on the existing guidance in ISA (UK) 320 *Materiality in planning and performing an audit*. We do not think this requires clarification in PN 10 at this stage.

One respondent drew attention to the challenges faced by auditors in obtaining financial and performance information covering interrelated but disparate bodies in the health sector, such as when funding is linked to the performance of overall NHS systems.

PAF response: The challenges faced in obtaining sufficient appropriate audit evidence in particular circumstances are addressed in ISA (UK) 500 *Audit Evidence*. As referred to below under Question 6, the PAF plans to consider the inclusion of provisions related to the sharing of information between interrelated entities in a future iteration of PN 10 when the UK version of the revised ISA 600 is issued.

It was noted that there is no requirement for a reasonable assurance regularity opinion for some bodies, such as those in local government, and so Part 2 is not relevant to such entities.

PAF response: This distinction is already addressed in paragraph 2-3.

One respondent stated that some auditors were reluctant to place reliance on the work of internal auditors to gain assurance over regularity and that internal and external auditors should work together to reduce duplication of work.

PAF response: The reliance placed or not placed by external auditors on the work of internal auditors is not an issue unique to the public sector and is addressed within ISA (UK) 610 *Using the Work of Internal Auditors*.

The same respondent felt that the importance of training should be highlighted in the table at 2-41 (examples of areas of risk and mitigating controls in relation to regularity).

PAF response: This table covers controls operated by reporting entities rather than auditors' methodologies, so training of auditors is not relevant here.

One respondent suggested clarifying the second bullet point in paragraph 2-12 and paragraph 2-44 to make clear that the auditor's procedures on transactions do not necessarily need to include tests of controls.

PAF response: These paragraphs reflect that tests of controls will be used in many cases to obtain assurance over regularity, but do not mandate that they are used. We have therefore retained the existing drafting.

It was noted that references to the European Union and European legislation would need to be reviewed in the light of EU Exit.

PAF response: This iteration of PN 10 will apply for audits of financial years during which transitional arrangements with the European Union will still have been in force, so references to transactions with European Union bodies and the application of legislation originating in the European Union may still be relevant. We will revisit these references in the 2021 iteration of PN 10.

Question 5: This version of Practice Note 10 has been drafted with the intention that further iterations be issued over the coming years to take account of further standards and guidance that will be released, as well as the result of wider developments in the auditing profession. **Do you consider that this approach is appropriate? What aspects, if any, of current developments not yet included should be incorporated into this version of the Practice Note?**

All respondents agreed with the principle of revisiting Practice Note 10 with further iterations in future years to take account of revisions to standards and guidance. Examples given of developments that should be covered included the revised ISA (UK) 315 and the upcoming Redmond and Brydon reviews.

There was a desire for these updates to be timely and involve consultation with stakeholders. One respondent noted that it would be desirable either for updates to Practice Note 10 to be available prior to the effective dates of new and revised standards or for supplementary guidance to be issued in the interim.

PAF response: The PAF intends for a 2021 revision of PN 10 to be issued in the latter part of that year and this will be subject to appropriate consultation with interested parties.

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:

International Standard on Quality Control (ISQC) (UK) 1

One respondent felt that the last sentence of paragraph I-4 (on the establishment of policies and procedures over engagement acceptance and continuance when the auditor does not have the option to withdraw from the engagement) was unclear.

PAF response: The contents of paragraph I-4 is a direct quotation from ISQC (UK) 1. We think that its meaning is clear.

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

One respondent requested guidance to support consistency on addressing fraud through management override of controls in the public sector context, similarly to the guidance on fraud in revenue recognition given in paragraphs I-46 and I-47.

PAF response: We consider that the guidance on addressing the risk of fraud through management override of controls in ISA (UK) 240 can be applied in the public sector context. We have therefore not added additional guidance beyond what is already included.

ISA (UK) 320 Materiality in planning and performing the audit

Several respondents noted that, because materiality may be set using a gross expenditure basis for public sector entities, proportionally small misstatements in asset or liability valuations are more likely to be material by value even where they do not impact key decisions in relation to, for instance: budgets; performance against Parliamentary control totals; the setting of Council Tax levels; or the level of usable reserves. The suggestion was that this leads to auditors performing extensive work on balances that are of limited interest to users of financial statements (such as property assets that are not managed on a commercial basis). These respondents requested guidance on addressing this situation, such as whether in some circumstances it would be appropriate for auditors to set an overall materiality based on gross assets, with a lower materiality threshold for areas of greater interest to users – one respondent felt that the absence of any such examples in the exposure draft could be seen to imply that this approach is not appropriate.

PAF response: The absence of such specific examples in PN 10 is not intended to imply that the suggested approach is inappropriate. However, the issue of disparities between the values of, and levels of interest in, balances and transaction streams in different areas of the financial statements is not unique to the public sector. Auditors should follow the guidance given in ISA (UK) 320 and elsewhere (such as the FRC's Audit Quality Thematic Review on Materiality) when setting materiality thresholds.

ISA (UK) 540 Auditing accounting estimates and related disclosures

One respondent felt that the section on inherent risk factors could usefully include consideration of estimation uncertainty, subjectivity and complexity in the public sector context against the examples mentioned in paragraph I-116.

Another respondent questioned whether the example given in paragraph I-116 of liabilities relating to defined benefit pension schemes as an area of very high estimation uncertainty is intended to suggest that such liabilities should always (or nearly always) be identified as a significant risk.

PAF response: This should be determined on case by case basis with reference to the guidance in ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment*.

The same respondent requested clarification of the example given in the same paragraph of general political uncertainty and the possible impact of future changes in public policy on the assumptions underlying accounting estimates as an inherent risk factor, including whether these should be treated as non-adjusting subsequent events or reflected in financial statement balances.

PAF response: The question of which events are adjusting or non-adjusting should be determined on a case by case basis with reference to the guidance in ISA (UK) 560 *Subsequent Events*.

ISA (UK) 600 Special considerations – audits of group financial statements (including the work of component auditors)

A respondent welcomed the proposed application of the provisions on 'Access to information' in paragraphs 13 and A14 to A19 of ISA 600 to the audits of combined financial statements of components that have no parent (paragraph I-195). This respondent felt that a similar provision would be helpful in other instances,

such as when the auditors of member bodies of pension funds require information from the fund auditor, or in the local government sector when precepting authorities (including providers of police, fire and transport services) disclose information obtained from local authorities in their financial statements.

PAF response: The PAF plans to consider the inclusion of such provisions in a future iteration of PN 10 when the UK version of the revised ISA 600 is issued.

ISA (UK) 701 *Communicating key audit matters in the independent auditor's report*²

One respondent requested guidance on the use of extended auditor reporting, including whether in some circumstances matters relating to value for money or regularity ought to be reported as Key Audit Matters.

PAF response: There was no specific guidance in the exposure draft of Practice Note 10 on the application of ISA (UK) 701. We have now added a new section providing guidance on ISA (UK) 701 that makes it clear that this is an option.

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 above to reflect comments received as part of the consultation and related discussions, in addition to the following changes (paragraph numbers relate to the exposure draft):

Paragraph 1-4: Stylistic drafting changes (no change in meaning).

Paragraph 1-168: Drafting change to clarify which part of the paragraph refers to the situation when the entity's operational activities are not to be transferred within the public sector.

Paragraph 1-170: Drafting changes to clarify that the auditor would only request confirmation from the entity's financial backer in some cases and that such confirmation would be confirmation that there are no plans that would be likely to impact on the entity's continued operational existence.

Paragraph 1-171: Drafting change to reflect the fact that this paragraph would apply when there are indications that the entity may cease operations.

Paragraph 1-178: Removed as this paragraph relates to cash accounts, for which the going concern basis is not relevant.

Paragraph 1-180: Added a footnote to clarify the types of bodies to which this paragraph applies.

Paragraph 1-182: Redrafted to leave the inclusion of an explanation of the meaning of the concept of going concern and/or that the going concern conclusions do not cover financial sustainability as optional based on the auditor's judgement.

General: References that indicate the auditor "should" or "must" do something have been adapted to follow the convention that the guidance in PN 10 is not worded as instructions (except in paragraph 1-58, which refers to legal obligations under money laundering regulations, and paragraphs 2-4 and 2-5 and the definition of Framework of Authorities in the Glossary, which relate to the concept of regularity). Other typographical corrections have also been made.