

PRACTICE NOTE 10: ANNUAL REVIEW REPORT TO THE FRC 2021

INTRODUCTION

1. The Public Audit Forum (PAF) has been designated by the Financial Reporting Council (FRC) as a 'SORP-making body' for the purposes of maintaining and updating Practice Note 10 *Audit of Financial Statements and Regularity of Public Sector Bodies in the United Kingdom* (PN 10).
2. Under paragraph 58 of the FRC's [Policy on developing statements of recommended practice \(SORPs\) \(January 2021\)](#) (the FRC Policy), SORP-making bodies are required to review, on an annual basis, the SORP for which they are responsible. As a minimum, a SORP-making body shall consider:
 - (a) any implications for the SORP of new and proposed accounting, auditing or actuarial standards – any divergence should be notified to the FRC as soon as possible;
 - (b) any evidence of widespread or significant failure in the relevant industry or sector to follow any part of the guidance contained in the SORP, of which the SORP-making body is aware;
 - (c) any developments in the industry or sector which suggest that further guidance in respect of their accounting, auditing or actuarial treatment is desirable; and
 - (d) any new or emerging factors that may impact the continued need for the SORP.
3. Under paragraph 60 of the FRC Policy, the account shall include:
 - (a) the current membership of the standing groups, including length of service and any steps taken to periodically refresh the membership;
 - (b) details of any changes made to the governance arrangements of the SORP-making body;
 - (c) the process and actions taken by the SORP-making body to engage with stakeholder groups; and
 - (d) whether the SORP-making body proposes to revise any of the SORPs for which it is responsible in the light of the findings of its annual review.
4. This document is the PAF's account of the findings of its annual review for 2021 that is required to be provided to the FRC under the FRC Policy. It has been prepared by the Standing Group established by the PAF for the purpose of carrying out the PAF's functions as the SORP-making body for PN 10 (hereafter called the Standing Group).
5. In carrying out the annual review, the Standing Group has complied with the FRC Policy as set out below and continues to be committed to acting in accordance with it.

MEMBERSHIP OF THE STANDING GROUP

6. Each of the public audit bodies that are members of the PAF (Audit Scotland, Audit Wales, the National Audit Office and the Northern Ireland Audit Office) have nominated one representative to be a member of the Standing Group. The National Audit Office has also nominated an additional member to provide secretarial functions for the Standing Group.
7. The following list indicates the length of service of members of the Standing Group:
 - i. Representative from Audit Scotland: since October 2019
 - ii. Representative from Audit Wales: since October 2019
 - iii. Representative from the National Audit Office: since October 2019
 - iv. Representative from the Northern Ireland Audit Office: since September 2020
8. The Standing Group's terms of reference require the technical director of each respective public audit body, who make nominations to the Standing Group, to have regard to the length of service of the current members and the need for membership to be periodically refreshed.

GOVERNANCE ARRANGEMENTS OF THE STANDING GROUP

9. In accordance with paragraph 25 of the FRC *Policy*, the Standing Group has during 2021 established terms of reference, which include a process for appointments.

ENGAGEMENT WITH STAKEHOLDER GROUPS

10. As part of the process for issuing the 2020 version of PN 10, the PAF carried out a public consultation on the exposure draft of the revised PN 10, the results of which are available on the PAF website [here](#).
11. The Standing Group also established a 'task and finish' group made up of members of major private sector firms that carry out audits of public sector entities. Members of the Standing Group also regularly meet with representatives of the firms and discuss their public sector audit work.
12. The results of these consultations have been taken into account in carrying out the annual review.

IMPLICATIONS OF NEW STANDARDS

13. **Fraud (including impact on the regularity opinion)**
 - i. ISA (UK) 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* (Revised 2021) comes into effect for audits of financial statements for periods commencing on or after 15 December 2021 (equating to the 2022-23 financial year for most public sector bodies).

- ii. The Standing Group understands that none of the major firms or national public audit bodies undertaking public sector financial audit work intend to early adopt ISA (UK) 240 (Revised 2021) in 2021-22.
- iii. The PAF therefore does not intend to revise the guidance on ISA (UK) 240 in PN 10 until early in 2022.
- iv. In the public sector, the auditor's responsibilities with respect to fraud (covered by ISA (UK) 240 and the related section of Part 1 of PN 10) are interrelated with the work that underpins the regularity opinion (covered by Part 2 of PN 10). Fraudulent transactions are irregular by definition, because they are not in accordance with the entity's framework of authorities.
- v. The following main changes to ISA (UK) 240 have been made in the revised version:
 - ISA (UK) 240 (Revised 2021) explicitly clarifies that the auditor is required to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud.¹
 - Additional requirements have been added to require the auditor to undertake risk assessment procedures and design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory (paragraph 12-1) and to add other requirements for understanding the risk of fraud (paragraphs 16 and 18-1).
 - Paragraph 13-1 has been added to clarify that the auditor shall remain alert for conditions that indicate a record or document may not be authentic.
 - Paragraphs 15-1 to 15-4 add requirements for discussion of fraud risks among the engagement team.
 - Paragraph 24-1 requires the auditor to determine whether specialised skills or knowledge are required for work on fraud risks.
 - The new stand-back assessment of audit evidence obtained is required to cover the risks of material misstatement due to fraud (paragraph 36-1).
 - Paragraph 39-1 requires that the explanation in the auditor's report of to what extent the audit was considered capable of detecting irregularities, including fraud, shall be specific to the entity's circumstances and the auditor's planned and performed procedures.
 - Some further changes emphasise the related requirements of existing ISAs (UK) (for example, paragraph 21-1 pointing to ISA (UK) 500 and paragraph 32-1 pointing to ISA (UK) 540).
 - The final version also includes a requirement for the auditor to discuss the risk of fraud with the audit committee.
- vi. The assurance provided by the auditor relating to regularity, where a regularity opinion is given in the auditor's report, is as high a level of assurance as that relating to fraud, because the auditor is required to give a positive assurance conclusion as to whether the transactions

¹ The objectives of the previous version of ISA (UK) 240, as reflected in PN 10 (Revised 2020) were "to identify and assess the risks of material misstatement of the financial statements due to fraud; to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and to respond appropriately to fraud or suspected fraud identified during the audit."

in the financial statements are materially in accordance with the framework of authorities. Furthermore, there is no direct requirement for the auditor's work on regularity to be entirely consistent with the approach set out in ISA (UK) 240 for work on fraud.

- vii. However, the PAF considers that, as part of the 2022 update of PN 10, it would be appropriate to amend the PN 10 sections on ISA (UK) 240 and on regularity (Part 2) to clarify the overlap in responsibilities with respect to fraud and regularity.
- viii. Changes to Part 2 (Regularity) of PN 10 could also include: bringing the risk assessment procedures for regularity into line with those for fraud; ensuring a stand-back assessment is performed of evidence underpinning the regularity opinion (noting that the concept of a stand-back assessment is not specific to ISA (UK) 240); and requiring the auditor's report to explain the extent to which the audit was considered capable of detecting material breaches of the framework of authorities. These changes would bring auditors' practices with respect to regularity more into line with those relating to fraud and the interrelationships and alignment between the two would be made explicit in the text.
- ix. Alongside the alignment with fraud issues, the PAF also intends to expand on the existing guidance in paragraphs 2-13 and 2-14 of the 2020 version of PN 10 on the setting of a materiality threshold for the regularity opinion, which should be determined in line with the requirements of ISA (UK) 320 that apply for the setting of materiality for the true and fair opinion. This will cover quantitative and qualitative considerations of materiality.
- x. The PAF intends to consider the timing and scope of this work on Part 2 of PN 10 during 2021, but intends at least the clarification of responsibilities with respect to fraud and regularity to be put in place for 2022.

14. Risk assessment

- i. ISA (UK) 315 *Identifying and assessing the risks of material misstatement* (Revised July 2020) comes into effect for audits of financial statements for periods commencing on or after 15 December 2021 (equating to the 2022-23 financial year for most public sector bodies).
- ii. The Standing Group understands that none of the major firms undertaking public sector financial audit work intend to early adopt ISA (UK) 315 (Revised July 2020) in 2021-22.
- iii. The PAF therefore does not intend to revise the guidance on ISA (UK) 315 in PN 10 until early in 2022.
- iv. The 2020 revision of PN 10 includes, under the section on ISA (UK) 540 *Auditing accounting estimates and related disclosures* (paragraph 1-116), some examples of inherent risk factors that may be relevant to public sector entities. In light of the increased importance of the assessment of inherent risk as ISA (UK) 315 (Revised July 2020) is adopted in the public sector, the PAF feels it would be appropriate to explore whether this guidance can be enhanced and expanded into the ISA (UK) 315 section of PN 10 in its next iteration.

15. Quality management

- i. In December 2020, the FRC issued a consultation on adopting ISQM (UK) 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or*

related services engagements, ISQM (UK) 2 Engagement quality reviews and revising ISA (UK) 220 (Revised November 2019) Quality control for an audit of financial statements. ISQM (UK) 1 and ISQM (UK) 2 replace ISQC (UK) 1, the extant standard that deals with a firm's responsibilities for its system of quality control.

- ii. The section on ISQC (UK) 1 in the 2020 iteration of PN 10 covers: client acceptance and continuance considerations when the engagement is mandated by statute; quality control for contracted-out engagements and engagements on an 'appointment by' basis; additional ethical, independence and confidentiality requirements for auditors in the public sector; and the appointment of engagement quality control reviewers.
- iii. The section on ISA (UK) 220 in the 2020 iteration of PN 10 is taken entirely from the paragraphs of ISA (UK) 220 (Revised November 2019) that deal with public sector-specific considerations (as well as those covering the overall objectives of the ISA (UK)).
- iv. ISQM (UK) 1 introduces a new approach to quality management at the firm level that emphasises the responsibility of firm leadership for proactively managing quality, while at the same time being scalable to deal with differences in the size of firms and nature of the services they provide.
- v. ISQM (UK) 2 addresses the appointment and eligibility of an engagement quality reviewer and their responsibilities relating to that review.
- vi. ISQM (UK) 2 and ISA (UK) 220 (Revised 2021) are effective for periods beginning on or after 15 December 2022 (equating to audits of 2023-24 financial statements for most public sector bodies).
- vii. Systems of quality management in compliance with ISQM (UK) 1 are required to be designed and implemented by 15 December 2022 and the evaluation of the system of quality management required by paragraphs 53-54 of ISQM (UK) 1 is required to be performed within one year following 15 December 2022.
- viii. Given the timing of the new quality management standards coming into effect, the PAF intends to consult public sector audit stakeholders during 2021 on the extent to which they may early adopt these standards and use this information to produce an indicative timetable for updating the quality management material in an appropriate future iteration of PN 10. Early adoption is being encouraged by the FRC and the PAF expects at least some of the national public audit bodies to early adopt the new standards. The FRC has encouraged bodies and firms to think about the steps that will be needed to implement a new quality management approach and what aspects of these could be put into place before the implementation deadline. The PAF would therefore expect to be considering updates for the new quality management standards in the 2022 iteration of PN 10.

16. Group audits

- i. The PAF also understands that the revised ISA (UK) 600 may be in effect by early 2022. The PAF will monitor developments in this area and their possible effect on PN 10.

17. The Standing Group is not aware of any evidence of widespread or significant failure by auditors of public sector entities to follow any part of the guidance contained in PN 10.
18. **Going concern**
- i. Feedback from stakeholders indicates that the guidance in the PN 10 section on ISA (UK) 570 *Going concern* is helpful in allowing auditors to apply the standard in the public sector in a proportionate manner.
 - ii. However, there are indications that the PN 10 section on ISA (UK) 570 *Going concern*, which is being implemented by the public sector for the first time during the 2020-21 financial year, could be clarified to increase consistency of approach among auditors in applying ISA (UK) 570 in the public sector context.
 - iii. The main area where stakeholders have asked for clearer guidance is in what circumstances does there exist a material uncertainty related to going concern for a public sector entity.
 - iv. The PAF's consultation response on the exposure draft for the 2020 iteration of PN 10 included the following commentary on material uncertainties related to going concern: *"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."*
 - v. In order to provide further guidance on this point, the National Audit Office, a member body of the PAF, which is responsible for issuing the Code of Audit Practice to local auditors, intends to release a guidance note on going concern with illustrative examples to explain when there is or is not a material uncertainty related to going concern.
 - vi. Subsequent to this, the PAF intends to review stakeholder responses to the local audit guidance note and consider whether aspects of the guidance could usefully be brought into PN 10 in order to be applied more widely for the public sector.

SECTOR DEVELOPMENTS

19. The most significant development in the public sector since issuing the 2020 version of PN 10 is the global COVID-19 pandemic. This has had a significant impact on public sector entities. However, it has not substantially changed the public sector audit and assurance framework.
20. The pandemic has led to increased remote working on the part of both auditors of public sector entities and the audited entities themselves. The issues this raises for carrying out ISA-compliant audits are not unique to the public sector and have already been covered widely in published guidance to the profession.
21. Other recent developments in the audit sector include the Government's white paper consultation on the future of audit, [Restoring trust in audit and corporate governance](#), published in March 2021. The consultation sets out proposals in response to recommendations made by three independent reviews:

Sir John Kingman's independent review of the FRC; the Competition and Market Authority's statutory audit market study; and Sir Donald Brydon's independent review of the quality and effectiveness of audit. While these proposals include matters that will be of significance to public sector auditors (including for the Public Interest Entities within the public sector audit client base and on the scope of audit work) these developments raise issues for the audit profession as a whole, so the PAF expects the resulting need for changes to the public sector-specific guidance in PN 10 to be limited. However, the PAF will keep developments in this area under review and consider any further emerging impacts on public sector audits.

NEW OR EMERGING FACTORS

22. The Standing Group is not aware of any new or emerging factors that may impact the continued need for the SORP.
23. There continues to be a need for guidance for auditors to apply ISAs (UK) and quality management standards in the public sector given the specialised nature of public sector financial statement audit and the fact that ISAs (UK) are designed primarily for private sector entities.
24. There is additionally no other primary source of guidance covering the audit of regularity other than PN 10.

REVISIONS TO PN 10

25. The PAF does not intend immediately to revise the 2020 version of PN 10 as a result of the 2021 annual review.
26. However, in order to incorporate guidance relevant to new standards taking effect for the 2022-23 financial year in the public sector, as well as quality management standards that may be early adopted, the PAF intends to work on a revised version of PN 10 to be issued for consultation in early 2022.