Response to the Consultation on the 2022 Revision of Practice Note 10

Ichabod's Industries is an accounting consultancy firm, primarily providing advice to more than 50 authorities that subscribe to its technical support service. This involves regular comment on the approaches taken by the auditors to the financial statements in order to assist authorities in facilitating compliance with auditing standards.

Before founding Ichabod's, I was for 20 years a senior manager at PricewaterhouseCoopers, responsible for advising the local government audit practice on accounting and audit issues. I was also responsible for drafting the original version of Practice Note 10 in 2001 and blog regularly for the Room 151 website on local audit matters.

Please find set out below our response to the question raised in the Public Audit Forum on materiality.

Stephen Sheen
13 September 2022

86 Heol Nant Glandulas, Cardiff, CF14 0AF
Telephone – 02922 411849   email – stephen.sheen@sky.com
Ichabod's is a company registered in England and Wales with the registration number 3838992

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?***

We are grateful that the Public Audit Forum is making efforts to improve the Practice Note 10 content relating to ISA (UK) 320. We have been concerned for a number of years that auditors in local government have been setting high levels of materiality for the financial statements as a whole when compared with the judgements made by authorities under the applicable financial reporting framework.

For instance, the Code of Practice on Local Authority Accounting (taking into account the anticipated usefulness of the information) advises that Property, Plant and Equipment assets carried at current value are normally measured once every five years (paragraph 4.1.2.38). Assuming annual property price inflation of 5%, this suggests an expectation that current values could increase by more than 20% before the decision-making capabilities of primary users of the accounts would be compromised. For a unitary authority, where the value of PP+E assets in the Balance Sheet is usually around double the amount of gross expenditure in the Comprehensive Income and Expenditure Statement, a typical benchmarking exercise based on 1.5% of gross expenditure would project material misstatement of the PP+E balance of 0.75% against the "true" figure. On a crude measure, this is almost a thirtieth of the tolerance implied by the Accounting Code.

As a result of these circumstances, we consider that the amendments and additions need to be better nuanced to secure the necessary change in general practice that guarantees materiality levels will not be set on this basis.

This is particularly important in making sure that materiality is set in comprehensive consideration of both the amount of the items in the financial statements and their potential significance to users and not just their potential significance. The key consideration is the sensitivity of users to potential misstatements in different balances or transactions before the misstatements would influence their decision-making. In certain circumstances, this has the consequence that materiality needs to be set with reference to what is of <u>least</u> significance to users.

Here is our technical argument as it relates to local government, previously presented to the CIPFA LASAAC Board responsible for the Code of Practice on Local Authority Accounting in response to a Spring 2022 consultation …

> ISA 320 Materiality in Planning and Performing an Audit is clear in paragraph 3 that where a discussion of materiality is present in the applicable financial reporting framework, this provides a frame of reference to the auditor in determining materiality for the audit.
>
> Auditors should therefore be working with the Code of Practice on Local Authority Accounting definition (paragraph 2.1.2.14):

> "… information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting authority. In other words, materiality is an authority-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual authority's financial statements."

The auditor's methodology should not therefore result in any practical outcome that involves claims that a misstatement is material if this is not supported by this Accounting Code definition. There is then a simple reflexive test that if the audit materiality is highlighting items that are clearly not material in real life, then the methodology will have been proven to be faulty.

This provides a challenge to the application of ISA 320 that requires recognition of local government circumstances and appropriate influence by "… law, regulation or other authority, and by the financial information needs of legislators and the public in relation to public sector programs …" (paragraph A3).

This challenge is particularly difficult in local government because of the impact that statutory requirements have on the interplay between the Balance Sheet and the measures of financial performance that are of most significance to users. There is little evidence of net assets being a primary focus for user attention. Transactions that impact only on the Balance Sheet of a local authority can be of greatly reduced significance, with a substantially larger tolerance for potential misstatements (eg, in Property, Plant and Equipment and Pensions Liabilities). In the commercial sector, it can be presumed that every £ counts equally for investors, as everything feeds into the key measures of either net profit or net assets.

The significant twist is that if all transactions and balances cannot be counted equally, then the overall audit materiality should not be based on what might be judged most important for users but what is least important. Otherwise, undue significance is given to potential misstatements that would have no influence over users.

This is the key criticism in the auditors' application of ISA 320 in local government – over-reliance on a benchmark chosen under paragraph A4 without properly considering the "relative importance" issue. Any benchmark chosen is only intended to be a starting point in determining materiality. Where the auditor follows mechanically a process that sets the benchmark based on what is determined to be of most interest to users (and the percentage applied to the benchmark is not adjusted appropriately), it is guaranteed to overstate overall materiality.

(The examples that accompany paragraph 1-86 of Practice Note 10 Audit of Financial Statements and Regularity of Public Sector Bodies in the United Kingdom are unfortunate in reflecting this error, but they are illustrative only. The content of PN 10 does not direct auditors in this way.)

The argument is not therefore that auditors could somehow raise their materiality exceptionally for particular balances. It is that ISA 320 fundamentally requires overall materiality to be set at the level that will be sufficiently high for all significant transactions and balances. This would therefore be in reference to the Balance Sheet items. Paragraph 10 would then allow this level to be dropped for the elements for which this level is inappropriate. Admittedly, these exceptions would cover a very substantial part of the financial statements, but this not inconsistent with ISA 320.

We suggest that the following enhancements are needed to the Consultation Draft:

- We understand that the Practice Note is to be read in conjunction with the ISAs, but in the section on ISA 320 silence about matters other than selecting a benchmark gives undue weight to that process. Some commentary would be helpful on:
    - paragraphs 2 and 3 and the prospect of a discussion of the concept of materiality in the applicable financial reporting framework that would remove paragraph 2 as a frame of reference
    - the fact that paragraph A4 only comments that a percentage is often applied to a chosen benchmark in determining materiality for the financial statements as a whole (and then only as a starting point)and does not require their use.

- Amend the proposed paragraph 1-88 to reflect clearly the principle of relative significance.

  1-88 In some public sector entities (for example, those that include major infrastructure assets or pension obligations), the value of gross assets and/or liabilities is much higher than the value of total expenditure and income. These circumstances could also apply to entities whose assets are carried at current value but where for decision-making the key elements of expenditure related to those assets are based on historical cost measures. The majority of the decisions of users of these entities' financial statements ~~are~~ might be taken based mainly on in-year transactions rather than the large asset or liabilities balances, for which there is often little intervention to be made by the entity from year to year (for example, historic or specialised property assets or statutory pension schemes). However, users may also periodically make economic decisions based on the overall assets and liabilities (for example, decisions to re-finance infrastructure assets or transfer pension obligations).

  In such circumstances, the different levels of significance that primary users give to different transactions and balances will mean that the sensitivity of these users to potential misstatements should be considered. Misstatements will be much larger for the less sensitive items before they would have the potential to influence decision-making. The appropriate benchmark for the financial statements as a whole could then be 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.

  Where the audited entity has custody of significant public assets, their service potential is an important contributor to the entity's ability to deliver its critical services, which may make them an appropriate benchmark for setting materiality for the financial statements as a whole, in line with paragraph A9 of ISA (UK) 320. In this context, the auditor's approach to determining materiality levels reflects the various needs of users of the financial statements for different purposes.

- Amend Example 4 – the scenario is a less detailed exposition of the basic circumstances that apply in the new Example 5, yet the outcome is different. We consider that the Example would be better off deleted, but as a minimum it would need to be extended to explain why users would be equally or more sensitive to potential misstatement of non-current assets as to misstatement of gross expenditure.