

Invitation to comment

Practice Note 10: Audit of Financial statements and regularity of public Sector Bodies in the United Kingdom (revised 2022)

We welcome the opportunity to comment on the proposed update of Practice Note 10.

MHA are involved in the audits of academies, higher education institutions, further education colleges and other not for profit organisations. Our comments on Practice Note 10 result from our experience in these sectors.

We are broadly supportive of the changes to PN10 in respect of fraud and materiality, and the provision of further guidance on obtaining assurance over regularity from both controls testing and from detailed substantive procedures (2-41 and 2-42).

We welcome the section in Practice Note 10 reflecting the FRC Revised Ethical Standard, and comments on partner rotation, which is reflected in the guidance provided in the Academies Accounts Direction 2021 to 2022 and the Post 16 Audit Code of Practice 2021 to 2022. We endorse a 10-year rotation policy, whilst noting a need to reflect the commerciality of rotation after fewer years with the need for objectivity.

While we endorse paragraph 1-232, we would propose amendments to this. The paragraph notes'may be in the public interest... to establish policies and procedures to promote compliance with the spirit of rotation of engagement partner responsibility'.

We would suggest that it **would** be in the public interest, and the FRC Ethical Standard has a **requirement** for the establishment of such policies and procedures.

Question 1

Do you consider that 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 concept of materiality in relation to regularity is complex. There is a need to determine a level for performance materiality as that informs the testing that is required. However when a transaction is identified that does not conform the relevant authorities it must, by definition, and as a matter of fact, be irregular as this a binary concept. The section on evaluation of irregularity from 2-75 is therefore helpful. It may be useful to note that irregularity is almost always going to be factual not judgemental.

(1-88 Box 1 page 35)

The consideration of the audit work required where there is disparity between significant balances and significant income and expenditure streams is not unique to public sector audits. However, Example 5 is a very helpful illustration of such an instance.

We would also welcome consideration being given to entities that have financial health gradings attached to them from their sectors regulators. For example, Further Education institutions have three metrics by which their financial health is graded by the ESFA. This is an area that should be considered when reviewing performance materiality depending on the grading of the institution the risk of manipulation or amend accounting treatment in order to obtain a more favourable score.

The concept of setting materiality as a criteria related to assets and liabilities is a difficult concept when regularity is about transactions and their conformity with the framework which governs them. Perhaps add the paragraph that the use of balance sheet balances is likely to be rare and exceptional.

Question 2

Does this section, (the guidance on applying ISQM (UK) 1 in the public sector), 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?

We are satisfied that this section addresses our requirements in relation to ISQM (UK) 1. In particular, the guidance in relation to engagement quality review (1-23 to 1-25) remains in line with current practice.

Question 3

Are these examples of 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?

We welcome the examples provided. However, we consider that there could be further issues arising in public sector audits that are different from those of other entities and additional examples would assist. We would suggest:

1-80 A further risk factor of **new service deliveries** or perhaps expanding the 'change' example to cover this?

- *There are requirements for new area of service delivery imposed on the public sector entity, for example as a result of a national emergency.*

We would also suggest expanding the 2nd bullet point as follows:

“there is the possibility of manipulation by management to achieve performance or other targets set internally, externally or by a regulator;

We also note in respect of this section on ISA 315 that 1-73 includes the concept of 'Ownership' in the public sector.

We consider that this concept is not sufficiently developed in paragraph 1-73 in order to encompass **control or influence**, and the impact on audit risk, though this is developed further in the section on susceptibility to misstatement due to management bias and other fraud risks. It would be helpful to expand at 1-73.

This also links to the issue of conflicts of interest, as the circumstances of public sector bodies means that relationships can be quite complex and opaque. For example there may be a greater likelihood of the existence of conflicts of loyalty than for commercial organisations.

1-79 Uncertainty (page 32) references 1-116. This reference should be 1-110.

1-79 final paragraph – a cross reference to 1-42 would help here.

1-80 Expand the paragraph on why a closely regulated regime increases inherent risk. Does this imply that the susceptibility to misstatement is always increased by the requirement to meet targets?

1-80 Explain a breach of Parliamentary control totals?

1-80 The final bullet point should refer to financial statements rather than the final form of accounts.

Question 4

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?

We can comment only on academies, higher education institutions and further education colleges. For these, the guidance provided in PN 10 is sufficient, supplemented by additional material, for example Annex C Summary of Regularity Concerns.

We would also comment here that the issue of propriety of transactions is rather downplayed. We accept the statement that it is not readily susceptible to objective verification; however on occasions the impropriety is of such significance that its effect on regularity must be considered, and may well result in a conclusion that the transaction is irregular.

Question 5

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?

No further comments

Question 6

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

The comments related to ISA 570 and the different position of public sector bodies regarding going concern are helpful. Would it be worth referring to the fact that many bodies have defined benefit pension schemes and have historically had weak balance sheets due to the existence of pension scheme liabilities, though these are generally long term factors which do not affect the assessment of going concern

Question 7

Do you consider there is any revision that could be made to support the use of the Welsh language?

No comment

Sudhir Singh – Partner and Head of Not for Profit
MHA
20 September 2022