

# Practice Note 10

# Proposed Revisions

Audit Scotland response



Prepared by Audit Scotland  
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# Audit Scotland response

Audit Scotland welcomes the opportunity to comment on the proposed revisions to Practice Note 10.

We hope our responses to the consultation questions set out in the following table are helpful.

## Questions and Audit Scotland response

**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 have some concerns about the appropriateness of the new paragraph 1-88 and the addition of Example 5 at Box 1 on page 35 of the exposure draft. Our concerns are that auditors of local authorities could interpret these additions as approval to use assets as the benchmark for calculating materiality for local authority annual accounts.

We do not consider assets to be an appropriate materiality benchmark for local authorities (other than pension funds). To support our view, we refer to the guidance at paragraph A4 of ISA (UK) 320 on the factors in determining an appropriate benchmark for materiality:

- *Whether there are items on which the attention of users tends to be focussed* – In our experience users' attention is focussed predominately on service expenditure. The valuation of assets is a secondary concern.
- *Nature of the entity* – The nature of local authorities is such that their principal role is to deliver local public services. While they hold significant assets which are used to deliver those services, the assets themselves are ancillary. The expenditure incurred in delivering the services is more closely related to the authorities' nature.
- *The way the entity is financed* – Local authorities are funded through grants and local taxation all of which are recognised in the income and expenditure statement. Capital expenditure is funded through capital grants, capital receipts, direct charges to the General Fund and borrowing. Depreciation and impairment of assets are not charged to the General Fund as a result of statutory adjustments. The focus of users is on service expenditure and charges to the General Fund.

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- *Relative volatility of the benchmark* – central government controls the level of grants provided to local authorities to fund expenditure. The grants are generally increased in a measured manner which makes them a relatively stable measure. Asset valuations in contrast are more volatile and can fluctuate significantly. For example, it is common for substantial increases in the year of asset revaluations. This volatility makes asset values an unsuitable benchmark.

Based on the above analysis, we recommend that para 1-88 be amended to clarify that example 5 should not apply to a local authority.

**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?

Most of the proposed changes apply to contracted out audits and therefore do not apply in Scotland (as Audit Scotland uses an appointments basis).

We consider that the paragraphs that do apply in Scotland - paragraph 1-23 (in respect of engagement quality review for bodies judged to have a high public profile) and paragraph 1-27 (on the individual assigned operational responsibility for the system of quality management) do provide appropriate and useful guidance. We have no suggested changes.

**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?

We consider that the example inherent risk factors listed at paragraph 1-79 are relevant to public sector audits and encompass the common areas of inherent risk that are particular to public sector entities. We have no additions or changes to propose.

**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?

We consider that part 2 provides guidance that is appropriate, sufficient and applicable to the relevant parts of the public sector.

However, in respect of one specific point, we note that paragraphs 2-34 and 2-34A both refer to the possibility of the threshold for materiality being different to that for the financial statements. We agree with that point. However, the examples all relate to situations where the threshold for materiality would be lower for regularity.

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We are not aware of any circumstances where it would be appropriate for the materiality threshold to be higher for regularity. We therefore suggest using the word 'lower' rather than 'different' paragraphs 2-34 and 2-34A may make the intention clearer.

**Question 5:** The consultation draft includes other changes, as outlined in the Annex below. 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?

We have examined the following changes and consider that they provide useful and appropriate guidance:

- Paragraphs 1-40 to 1-44 on the interaction between fraud and regularity responsibilities.
- Paragraphs 1-156 and 1-162 which provide additional clarification on the adoption of the going concern basis of accounting.
- Paragraph 1-195 on cases where those charged with governance in a group is unclear.
- Paragraphs 1-227 to 1-233 on applying the revised ethical standard to the public sector.

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

We have not identified any other changes that are required.

**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 through 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?

We have no comment to make.

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## Audit Scotland response

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