
Grant Thornton UK LLP

Alison Taylor
Director of Finance (S151 Officer)
Carlisle City Council
By email

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Dear Alison

Audit Scope and additional work 2020/21

Introduction

As you are aware, local audit has gone through major changes in the last couple of years. More and more councils are getting involved in complex and innovative financial arrangements, increased regulatory pressures, the expectations of stakeholders and enhancements to Codes and Standards have fundamentally changed the landscape in which we work. COVID - 19 and lockdown have added further unanticipated pressures on both auditors and audited bodies. In this letter, I set out my expectations of the increased audit work which will be required in 2020/21. I also set out the expected fee impact, the need for which has recently been acknowledged by both the Redmond Review and MHCLG's subsequent response. I hope this is helpful in setting out the context in which we will work with you, as well as a sign of Grant Thornton's continued commitment to the highest audit quality.

Looking back to 2019/20

In February 2020, I wrote to you regarding the increased regulatory focus facing all audit suppliers and the impact this would have on the scope of our work for 2019/20 and beyond. I referred to this as 'raising the bar', reflecting the expectation from the FRC that all audit work should now be of level 2a (limited improvement only) or better. I set out my expectation that there would be an additional fee requirement for the 2019/20 audit, compared to the scale fee published by PSAA, of £10,000 (an increase of 24%). This was reflected in our Audit Plan dated March 2020.

The subsequent COVID 19 pandemic and the issues encountered had a further significant impact on the cost of us as auditors discharging our responsibilities. We have not yet concluded the audit for 2019/20. On the basis of our work to date, I am not able to give an accurate estimation of the fee.

The main reasons for the further variation are as follows:

- The disruption caused by COVID - 19, impacting both on your closedown procedures and our ability to audit remotely; as well as the additional audit considerations

including in respect of asset valuations. These meant that like you, we incurred considerable extra costs. Across all firms, only 45% of local government audits were signed off by the target date of 30 November, which indicates the scale of the challenge involved.

- The Council having to redo its valuation of property plant and equipment and investment property following auditor challenge on various assumptions and data sets used by its valuer expert.

In the sections below, I set out the main factors which will impact on the audit fee for 2020/21. These include the introduction of the new NAO Code of Audit Practice, with consequent implications for Value for Money work; the revision to major auditing standards, including those covering estimates and fraud, and the update of Practice Note 10 (the adaptation of auditing standards to public sector audits).

Following the national lockdown in January 2021, COVID - 19 will also continue to impact in a large way on the audit, and I have also commented on this below. We also note that the Government [response](#) to the Redmond Review, published on 17 December 2020 promised that MHCLG will provide relevant local authorities with £15 million in additional funding in 2021/22 to be used to support the additional costs of reporting and audit anticipated related to the 2020/21 financial year.

New audit requirements for 2020/21 – the new NAO Code

On 1 April 2020, the National Audit Office introduced a new [Code of Audit Practice](#) which comes into effect from audit year 2020/21. The most significant change in the Code is the introduction of a new 'Auditor's Annual Report', which brings together the results of all the auditor's work across the year. The Code also introduced a revised approach to the audit of Value for Money. These changes are set out in more detailed in the NAO's [Auditor Guidance Note 03](#) which was published in October 2020.

We plan to issue our Audit Plan for 2020/21 in July 2021. I have set out below the main changes in respect of Value for Money, and the implications for the timing and resourcing of our work, as well as for the audit fee.

There are three main changes arising from the NAO's new approach.

- A new set of key criteria, covering governance, financial sustainability and improvements in economy, efficiency and effectiveness
- More extensive reporting, with a requirement on the auditor to produce a commentary on arrangements across all of the key criteria, rather than the current 'reporting by exception' approach
- The replacement of the binary (qualified / unqualified) approach to VfM conclusions, with far more sophisticated judgements on performance, as well as recommendations on any significant weaknesses in arrangements identified during the audit.

Grant Thornton very much welcomes the changes, which will support auditors in undertaking and reporting on work which is more meaningful and makes impact with audited bodies and the public. We agree with the move away from a binary conclusion, and with the replacement of the Annual Audit Letter with the new Annual Auditor's Report. The changes will help pave the way for a new relationship between auditors and audited bodies which is based around constructive challenge and a drive for improvement.

The following are the main implications in terms of audit delivery:

- We are aiming to publish our work on the Auditor's Annual Report at the same time as the Auditor's Report on the Financial Statements. To ensure we are able to complete the necessary work by the due date, we propose to undertake our initial planning in July 2021 and to share the results of our risk assessment with you by 30 July 2021. We will aim to complete the fieldwork by 15 September 2021. We will allow sufficient

time for you to comment on our risk assessment and audit findings at each key stage before we present the results to Audit Committee.

- Where auditors identify weaknesses in Value for Money arrangements, there will be increased reporting requirements on the audit team. We envisage that across the country, auditors will be identifying more significant weaknesses and consequently making an increased number of recommendations (in place of what was a qualified Value for Money conclusion). We will be working closely with the NAO and the other audit firms to ensure consistency of application of the new guidance.
- The new approach will also potentially be more challenging, as well as rewarding, for audited bodies involving discussions at a wider and more strategic level. Both the reporting, and the planning and risk assessment which underpins it, will require more audit time, delivered through a richer skill mix than in previous years. Our estimate is that for your audit, this will result in an increased fee of £9,000 (35% of the overall increase on fees) for 2020/21. This in line with increases we are proposing at all our local audits.
- PSAA recognise that the additional work required as a result of the new Code will continue in future years and are consulting on how best to reflect this in any revision to scale fees with effect from 2021/22. For 2020/21 the fee variation will be approved by PSAA via the fee variations process in the usual manner.
- There will be increased documentation and reporting requirements on the audit team. The value for money work will now cover a much wider scope, as set out above. Each year we will need to assess the arrangements in place across these areas and explore the arrangements in more detail than previously. We envisage that across the country, auditors will be identifying more significant risk areas and will be reporting more extensively than in previous years. The financial and governance aspects of the COVID - 19 pandemic are likely to feature heavily in our work.

Enhanced auditing standards for 2020/21: ISA 540 - Estimates

In the period December 2018 to January 2020 the Financial Reporting Council issued a number of updated International Auditing Standards (ISAs (UK)) which are effective for audits of financial statements for periods beginning on or after 15 December 2019. The single most significant of these for this year's audit is ISA (UK) 540 (revised): Auditing Accounting Estimates and Related Disclosures which includes a number of enhancements in respect of the audit risk assessment process for accounting estimates.

In summary, the revised Standard reflects increasing focus from regulators and other stakeholders on all key estimates, especially those which are complex, require significant judgements. ISA 540 has been enhanced to place increasing demands on auditors to understand and assess an entity's internal controls over accounting estimates.

In practice, you will see an increased focus during our audit on key internal controls including:

- How management identifies the need for and applies specialised skills
- The information system as relates to estimates
- How management reviews the outcomes of previous accounting estimates
- The role of those charged with governance: to what extent does the Audit Committee understand and oversee the estimation process?

We will also look for you to articulate clearly:

- How management understands the degree of estimation uncertainty related to each accounting estimate; and

- How management address this estimation uncertainty when selecting their point estimate.

The following are examples of where this could apply:

- Valuations of land and buildings, council dwellings and investment properties
- Depreciation
- Year-end provisions and accruals
- Credit loss and impairment allowances
- Valuation of defined benefit net pension fund liabilities
- Fair value estimates

As the audit progresses, we will discuss the practical ways in which you can support us in meeting our obligations through the audit.

Enhanced auditing standards for 2020/21: ISA 240 - Risks in respect of fraud

The auditor's responsibilities in relation to fraud in an audit of the financial statements are set out in ISA 240. This was most recently updated in January 2020, with effect for audit year 2020/21. Note that the FRC is currently [consulting](#) on further enhancements to the Standard, reflecting concerns expressed amongst others by Sir Donald Brydon that that auditors are not doing enough work to detect material fraud.

In response to the new Standard, and to the increased expectations of regulators, we are heightening our focus on fraud risks. The following are examples of where this could apply:

- Increased scope and coverage of journals testing
- Increased cut off testing
- Increased testing of income and expenditure
- Automated/data interrogation techniques
- Keeping materiality under review throughout the audit.
- More robust reporting (including the use of Statutory Recommendations where appropriate).

As with estimates, our work in this area may look and feel different to you, and you will notice an increased audit presence. We will discuss emerging findings with you, and ensure you have an early opportunity to comment on findings.

Revised ISA (UK) 700 Forming an opinion and reporting on financial statements (Updated January 2020):

This revised Standard is effective for engagements relating to financial periods commencing on or after 15 December 2019. The key change is that all auditor's reports will be required to include an explanation as to what extent the audit was considered capable of detecting irregularities including fraud. This explanation may include:

- how the engagement team obtained an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework
- which laws and regulations the engagement team identified as being of significance in the context of the entity
- the engagement team's assessment of the susceptibility of the entity's financial statements to material misstatement, including how fraud might occur
- the engagement partner's assessment of whether the engagement team collectively had the appropriate competence and capabilities to identify or recognize non-compliance with laws and regulations

- the engagement team's understanding of the entity's current activities, the scope of its authorization and the effectiveness of its control environment where the entity is a regulated entity
- in the case of a group audit, how the engagement team addressed these matters at both at the group and component levels and relevant communications with component auditors.

Practice Note 10 (PN 10): The application of auditing standards for public sector audits

Reflecting the differences between public sector and commercial audits, Practice Note 10 provides guidance for auditors on the application to relevant standards in the public sector. An updated version of PN 10 was published in November 2020. This updated version reinforces the enhancements described above in respect of estimates and risk of fraud.

In addition, there is one other major change in PN 10 and this is in respect of the auditor's responsibilities in respect of going concern. As auditors, we are required to obtain sufficient appropriate audit evidence regarding, and conclude on:

- whether a material uncertainty related to going concern exists; and
- the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

The revisions to PN 10 are helpful in that they allow auditors to apply a 'continued provision of service approach' to auditing going concern where appropriate. Applying such an approach enables auditors to change focus somewhat. Whilst we will still undertake relevant work in respect of management's disclosure around going concern, the concept of the 'material uncertainty' disclosure is far less likely to apply. The NAO's guidance to auditors makes clear that auditor's focus should instead be based on the financial resilience of the authority. As such, there is no reduction in respect of work on going concern and financial resilience, but rather a shift in emphasis.

Other revised Auditing Standards

In November 2019, the FRC issued an update to ISA 220, covering Quality Control of Financial Statements. This revised standard highlights the increased importance for the engagement lead auditor in planning, supervising and reviewing the work of the local audit team.

Impact of COVID - 19

As last year, we expect that our detailed work programme will need to take account of a number of risks arising from COVID - 19 related issues, including lockdown. These include potential uncertainties around the valuation of property and pension liabilities, as well as the accounting for government income received in respect of COVID - 19 pressures. Whilst lockdown continues, there are also complications arising from the remote preparation of accounts and working papers, as well as challenges for us in providing support for our junior team members working remotely. Please note, the proposed fees for 2020/21 set out in the letter do not include any additional fees to reflect potential additional work necessary in 2020/21 due to Covid-19. We continue to monitor developments in this area and will update you accordingly as clarity emerges on its impact in the current year.

Overall impact

MHCLG has acknowledged, via their response to Redmond, that audit fees need to increase due to the additional work being undertaken by auditors and the pressure on the audit market. Funding of £15m is being provided to local government to cover these additional costs in 2020/21.

Our estimate is that, for your audit, this will result in an overall fee of £66,733. This is in line with increases we are proposing at all our local audits. I set out below the core strategic constituents of this fee.

| | Total (£) |
|---|------------------|
| Scale fee published by PSAA | 41,033 |
| Plus: | |
| Ongoing increases to scale first identified in 2019/20 | |
| Raising the bar/ regulatory factors | 4,050 |
| PPE | 4,100 |
| Pensions | 2,050 |
| New issues for 2020/21 | |
| Increase in respect of additional work on Value for Money under new NAO Code | 9,000 |
| Impact of new auditing standards | 6,500 |
| Sub total | 25,700 |
| Local risk factors (e.g. complex new accounting issues / evident reductions in quality of accounts prep/ financial standing issues) | nil |
| Increase to scale | 25,700 |
| Fee proposed for 2020/21 | 66,733 |

All variations to the scale fee will need to be approved by PSAA.

Next steps

I hope this is helpful in explaining how the audit world is changing, as well as the practical implications in terms of the Audit Plan, and the benefits to audited bodies from an even more rigorous and robust audit. I look forward to discussing this in more detail at our next meeting. If you have any questions in the meantime, please don't hesitate to contact me.

Yours sincerely

Gareth Kelly

Engagement Lead, Public Sector Assurance
For and on behalf of Grant Thornton UK LLP