



## CONSULTATION ON THE 2022 REVISION OF PRACTICE NOTE 10

Issued 16 September 2022

ICAEW welcomes the opportunity to comment on the Consultation on the 2022 revision of Practice Note 10 published by the Public Audit Forum (PAF) on 26 June 2022, a copy of which is available from this [link](#).

ICAEW believes that Practice Note 10 has an important role in helping ensure public sector audit is appropriately tailored to the areas of highest operational risk for public sector bodies and the areas of most interest to users of their accounts without departing from the requirements of the ISAs.

In this revision of Practice Note 10, we encourage PAF to focus on considering further interpretations to the ISAs that support a more proportionate approach to the audit of the valuation of operational property.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of sustainable economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports, and regulates more than 165,000 chartered accountant members in over 147 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical, and ethical standards.

As a regulator of the accountancy and audit profession, ICAEW is currently the largest Recognised Supervisory Body (RSB) for local audit in England. We have ten firms and over 85 Key Audit Partners registered under the Local Audit and Accountability Act 2014.

This response has been prepared by ICAEW's Public Sector team within the Reputation & Influence Department in consultation with ICAEW's Public Sector Advisory Group and ICAEW's Audit and Assurance Faculty Board. ICAEW's Public Sector team supports members working in and with the public sector to deliver public priorities and sustainable public finances, including over 9,500 in ICAEW's Public Sector Community. ICAEW engages with policy makers, public servants, and others to promote the need for effective financial management, audit and assurance, financial reporting and governance and ethics across the public sector to ensure public money is spent wisely.

For questions on this response please contact our Public Sector team at [representations@icaew.com](mailto:representations@icaew.com) quoting REP 76/22.

## KEY POINTS

### Practice Note 10 can help ensure auditors and regulators focus on the areas of greatest risk

1. Public sector audit is vital. Citizens and their elected representatives rely on the audits for assurance over whether taxpayers' money has been spent effectively and public assets are appropriately safeguarded.
2. ICAEW strongly supports the use of International Standards on Auditing (ISAs) for audits of public sector bodies in the United Kingdom because it is right that they are subject to the highest international standards of scrutiny.
3. As the Financial Reporting Council (FRC) is strongly encouraging the auditors of private sector bodies to early adopt the ISQM (UK) 2 *Engagement quality reviews* standard and ISA (UK) 220 (Revised July 2021) *Quality management for an audit of financial statements*, we believe that this revision of Practice Note 10 should include public sector specific guidance to encourage early adoption of ISQM 2 and ISA 220 by auditors of public sector bodies.
4. PAF may wish to consider including guidance on who can perform EQCRs for the audit of public sector bodies as a recent FRC report highlighted variation in the approaches taken. ICAEW believes it would be impractical to require that local audit EQCRs must be carried out by Key Audit Partners (KAPs) given the significant capacity issues in the local audit market.
5. However, whilst we believe that the public sector should be held to the same high standards of scrutiny as the private sector, it is important to recognise that audit and financial reporting plays a slightly different role in the public sector than the private sector. Crucially, citizens cannot decide to withhold their taxes in the same way that corporate shareholders or commercial lenders can decide to divest resources from a private company. Whilst maximising profit may be the primary motivation for most private sector resource providers, good quality public services and value for money is the priority for most taxpayers. Therefore, the areas of most interest to users of public sector accounts may differ from the areas of most interest to users of private sector accounts.
6. ICAEW agrees with the status of Practice Note 10 as a statement of recommended practice. We do not believe it is necessary for Practice Note 10 to adapt the ISAs in the manner that the Financial Reporting Manual adapts International Financial Reporting Standards (IFRS) as the ISAs are designed to be suitable for any recognised accountancy framework.
7. Where there is a perception that auditors are not focussing on the interests of the users of public sector accounts or the areas of greatest risk for public bodies, ICAEW believes that this is usually best resolved by changes to the financial reporting framework or the overall regulatory framework.
8. For example, we are concerned that there appears to be an assurance gap over the risk of external fraud for public sector bodies, including local authorities and NHS trusts, that are not subject to a regularity opinion. As paragraph 1-42 in the consultation draft acknowledges, external fraud will not necessarily result in misstatements in the financial statements. Our [submission to the Public Accounts Committee's inquiry into the Department for Business, Energy and Industrial Strategy's 2020/21 accounts](#) highlighted how at least £16.5bn of COVID-19 business grants distributed by local authorities do not appear to have been subject to any external assurance.
9. However, we believe that expanding the scope of the audit beyond the requirements of ISA 240 would not be the best way of closing this perceived assurance gap, as this would risk transferring the burden of detecting fraud from management to the auditors. Clearly, auditors

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have an important role in the detection of fraud, but ISA 240 states that “the primary responsibility for the prevention and detection of fraud rests with both those charged with the governance of the entity and management”.

10. ICAEW recommends a ‘whole-system approach’ to fraud prevention and assurance including a standard assurance framework for grants, an expansion of the remit of the Public Sector Fraud Authority to cover local authorities and additional resources for fraud detection and recovery. In addition, we would like to see amendments to the reporting framework that require public sector bodies to report the steps they have taken to prevent and detect external fraud.
11. Nevertheless, we believe that there is scope in other areas for Practice Note 10 to assist and encourage public sector auditors and audit regulators to focus on the areas of most interest to public bodies and the people they serve without departing from the requirements of the ISAs.
12. We believe, alongside changes to applicable financial reporting frameworks, it would be helpful for further guidance with respect to the audit of operational property valuations to ensure that audit effort is proportionate to the risks associated with misstatement. In most cases any changes to the valuations do not affect these reported outturns or decision making relating to the assets concerned.
13. In addition, as public sector bodies report their outturn against non-GAAP performance measures, we believe there should be greater focus on the audit of the adjustments between IFRS and the outturn against budget.

**PAF should prioritise encouraging a more proportionate approach to the audit of the valuation of operational property**

14. There is a widespread perception amongst auditors and finance teams that audit work on operational property valuations within the public sector currently requires a disproportionate amount of effort in the context of the lower risk to the finances of public bodies in comparison with private sector entities.
15. This perception has increased since the Financial Reporting Council’s 2020 report on major local audits where it stated that the quality of audit work over property valuation as “the area of greatest concern”. Consequently, audit firms have increased their effort in this area. their effort in this area.
16. ICAEW believes that the business risk involved in the valuation of operational property, particularly specialised assets with no active market, is lower than many other aspects of public sector financial reporting. While it is important that these assets are recognised in accordance with accounting standards, the risks associated with their valuation in the accounts are much less significant than they would be if a similar asset were owned outright by a private sector business dependent on a future revenue stream to support that valuation.
17. Most public bodies do not have debt secured on their wholly owned property assets, or asset covenants in their debt agreements that frequently make property valuations relatively more important to private sector organisations. In addition, the risk that downward revaluations or asset impairments pose to the ability of private sector businesses to service debt or pay dividends is not relevant to almost all bodies in the public sector. Similarly, there are in most cases no enterprise or stock market valuations that are dependent on or informed by operational property valuations reported in public body balance sheets.
18. Valuations of operational property typically do not affect outturn against budget and are of relatively limited use to users of the accounts or to decision-making. Therefore, potential misstatements in operational property valuations are likely to have significantly less impact on public bodies than (for example) errors in the valuation of investment property. We believe it is justified that significant audit effort has been directed in recent years to the valuation of investment property given that this is an area of significant business risk in local authorities in particular as it affects the level of usable reserves and financial sustainability.
19. We welcome HM Treasury’s ongoing review of the valuation methodology required by public sector reporting frameworks and this may help to provide useful clarification around the

extent to which preparers are required to engage professional valuers and the tolerances within which valuations are required to be performed. However, we also believe that Practice Note 10 has a key role to play in the ‘whole-system’ approach needed to ensure audit effort is proportionate to the risks involved and is focused on the areas of most value to stakeholders.

20. We support additional guidance that highlights that it may be appropriate under the ISAs to use gross assets as the benchmark for overall account materiality, while applying a lower materiality to more sensitive profit and loss balances.
21. However, we are concerned that this change alone could be insufficient to prevent excessive audit work on operational property valuations and hence urge PAF to consider further clarification within Practice Note 10. For example, PAF may want to consider including additional guidance for applying ISA 620 *Using the work of an expert* to the audit of operational properties.

## ANSWERS TO SPECIFIC QUESTIONS

### ***Question 1: 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?***

22. We support the addition of paragraph 1-88 and example 5 that highlights that it may be appropriate to use gross assets as the benchmark for overall account materiality.
23. The revisions provide helpful guidance to auditors on how to avoid the materiality level leading to excessive testing of assets and liabilities that have a gross value significantly higher than total expenditure. This is often the case in local authorities, where the total value of property, plant and equipment on the balance sheet is regularly more than five times gross expenditure. The changes to the regularity section should alleviate potential concerns that this could lead to insufficient testing to support the regularity opinion.
24. As paragraph 1-86 in the revised draft acknowledges, public sector accounts are used in a fundamentally different way to private sector accounts. While a relatively small misstatement of assets or revenue may materially impact the decision of a corporate investor over whether to invest in shares in a company, it is unlikely to change the decision making of public sector accounts users.
25. Practice Note 10 could provide helpful guidance to encourage auditors to be bolder in setting materiality at a higher percentage of the chosen benchmark than would be done for corporate equivalents. This is particularly true for some smaller bodies as there is no audit threshold in parts of the public sector and the precise numbers in their accounts may be of limited interest to the primary users identified in the reporting framework.
26. Even with amendments to materiality guidance in Practice Note 10, the value of operational property will still be material for most local authorities, NHS bodies and academies. Therefore, we are concerned that the changes will be insufficient to resolve the disproportionate approaches to property valuation as they will not result in substantial changes to the work effort. We therefore recommend that PAF explore further guidance on other ISAs that would help auditors ensure a more proportionate approach without risking significant regulatory challenge. We have set out some ideas in response to question 7.
27. We recommend that paragraph 1-87 in the 2020 revision of Practice Note 10 is reinstated. This provided helpful guidance on the types of transactions that could be qualitatively material even if not material by nature.

### ***Question 2: 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?***

28. The section on ISQM 1 *Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements* provides helpful

guidance for public sector auditors, including contractor auditors, on quality management arrangements but there are areas where the wording could be tightened to increase clarity. For example, it is potentially ambiguous whether paragraph 1-18 is referring to the FRC's revised Ethical Standard section of Practice Note 10 or a specific section within the Ethical Standard. It might be helpful to provide paragraph references to the section of Practice Note 10 that provides guidance on the Ethical Standard. References to the relevant paragraphs in ISQM 1 would also be helpful in the section of the Practice Note 10 guidance on confidentiality.

29. ICAEW recommends that public sector specific guidance on ISQM (UK) 2 and ISA (UK) 220 (Revised July 2021) should be included in this revision of Practice Note 10.
30. This would assist firms performing public sector audits in revising their quality management arrangements ahead of the compulsory introduction of ISQM 1 by December 2022. ISQM 2 and the revisions to ISA 220 are closely linked with ISQM 1. It would also help provide confidence to public sector auditors to early adopt ISQM2 as "strongly encouraged" by the FRC.
31. We accept that there is unlikely to be the need for extensive public sector specific interpretations of ISQM 2 or the revised ISA 220. However, PAF may want to consider whether they can provide any helpful interpretation guidance to clarify the requirements of which sorts of public sector audits need an Engagement Quality Control Review (EQCR). The most recent FRC report on major local audits noted there was "variation" in the approaches of the seven firms, suggesting additional guidance may be necessary.
32. There is also a need for guidance on who can perform local audit EQCRs, though we accept that Practice Note 10 may not be the best vehicle for that guidance. ICAEW believes it is impractical for it to be mandated that EQCRs must be carried out by KAPs as there is a very limited pool of KAPs, especially in some smaller registered firms. This may lead to further capacity issues in the market, posing a far greater risk to quality than EQCRs being carried out by other individuals with the adequate skills and experience.

***Question 3: 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?***

33. We are largely content with the example inherent risk factors but believe the list could be expanded to cover some of the factors that have contributed to recent local audit delays including:
  - Uncertainty caused by fragmented and short-term funding schemes often dependent on the outcome of bids resulting in weaknesses in financial management;
  - Regular changes to statutory guidance and legislation with significant areas of interpretation;
  - Statutory overrides between the budgeting and accounting basis; and
  - Budgetary controls leading to an increased risk of bias in estimates or aggressive and complex revenue generating schemes.

***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?***

34. It is not applicable to all parts of the public sector as there are many parts of the public sector where the auditor is not required to give a regularity opinion, including local authorities and certain government companies like the British Business Bank.
35. It also does not apply to academy trusts as they are scoped out by paragraph 2-3. Instead, a reporting accountant produces a limited assurance report on regularity under ISAE 3000 as required by the [framework and guide for external auditors and reporting accountants of academy trusts](#).

36. Although inconsistency between the audits of different types of public sector bodies is unhelpful, we do not believe it is the role of Practice Note 10 to introduce a major change in approach. A regularity opinion for local authorities would be inappropriate as they are accountable to local residents rather than Parliament for their spend and income. Equally, we would not support the ESFA changing their overall approach to obtaining assurance over the regularity of expenditure and income of academy trusts. Moving from the current limited assurance opinion over regularity to a reasonable assurance opinion would place a significant additional burden on auditors, potentially leading to increased audit costs and / or additional capacity issues.

**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?**

37. Consistent with our belief that Practice Note 10 should help drive auditors to focus on the areas of greatest interest to users of public sector accounts, we support the proposed clarification guidance on the application of ISA 570 in the public sector.
38. We have no substantive comments on the introduction of the Revised Ethical Standard 2019 into Practice Note 10 as this clarifies its interaction with the unique legal position of the national audit agencies and the auditor generals.

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

39. ICAEW believes that Practice Note 10 could go further in assisting public sector auditors focus on the areas of most interest to users and greatest risk to public sector bodies.
40. We believe that PAF should consider expanding the interpretation guidance for ISA 240 to encourage auditors to consider the risk of manipulation in the adjustments between the accounting and budgeting bases. Local authorities are required to post a series of overrides from the IFRS-based accounting outturn to arrive at the statutory outturn against their budget that determines their council tax.
41. Some of these adjustments, such as the minimum revenue provision, are complex and judgemental, making them potentially subject to manipulation if council management wishes to report a certain outturn.
42. ICAEW [recommended in its response to a Department for Levelling Up, Housing and Communities consultation](#) on the minimum revenue provision that clearer guidance is introduced for auditors to clarify expectations and ensure that this override is an area of focus. PAF should consider whether Practice Note 10 should include guidance on the MRP and other statutory overrides, including whether there should be a presumed significant risk of fraud in recognition. This may also be relevant for adjustments between the Statements of Parliamentary Supply and net expenditure in central government.
43. On the other hand, one area where we consider the risk of fraudulent financial reporting to be very low is in the valuation of operational property. As the valuations are not generally used in decision making and do not affect net outturn, there is limited incentive for management to seek to manipulate the value. We believe that this low risk should be reflected in the audit approach.
44. In addition to the changes to the materiality guidance introduced in the consultation draft, we believe that PAF should consider further interpretations to ensure a proportionate approach to the audit of operational property valuations.
45. One option would be to consider a specific interpretation of ISA 620 for specialised operational property with no active market, such as railway lines and hospitals. It does not represent value for money for taxpayers for the public sector body and the auditor to both hire separate experts given it is not a decision-useful valuation method as it gives no indication of potential sales price. We, therefore, advocate that Practice Note 10 states that there is a rebuttable presumption that it is not necessary for an auditor to use its own expert

for operational properties with no active market if management has already hired a suitably qualified expert to perform the valuation.

46. Other options could also include public sector specific interpretations of ISA 540, ISA 315 or ISA 450 that reflect the low risk to the business and the low risk of management manipulation in operational property valuation.
47. Narrative reporting is of particular interest to users of annual public sector financial reports. Therefore, we would encourage PAF to clarify guidance on interpreting ISA 720 (the auditor's responsibilities relating to other information) in the public sector context to help auditors drive improvements in the quality of narrative reporting.
48. PAF may also want to consider clarifying the applicability of Practice Note 10. The consultation draft states that Practice Note 10 applies to bodies classified as public sector by the Office for National Statistics. However, the Office for National Statistics regularly reassesses its classifications and it is unclear whether PAF intends for these reclassifications to change the audit approach. For example, PAF should clarify whether the audits of train operating companies that were reclassified as public sector following changes to their franchise arrangements in response to COVID-19 restrictions should be carried out in line with the guidance in Practice Note 10. The companies still have shareholders external to government whose areas of interest are more similar to those of other private sector investors than the users of other public sector accounts.
49. In addition, Practice Note 10 is not regularly used directly by the auditors of academy trusts because guidance is provided by the ESFA's framework and guide. We urge PAF to work with the ESFA to ensure any changes to guidance in Practice Note 10 are appropriately adopted, where relevant, in the academies' framework and guide.

***Question 7: 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?***

50. N/A – question not answered.