

AUDIT & GOVERNANCE COMMITTEE

26th March 2020

Joint Report of Grant Thornton and the Executive Director Finance

UPDATE ON AUDIT MATTERS FROM PUBLIC SECTOR AUDIT APPOINTMENTS LIMITED

Purpose

To provide an update on the potential implications of External Audit market changes for consideration and discussion.

Recommendation

That Members consider the update from Public Sector Audit Appointments (PSAA), which sets out the changes in the audit market, and associated Future Procurement and Market Supply Options Review as attached at Appendix 1 and Appendix 2 respectively.

Executive Summary

Over the last few months the Council's external auditors have been engaging with the Council on the current state of the audit market and the impact of increased regulation. At the meeting of the Audit and Governance Committee on 13th February 2020, Members considered and endorsed proposals for increased audit fees for 2019/20. As set out in the letter, these factors are driving increased work for the auditors and fees for local government. The Committee also discussed the sustainability of the local audit market.

Public Sector Audit Appointments (PSAA) has subsequently written to Section 151 Officers to set out the changes in the audit market and the need for additional fees. It also explains PSAAs approach to the 2020/21 fee consultation and that this will be revisited once there is clarity on the 2019/20 fees and the revised NAO code. The update provides useful context for the discussions the Committee had on audit fees and is attached at **Appendix 1**.

In addition, PSAA has recently commissioned an independent review of the sustainability of the local government audit market - undertaken by an independent consultancy firm. Importantly the document, attached at **Appendix 2**, considers the sustainability of audit supply alongside improvements in audit quality and the associated fee implications. The research concludes that 'almost all of the approved firms have reservations about remaining in the market'. The report goes on to cite that these reservations have arisen as 'fees have not risen to compensate for the higher risks that the firms perceive they face' and secondly because 'the timing of local audits is problematic [given the 31 July deadline]'.

As discussed at the last meeting, it is anticipated that the outcome of the Redmond review of local authority financial reporting and external audit will provide clarity for the future.

Background Information

The Local Audit and Accountabilities Act 2014 requires Local Authorities to appoint their own External Auditors. At the meeting on 13th December 2016, Council approved that the Authority opts into the appointing person arrangements made by the Public Sector Audit Appointments (PSAA) for the appointment of External Auditors (for the Accounts from 2018/19).

As part of closing the Audit Commission the Government novated external audit contracts to PSAA on 1 April 2015. These were due to expire following conclusion of the audits of the 2016/17 accounts, but were extended and meant that for the audit of the 2018/19 accounts it would be necessary for authorities to either undertake their own procurements or to opt in to the appointed person regime under which PSAA were specified by the Secretary of State as an appointing person under regulation 3 of the Local Audit (Appointing Person) Regulations 2015.

PSAA was originally established to operate the transitional arrangements following the closure of the Audit Commission and is a company owned by the Local Government Association's Improvement and Development Agency (IDeA).

Regulation 19 of the Local Audit (Appointing Person) Regulations 2015 requires that a decision to opt-in must be made by Full Council. The Audit & Governance Committee at the meeting on 27th October 2016 endorsed this approach.

PSAA has recently commissioned an independent review of the sustainability of the local government audit market. The review was undertaken by an independent consultancy firm, Touchstone Renard (TR). The full report is attached at **Appendix 2 – Future Procurement and Market Supply Options Review**.

PSAA commissioned this work in its role as the 'appointing person' for the national scheme for the appointment of external auditors to principal local authorities in England.

The TR report draws on the views of audit firms active in the local authority market as well as others that are not. In doing so it identifies a number of distinctive challenges in the current local audit market. In particular it highlights the unprecedented scrutiny and significant regulatory pressure on the auditing profession; the challenges of a demanding timetable which expects publication of audited accounts by 31st July each year; and the impact of austerity on local public bodies and its effect on both the complexity of the issues auditors face and the capacity of local finance teams.

PSAA are sharing the report publicly to inform debate and support ongoing work to strengthen the system and help to deliver long term sustainability. In particular, they hope that this work will be helpful to the review which Sir Tony Redmond is currently conducting.

PSAA have said that this very important report will inform forward planning, especially in relation to future procurement processes. Their independent review has captured the views of firms at a point in time at which the audit industry is subject to extreme pressures. It highlights some of the difficulties which potentially arise downstream if action is not taken to address current uncertainty and instability.

The position will inevitably change as future developments occur. The Government's response to the Kingman, Competition and Markets Authority and Brydon Reviews will hopefully bring welcome certainty for the industry in due course. In addition, the Redmond Review, looking specifically at local audit and accounting, will conclude later in the year and, hopefully, make positive recommendations for the future of local audit.

PSAA's current contracts provide medium term assurance for the audit of relevant local bodies. The TR report will help work with other local audit stakeholders to address the challenge of long term sustainability.

Equalities implications

None.

Legal implications

None directly from this report.

Financial implications

Opting into the appointing person arrangements made by the Public Sector Audit Appointments (PSAA) for the appointment of External Auditors was considered the most cost effective procurement option. Costs of undertaking our own procurement process would be higher than the PSAA route and offers greater opportunity in achieving a lower audit base fee due to economies of scale and buying power available under joint procurement – and delivered reduced ongoing audit costs as shown below.

Audit	Scale Fee	Additional Fees	Grant Certification Fees	Total
2019/20*	38,375	7,500	18,500	64,375
2018/19	38,375	4,500	14,500	57,375
2017/18	38,375	-	13,573	51,948
2016/17	49,838	-	13,727	63,565
2015/16	49,838	-	13,572	63,410

* Indicative

Risk implications

None directly from this report.

Report Author:

Please contact Stefan Garner, Executive Director Finance, extension 242.

<i>Background Papers:-</i>	Council 13 th December 2016, Appointment of External Auditor – re Accounts Audit Commencing 2018/19

Update on audit matters from Public Sector Audit Appointments Limited

Dear S151 officer,

Given all the turbulence within the audit industry at the moment, it may be helpful to summarise the local audit position in relation to the three financial years spanning 2018-21.

By this time of the year we would normally expect the vast majority of audits of 2018/19 accounts to be a matter of record and consigned to history. However, at the end of January there remain nearly 80 opinions still outstanding. That is an incredibly unsatisfactory position, particularly for all the bodies and auditors concerned, and a significant concern going forward.

In response to the significant challenges, PSAA has recently commissioned independent research into the sustainability of the audit market which we plan to publish soon. As well as informing our own forward planning, we are keen to ensure that this and other research is available to support the work of the Redmond Review.

One of the consequences of the multiple pressures and challenges which have arisen in 2018/19 audits is an increase in the number of proposed fee variations for additional audit work. In previous years the level of such variations has remained relatively stable at around 5% of the sector's aggregate audit fees. However, while PSAA is still awaiting submission of some of the relevant proposals, it is already clear that a higher level of variations is likely to be proposed for 2018/19 than previously.

Meantime, audits of 2019/20 accounts are approaching. In planning for this next round, PSAA has tried to address two of the concerns which featured most frequently in our conversations and exchanges with bodies about their 2018/19 audit experience. Firstly, bodies want greater certainty about when their audit will take place and, if for any reason it cannot be undertaken in time to meet the 31 July target date for publication of audited accounts, they want to know that is the case at the earliest opportunity. Secondly, if there is any likelihood of additional audit work being required which may lead to a fee variation proposal, again bodies want early information and explanation.

Against this backcloth PSAA has therefore worked with auditors to address both of these issues - the planned timetable and any likely fee variations - in their audit planning submissions to bodies as part of a concerted effort to strengthen auditor-audited body communications.

This theme carries through into preparations for audits of 2020/21 accounts. We are currently consulting on the scale of audit fees for this year in accordance with the timetable prescribed in statutory regulations, which requires PSAA to fix the scale of fees before the start of the relevant year of account.

<https://www.psa.co.uk/audit-fees/consultation-on-2020-21-audit-fee-scale/>. This means having to set the fees ahead of the results of the completion of the 2018/19 round and ahead of the commencement of 2019/20 audits. Additionally, in looking ahead to 2020/21, we can also see a series of new developments which are likely to impact on the audit including revised auditing and accounting standards as well as a new Code of Audit Practice. Although these developments will affect all bodies, the impact will vary dependent on the specific local circumstances of each body.

Again, PSAA is encouraging auditors and local bodies to consider these issues in audit planning discussions, to give proper early notice of factors which may require additional work and have implications for fees, and also to allow time for actions which might mitigate risk to the smooth conduct of the audit. We note that the NAO will be consulting on guidance for auditors' work on the new Code of Audit Practice, and so detailed conclusions about how it will affect individual bodies will need to be reserved until the guidance is finalised.

In discussing the fee implications of any factors, whether they relate to developments which affect all bodies or are more specific to an individual local audit, we particularly need the parties to consider both short and long term implications. Some issues will have a one-off impact, affecting a single year. Any resulting variation proposal is for a one-off adjustment. Others will have ongoing implications which may or may not be the same as the impact in the first year. These are likely to point to a need to vary the body's scale fee. **Note 1** below explains PSAA's approach to fees more fully, and sets out the importance of revising scale fees where new developments or other local factors have clear ongoing implications.

It is important to stress that the 2019/20 local discussions on fees are happening at the planning stage, which is earlier than has generally been the case in previous years (perhaps not until the results of the audit were reported to you). One of the advantages of earlier discussion is that it allows more time for scrutiny and reflection. If you are unsure about a proposed fee variation, it can be deferred for any relevant information to be collated and examined with a view to revisiting the matter at an agreed later date. Please remember that PSAA reviews and determines every proposed additional fee, whether agreed or not – this is a statutory requirement.

We hope that this information is helpful to you and would be grateful if you would share it with members of your Audit Committee and any other relevant members and officers.

Tony Crawley

Chief Executive
Public Sector Audit Appointments Limited

28 February 2020

Note 1

PSAA's approach to fees

PSAA's position is unusual because, as the appointing person for principal local authorities, the company is required to set a scale of fees spanning more than 480 audits, each of which is unique, reflecting differing levels of size, responsibility, complexity, capacity, capability, risk, etc.

The company's current scale of fees reflects the continuation of a methodology developed by the Audit Commission during its tenure. It is intended to reflect a good representation of the risks associated with the conduct of each of the individual audits within PSAA's jurisdiction, assuming the timely production of draft accounts and working papers of an appropriate standard. However, PSAA recognises that every fee within the scale is subject to a margin for error and is also susceptible to change over time. Accordingly, the company's arrangements in relation to fees are designed to include a number of checks and balances to enable the scale to be adjusted as and when appropriate. These include:

- i) Placing the extant scale of fees at the heart of any tender process and inviting suppliers to express their bids as a proportion of the current scale;
- ii) Pooling winning firms' bids so that the fees of individual bodies are not linked to the bid prices of the individual firm that is appointed as their auditor;
- iii) Consulting with bodies, as appropriate, when firms exercise their right to submit proposals to charge additional fees for additional audit work over and above that assumed in the relevant scale fee;
- iv) Similarly consulting with bodies when firms submit proposals to amend the scale fee of an individual body to reflect an ongoing change to the level of audit work required.

Each of these arrangements is discussed in more detail below.

i). Linking tender prices to the extant scale of fees

When PSAA goes out to tender for audit services, as it did most recently in 2017, it provides suppliers with details of the then current scale of fees and invites firms to price their bids by reference to that scale. This is a vital opportunity for firms to bring their own experience and judgement to bear about the reasonableness of current scale fees in the context of current and expected future market conditions and risks. If the firm considers the current scale to be generous, it can bid at say, 70 or 80% of scale. Conversely, if current fees are felt to be too low, the firm can bid at say, 120 or 130% of scale. PSAA does not impose any parameters in this process - each firm is completely free to reflect its own considered judgement.

Following a rigorous evaluation of tenders, the contracts awarded to successful suppliers reflect the specific price at which each individual firm has bid.

ii). Pooling firms' costs

In setting the overall scale of audit fees, PSAA has regard not only to the payments which will be due to firms under the contracts awarded but also the need to fund PSAA's own costs incurred in carrying out its functions - principally letting and managing contracts, appointing auditors and setting a scale of fees.

When re-setting the fees of individual bodies within the scale following a procurement, PSAA does not reflect the specific costs of the particular audit firm appointed to the body. Rather it applies average costs, taking into consideration details of all the contracts awarded to successful suppliers – with the result that, for example in 2018/19, all bodies received the same proportionate fee adjustment. This shares the risk of price variations between firms across the system and also avoids the need to vary a body's scale fees because it has been allocated a new auditor.

iii). Charging for additional audit work

The nature of an audit is such that it may be necessary for an auditor to carry out more audit work than has previously been required or planned. PSAA has the power to determine the fee above or below the scale fee where it considers that substantially more or less work was required than envisaged by the scale fee.

In such circumstances, the auditor may therefore be entitled to charge for the additional work depending upon the specific drivers which have given rise to it. If, for example, additional work arises because the auditor has not conducted the audit in accordance with expected standards, the auditor must bear the cost. Alternatively, if additional work is necessary because the local body has not met its obligations to deliver accounts and working papers which enable the auditor to reach the required level of assurance, the auditor may be entitled to propose a fee variation to reflect the scale of the work concerned.

Additional work may also be required as a result of the introduction of new accounting or auditing standards, or new regulatory requirements. Where these have arisen after bids have been submitted and could not reasonably have been foreseen, the auditor will usually be entitled to propose an appropriate fee variation.

It is important to emphasise that the process for approving one-off fee variations (and/or ongoing scale fee adjustments - see para 4 below) is itself subject to careful checks and balances. Auditors are required to discuss any relevant proposals with appropriate representatives of the body concerned. All such proposals are subject to approval by PSAA. In making any submissions to PSAA, auditors are required to confirm that proposals have been discussed with the body and to indicate whether or not they have been agreed by the body. In turn, PSAA will consider the legitimacy and reasonableness of the proposals and advise the parties accordingly.

iv). Amendments to scale fees

The vast majority of fee proposals submitted by auditors in respect of additional audit work are limited to one-off fee variations. In some cases it is apparent that this does not reflect possible longer term implications. This is an important conversation which will sometimes alert the body to potential ongoing work and expected further variations which can be avoided by the body taking additional measures or taking other remedial actions. In other circumstances it will highlight the need to adjust the scale fee going forward so that the additional work concerned is properly reflected as a recurring requirement.

By routinely working through longer term implications and engaging in constructive discussions, bodies and firms can play a critically important role in helping PSAA to ensure that the scale of fees is subject to continuous review and, where appropriate, updating.

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