



# Grant Thornton

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Dear Julie

### **Audit scope and additional work 2019/20**

In recent conversations, including at Cumbria County Council's Audit and Assurance Committee, we have discussed the increased regulatory focus facing all audit suppliers and the impact this will have on the scope of our work for 2019/20 and beyond. You will have also recently received a letter via email from Tony Crawley of PSAA explaining the changing regulatory landscape. In his letter, Mr Crawley highlights: *"significantly greater pressure on firms to deliver higher quality audits by requiring auditors to demonstrate greater professional scepticism when carrying out their work across all sectors – and this includes local audit. This has resulted in auditors needing to exercise greater challenge to the areas where management makes judgements or relies upon advisers, for example, in relation to estimates and related assumptions within the accounts. As a result, audit firms have updated their work programmes and reinforced their internal processes and will continue to do so to enable them to meet the current expectations."*

I promised I would set out in more detail the likely impact of this on our Council and Scheme audits, and I am pleased to do so in this letter. Should further matters arise during the course of the audit that have fee and timetable implications, we will also address those at that point.

Across all suppliers, and sectors (public and private), the Financial Reporting Council (FRC) has set out its expectation of improved financial reporting from organisations and the need for auditors to demonstrate increased scepticism and challenge, as well as to undertake additional and more robust testing. There is a general 'raising of the quality bar' following a number of recent, high-profile company failures that have also been attributed to audit performance. Alongside the FRC, other key stakeholders including the Department for Business, Energy and Industrial Strategy (BEIS) have expressed concern about the quality of audit work and the need for improvement. The FRC has been clear to us that it expects audit quality in local audit to meet the same standards as in the corporate world and the current level of financial risk within local audit bodies supports this position.

As a firm, we are absolutely committed to meeting the expectations of the FRC and other key stakeholders with regard to audit quality and public sector financial reporting. To ensure the increased regulatory focus and expectations are fully met, we anticipate that, as first seen in 2018/19, we will need to commit more time in discharging our statutory responsibilities, which will necessitate an increase in costs. I set out below the implications of this for the Council and Scheme audits.

### **Increased challenge and depth of work – raising the quality bar (Council and Scheme)**

The FRC has raised the threshold of what it assesses as a good quality audit. The FRC currently uses a four-point scale to describe the quality of the files it reviews, as follows:

| Score   | Description                                   |
|---------|---|
| 1 or 2a | Acceptable with Limited Improvements Required |
| 2b      | Improvements required                         |
| 3       | Significant Improvements Required             |

Historically, the FRC's definition for 2b was 'acceptable but with improvements required' and, as such, both the Audit Commission and PSAA considered a '2b' to represent an acceptance level of audit quality for contract delivery purposes. The FRC has now set a 100% target for all audits (including local audits) to achieve a '2a'. Its threshold for achieving a '2a' is challenging and failure to achieve this level is reputationally damaging for individual engagement leads and their firm. Non-achievement of the standard can result in enforcement action, including fines and disqualification, by the FRC. Inevitably, we need to increase the managerial oversight to manage this risk. In addition, you should expect the audit team to exercise even greater challenge of management in areas that are complex, significant or highly judgmental. We will be required to undertake additional work in the following areas, amongst others:

- use of specialists
- information provided by the entity (IPE)
- journals
- management review of controls
- revenue
- accounting estimates
- financial resilience and going concern
- related parties and similar areas.

As part of our planning, we have also reflected on the level of materiality which is appropriate for your audit. As outlined above, the profile of local audit has increased considerably over the past year. The reviews led by Sir John Kingman, Sir Donald Brydon and Sir Tony Redmond are focusing attention on the work of auditors everywhere. Parliament, through the work of its Scrutiny Committees, has made clear its expectations that auditors will increase the quality of their work. Reflecting this higher profile, and the expectations of stakeholders, we propose to reduce the materiality level for all major council audits. This will increase the volume and scope of our testing and reporting to those charged with governance, as well as providing you with additional assurance in respect of the audit.

As a result, you may find the audit process for 2019/20 and beyond even more challenging than previous audits. This mirrors the changes we are seeing in the commercial sectors.

#### **Property, plant and equipment (PPE or 'Fixed Assets') (Council only)**

The FRC has highlighted that auditors need to improve the quality of audit challenge on Property, Plant and Equipment (PPE) valuations across the sector. We will therefore increase the volume and scope of our audit work to ensure an adequate level of audit scrutiny and challenge over the assumptions that underpin PPE valuations. We have also determined that, for major local audits, we will now be engaging our own external valuer to provide appropriate assurance to the standards expected by the FRC for an authority of your size.

#### **Pensions (IAS 19) (Council only)**

The FRC has highlighted that the quality of work by audit firms in respect of IAS 19 needs to improve across local government audits. Specifically, for the following areas, we will increase the granularity, depth and scope of coverage, with increased levels of sampling, additional levels of challenge and explanation sought, and heightened levels of documentation and reporting. Our planned additional procedures include:

- verification of the accuracy and completeness of the data provided to the actuary by both the admitted body and the administering authority.
- checking the value of the Pension Fund Assets at 31 March per the Council's financial statements against the share of assets in the Pension Fund statements.

- review and assess whether the significant assumptions applied by the actuary are reasonable and are followed up on areas identified by either our review or PwC as outliers.
- ensuring that the instructions from the audit team to the Pension Fund auditor include enquiries in respect of service organisation reports as well as testing in respect of material level 3 pension assets (please note that this is outside the scope of PSAA's fee variation process).

### **Complex accounting issues and new accounting standards (Council and Scheme)**

You are required to respond effectively to new accounting standards and we must ensure our audit work in these new areas is robust. This year we will both be responding to the introduction of IFRS16. IFRS16 requires a leased asset, previously accounted for as an operating lease off balance sheet, to be recognised as a 'right of use' asset with a corresponding liability on the balance sheet from 1 April 2020. There is a requirement, under IAS8, to disclose the expected impact of this change in accounting treatment in the 2019/20 financial statements.

We know the Council has appreciated our responsiveness in the past and we would wish to continue to be able to do this in the future.

### **Ethical matter requiring an out of area Audit Team (Council only)**

As I outlined at the December Audit and Assurance Committee there is a significant ethical matter, which directly impacts on the delivery of the 2019/20 Cumbria County Council audit. The appointment of the former audit manager on this audit to a post at the Council means that your audit will need to be resourced by a non-local audit team. This will add significant travel and accommodation expenses to the cost of delivering your audit and also means we are unlikely to be in a position to deliver your audit ahead of the 31 July 2020.

### **Valuation of level 3 investments (Scheme only)**

The Financial Reporting Council (FRC) has highlighted that the quality of work by all audit firms in respect of valuations of hard to value investments needs to improve across the sector. Accordingly, we plan to enhance the scope and coverage of our work to ensure an adequate level of audit scrutiny and challenge over the assumptions and evidence that underpin the valuations of level 3 investments this year to reflect the expectations of the FRC and ensure we issue a safe audit opinion.

### **Directly held property (Scheme only)**

The Financial Reporting Council (FRC) has highlighted that the quality of work by all audit firms in respect of valuations of Directly held property investments needs to improve across the sector. We have therefore increased the volume and scope of our audit work to ensure an adequate level of audit scrutiny and challenge over the assumptions that underpin directly held property valuations.

### **Provision of IAS 19 Assurances to Scheme Employer auditors (Scheme only)**

As outlined above, the FRC has highlighted that the quality of work by audit firms in respect of IAS 19 needs to improve across local government audits. As scheme auditor we are requested to carry out a programme of work by scheme employer auditors to provide assurances around the accuracy and completeness of data provided to the actuary. We will increase the granularity, depth and scope of coverage of our work in this area.

### **Impact on the audit and associated costs**

You will note we did not raise additional fees across the sector as a whole in 2018/19 in respect of the additional work required in response to the implementation of IFRS9 and IFRS15. This was a goodwill decision we took in support of the strong relationship we have with the sector. However, the volume of additional work now being required, as set out above, means we are no longer able to sustain that position. This is an issue not just across public services but also in the private sector where fees are being increased by all of the major suppliers by more than 20%.

We benefit from effective and constructive working relationships, which we have established during our engagement with you to date. This allows us to absorb some of the impact of these changes. Using our strong working knowledge of you and efficiencies that we are continuously seeking to implement as part

of our focus on continued collaborative working with you, we have sought to contain the impact as much as possible to below the market average.

We have assessed the impact of the above as follows for 2019/20, with the comparative position for the two previous years shown. Please note these are subject to approval by PSAA in line with PSAA's normal process. Should other risks arise during the course of the audit, which we have not envisaged at this stage may require further adjustment to the fee.

## Council

| Area  | Cost £         |               |                |
|---|----------------|---------------|----------------|
|   | 2019/20        | 2018/19       | 2017/18        |
| <b>Scale Fee</b>                                | <b>88,254</b>  | <b>88,254</b> | <b>114,615</b> |
| <i>Additional Fee</i>                           |                |               |                |
| Increased challenge and depth of work           | 3,300          | 0             | 0              |
| Materiality                                     | 4,000          | 0             | 0              |
| PPE   | 4,350          | 0             | 0              |
| Pensions  | 3,500          | 4,000         | 0              |
| New standards/ developments                     | 2,500          | 0             | 0              |
| Out of area audit team                          | 6,210          | 0             | 0              |
| Journals control weakness                       | 0              | 1,000         | 0              |
| <b>Total Additional Fee</b>                     | <b>23,860</b>  | <b>5,000</b>  | <b>0</b>       |
| PPE Valuation – cost of auditor's expert        | 5,000          | 0             | 0              |
| <b>Total Council Audit Fee including valuer</b> | <b>117,114</b> | <b>93,254</b> | <b>114,615</b> |

This would give a scale fee for the statutory accounts audit for 2019/20 of £88,254 plus VAT plus a variation of £28,860. This includes the cost of the external valuer, which we have determined to be necessary to support our audit work in this area.

The additional work we are now planning across the whole of our portfolio and the significant local ethical issue described above will inevitably have an impact on the audit timetable and whether or not your audit can be delivered to the appropriate quality standards. Grant Thornton remains the largest trainer of CIPFA qualified accountants in the UK and is committed to continue to resource its local audits with suitably specialised and experienced staff but the pool of such staff is relatively finite in the short-term. I will be happy to explain the impact of the further work we are planning to undertake on our delivery timetable for your audit.

Please note that PSAA's arrangements require a separation of fees and remuneration, which means that Grant Thornton does not receive 100% of the current fees charged.

**Scheme**

| Area   | Cost £        |               |               |
|--|---------------|---------------|---------------|
|  | 2019/20       | 2018/19       | 2017/18       |
| <b>Scale Fee</b>   | <b>18,957</b> | <b>18,957</b> | <b>24,620</b> |
| <i>Additional Fee</i>                                      |               |               |               |
| Increased challenge and depth of work                      | 1,500         | 0             | 0             |
| Valuation of level 3 investments                           | 1,500         | 0             | 0             |
| Directly held property – work of experts                   | 750           | 0             | 0             |
| Journals Control Weakness                                  | 0             | 500           | 0             |
| Equity protection  | 0             | 1,000         | 0             |
| McCloud ruling   | 0             | 3,000         | 0             |
| <b>Total Additional Fee</b>                                | <b>3,750</b>  | <b>4,500</b>  | <b>0</b>      |
| <b>Total Scheme Audit Fee</b>                              | <b>22,707</b> | <b>23,457</b> | <b>24,620</b> |
| <i>Audit Related Services</i>                              |               |               |               |
| Provision of IAS 19 assurances to scheme employer auditors | 7,000         | 5,000         | 3,942         |
| <b>Total Audit and Audit Related Services Scheme Fee</b>   | <b>29,707</b> | <b>28,457</b> | <b>28,562</b> |

This would give a scale fee for the statutory accounts audit for 2019/20 of £18,957 plus VAT plus a variation of £3,750 and other audit related services of £7,000.

Please note that we will be unable to issue our Scheme opinion until we are able to issue our Council opinion. As such, the significant local ethical issue described above will also have an impact on the Scheme audit timetable.

**Future changes to audit scope**

As I have previously raised in meetings and at the Audit and Assurance Committee, the National Audit Office is currently consulting on revisions to the Code of Audit Practice and has also indicated its intention to consult on the accompanying Auditor Guidance Notes. This defines the scope of audit work in the public sector. The most significant change is in relation to the Value for Money arrangements. Perhaps in addition to auditors delivering an overall, binary, conclusion about whether or not proper arrangements were in place during the previous financial year, the draft Code requires auditors to issue a commentary on each of the criteria. This will allow auditors to tailor their commentaries to local circumstances. The Code proposes three specific criteria:

- a) Financial sustainability: how the body plans and manages its resources to ensure it can continue to deliver its services;
- b) Governance: how the body ensures that it makes informed decisions and properly manages its risks; and
- c) Improving economy, efficiency and effectiveness: how the body uses information about its costs and performance to improve the way it manages and delivers its services.

Under each of these criteria, statutory guidance will set out the procedures that auditors will need to undertake. An initial review of arrangements will consist of mandatory procedures to be undertaken at every local public body plus any local risk-based work. The consultation closed on 22 November 2019. A new Code will be laid before Parliament in April 2020 and will apply from audits of local bodies' 2020/21 financial statements onwards.

Until the consultation is finalised and more details emerge of what is expected of auditors, it is difficult to cost the impact. However, as soon as the requirements are finalised and it is clear exactly what the expectations will be, I will share with you further thoughts on the potential impact on the audit and associated costs.

I hope this is helpful and allows you to plan accordingly for the 2019/20 audit. Should you wish to discuss this further, please do not hesitate to contact me. We will be sharing our detailed Audit Plan with you in due course.

We look forward to working with you again this year.

Yours sincerely

***Gareth Kelly***

**Gareth Kelly**  
**Engagement Lead and Key Audit Partner**

For and on behalf of Grant Thornton UK LLP