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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 received a letter via email in February 2020, 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. 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 like Cumbria County Council, we are now 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).

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. This will now include the appointment of a valuer's auditor expert to support and corroborate our assurance work in this area.

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.

Addition of a significant audit risk in respect of Covid 19 (Council and Scheme):

The crisis has increased audit risk factors in the following areas:

- Remote working arrangements and redeployment of staff to critical front-line duties may impact on the quality and timing of the production of the financial statements, and the evidence we can obtain through physical observation;
- Volatility of financial and property markets will increase the uncertainty of assumptions applied by management to asset valuation and receivable recovery estimates, and the reliability of evidence we can obtain to corroborate management's estimates;
- Financial uncertainty will require management to reconsider financial forecasts supporting their going concern assessment and their overall financial resilience and whether material uncertainties for a period of at least 12 months from the anticipated date of approval of the audited financial statements have arisen; and
- Disclosures within the financial statements will require significant revision to reflect the unprecedented situation and its impact on the preparation of the financial statements as at 31 March 2020 in accordance with IAS1, particularly in relation to material uncertainties.

We will set out in the Audit Plan the additional work we propose to undertake in respect of this new significant risk for the Council audit (please refer to the audit plan addendum presented to the July Audit and Assurance Committee for work planned on the Scheme audit). Fundamental to our response will be working with you to understand the arrangements the Authority has in place to address relevant risks in respect of Covid-19 in its accounts preparation. We will also review the appropriateness of your disclosures, including those in respect of any estimation uncertainties around for example PPE and Pensions asset valuations.

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
Scale Fee	88,254	88,254	114,615
<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
COVID 19 new significant risk	5,000	0	0
Journals control weakness (part year affected)	750	1,000	0
Total Additional Fee	20,900	5,000	0
PPE Valuation – cost of auditor's expert	5,000	0	0
Total Council Audit Fee including valuer	114,154	93,254	114,615

This would give a scale fee for the statutory accounts audit for 2019/20 of £88,254 plus VAT plus a variation of £25,900. 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 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
Scale Fee	18,957	18,957	24,620
<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
COVID-19 significant risk	3,750	0	0
Total Additional Fee	7,500	4,500	0
Total Scheme Audit Fee	26,457	23,457	24,620
Direct Property Valuation – cost of auditor’s expert	4,500	0	0
<i>Audit Related Services</i>			
Provision of IAS 19 assurances to scheme employer auditors	7,000	5,000	3,942
Total Audit and Audit Related Services Scheme Fee	37,957	28,457	28,562

This will give a scale fee for the statutory accounts audit for 2019/20 of £18,957 plus VAT plus a variation of £12,000 and other audit related services of £7,000. This includes the cost of the external valuer, which we have determined to be necessary to support our audit work in this area.

Please note that we will be unable to issue our Scheme opinion until we are able to issue our Council opinion.

Future changes to audit scope 2020/21

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 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