

Annex 1 – What are auditors required to do?

Financial Audit

A financial audit is the examination of the financial statements of a local authority - as presented in the annual report and accounts - by someone independent of that organisation.

The purpose of a financial audit is to form a view on whether the financial statements:

- give a true and fair view of the financial position and of the Authority at the end of the financial year (31 March), and of the Authority's expenditure and income for the year then ended;
- have been prepared properly in accordance with the statutory accounting code; and
- have been prepared in accordance with the requirements of relevant legislation

The scope of the financial audit opinion is defined in *International Standards in Auditing (UK)*.¹ ISAs require the auditor to form an opinion on “*whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.*” (ISA 200) For Local Authority accounts the applicable financial reporting framework is CIPFA's Statutory Code of Accounting Practice.

In doing so they “*require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.*” (*ibid*) Reasonable assurance is defined as a high but not absolute level of assurance. In practice, audit firms will use statistical procedures to design audit tests that provide 95% confidence that the financial statements are free from material misstatement.

The final key concept for a financial audit is materiality. ISAs state that “*misstatements including omissions are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.*” ISA 320. Matters can be material due to value, nature or context.

ISAs require the auditor to make “*judgments about matters that are material to users of the financial statements ... based on a consideration of the common financial information needs of users as a group.*” (*ibid*) They do not require consideration of the effects of misstatements on *specific* users.

If a local authority has wholly owned subsidiary companies that are material to the operations of the authority, the authority is required to prepare group accounts. When an authority prepares group accounts, the financial audit covers the finances of both the authority and the group. It does not cover the finances of the subsidiary companies, which will be audited separately.

Once auditors have completed their work, they present an audit completion report to the client explaining what they have done, and issue an audit certificate providing their opinion on accounts.

¹ [https://www.frc.org.uk/getattachment/34c335dd-d191-462c-9214-e59a31c33349/ISA-\(UK\)-200_Revised-June-2016_Updated-January-2020_final-With-Covers.pdf](https://www.frc.org.uk/getattachment/34c335dd-d191-462c-9214-e59a31c33349/ISA-(UK)-200_Revised-June-2016_Updated-January-2020_final-With-Covers.pdf)

Value for money audit

A value for money audit is a risk-based examination by an independent person to enable that person to form a view on whether an authority has put in place proper arrangements for securing economy, efficiency and effectiveness in its use of resources.

International Standards on Auditing (UK) do not apply to value for money audits. The Statutory Code of Audit Practice requires the auditor to form a judgement on the nature and amount of work required to support the audit opinion.

Audit opinions

Both the financial audit and value for money audit opinions can be **clean** or **qualified**.

A **clean opinion** means that the auditor has concluded that in all **material** respects the accounts are true and fair/the authority has proper arrangements in place.

There are three types of qualified opinion:

- an **except for** opinion – which is a conclusion that in all material respects the accounts are true and fair/proper arrangements are in place except for the matters detailed in the audit certificate and report OR a conclusion that the supporting evidence provided by the authority is so deficient that the auditor is unable to conclude whether one or more material items in the accounts are true and fair/a material element of proper arrangements are in place.
- an **adverse** opinion – which is a conclusion that the accounts are not true and fair/proper arrangements are not in place.
- a **limitation in scope** opinion – which is a conclusion that the supporting evidence provided by the authority is so deficient that the auditor is unable to conclude whether the accounts are true and fair/proper arrangements are in place.

The updated Code of Audit Practice, effective from 2020-21, replaces the binary value for money opinion with a requirement to produce a narrative certificate and report.

How is a financial audit conducted?

- The local authority prepares its annual report and accounts.
- Auditors start their examination by gaining an understanding of the local authority's activities to gain an understanding of the economic, service delivery, leadership and political issues that might have affected it during the reporting period.
- For each major area of activity listed in the accounts, the auditors identify and assess any risks which could have a **material** impact on the financial position or financial performance of the local authority. They may test some of the measures (called internal controls) that the organisation has put in place to mitigate those risks.
- Based on the risks and controls identified, auditors consider what management has done to ensure the financial statements are accurate and examine supporting evidence, normally using a mixture of analytical procedures and sample testing.
- Auditors then make a judgement as to whether the annual report and accounts taken as a whole presents a true and fair view of the financial results and position of the organisation and its cash flows.

How is a value for money audit conducted?

- The local authority prepares its annual governance statement.

- Auditors start their examination by reading the statement. They would normally consider the Chief Financial Officer's "Section 25 report" setting out the reasonableness of assumptions and adequacy of financial reserves supporting the budget along with the mid-term financial strategy or equivalent. They may also consider reports issued by other inspectorates. However, none of these processes are mandated by standards or statutory guidance.
- If auditors identify a risk of a **material weakness** of the systems in place to support the delivery of value for money outcomes, they will undertake testing to assess that risk.
- Auditors then make a judgement on whether the authority has put proper arrangements in place for securing economy, efficiency and effectiveness in its use of resources.

What is materiality?

- Materiality is a key concept when preparing and auditing financial statements.
- A matter is considered to be material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the main users of a set of financial statements make on the basis of those financial statements.
- Auditors are required to assess materiality at the start of an audit engagement and to keep it under review throughout the audit.²
- If errors are identified in a set of financial statements and not amended by the local authority, the auditor is required to assess whether they are individually or cumulatively material when forming the audit opinion.³

What don't auditors currently do?

- Audit other information provided to elected members or central government, such as the balanced budget, the single data list data returns or the mid-term financial strategy or equivalent.
- Form a view on whether a local authority has delivered value for money. A local authority may have appropriate systems in place but still not deliver value for money outcomes.
- Check every figure in the financial report – audits are based on selective testing only.
- Look at every transaction carried out by the organisation.
- Provide assurance over whether government grants have been spent on appropriate purposes.
- Judge the appropriateness of the organisation's business activities or strategies or decisions made by elected members or statutory officers
- Test the adequacy of all or even any of an organisation's internal controls.
- Undertake specific procedures to detect or prevent fraud.

What can't auditors do?

- Predict the future – A financial audit relates to a specific past accounting period. It does not judge what may happen in the future, and so cannot provide assurance that the organisation will continue in business indefinitely.

Can external auditors rely on the work of internal audit?⁴

- The interface between internal and external audit is governed by *ISA (UK & Ireland) 610 Using the work of internal auditors*.

² [ISA\(UK\)320 - materiality in performing and planning an audit](#)

³ [ISA\(UK\)450 - evaluation of misstatements identified during an audit](#)

⁴ [ISA\(UK\)610 - using the work of internal auditors](#)

- Key elements of the ISA are as follows:
 - The use of internal auditors to provide direct assistance is prohibited for audits conducted in accordance with UK auditing standards.
 - The external auditor can choose to place reliance on the work of internal audit should its planned testing cover relevant areas. To do so the external auditor is required to assess (a) the extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors; (b) the level of competence of the internal audit function; and (c) whether the internal audit function applies a systematic and disciplined approach, including quality control.
 - Assuming the assessment of internal audit's organisational structure and quality control procedures indicates that it can be relied upon, the external auditor is required perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether: (a) the work of the function had been properly planned, performed, supervised, reviewed and documented; (b) sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and (c) conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.
- In practice, the quality control procedures set out in ISA610 are onerous, and it is considered to be more efficient for the external auditor to undertake additional testing rather than rely on the work of internal audit.
- As with all auditing standards, ISA 610 does not apply to the value for money audit. However, the Review is not aware of any instances where external audit has placed reliance on the work of internal audit when forming their value for money opinion.

Concerns about the financial audit framework raised by the Brydon Review

- Although focused on corporate audit, the Brydon Review raised some concerns about the current financial audit framework that are as relevant to local authority audits. Key amongst these are:
 - the growing challenge in using 'true and fair' as a descriptor of financial reporting given that corporate accounting increasingly involves the use of estimates and judgments. Together with the fact that the audit intends to provide assurance that the company accounts are free of material misstatements, it is difficult to see how either directors or the auditor can communicate effectively that modern company accounts are 'true' in accordance with any reasonable person's understanding of the word (para 2.3.1. & chapter 11)
 - All entities are required to keep adequate accounting records and auditors have statutory responsibilities in relation to these. However, auditors demonstrated lack of understanding of what was expected of them regarding accounting records, beyond establishing their adequacy to prepare the financial statements (chapter 12)
 - The confusion and expectation gap between the reality and the expectations of performance of auditors in their duties to assess the risk of and identify material fraud (chapter 14).
- An assessment of the impact of the Brydon Review recommendations on local authority audit is included at Annex 5.