# Restoring Trust in Audit and Corporate Governance - Consultation on the Government's Proposals

## Response from Audit Scotland, the Auditor General for Scotland, and the Accounts Commission for Scotland

**Prepared by Audit Scotland**

1 July 2021

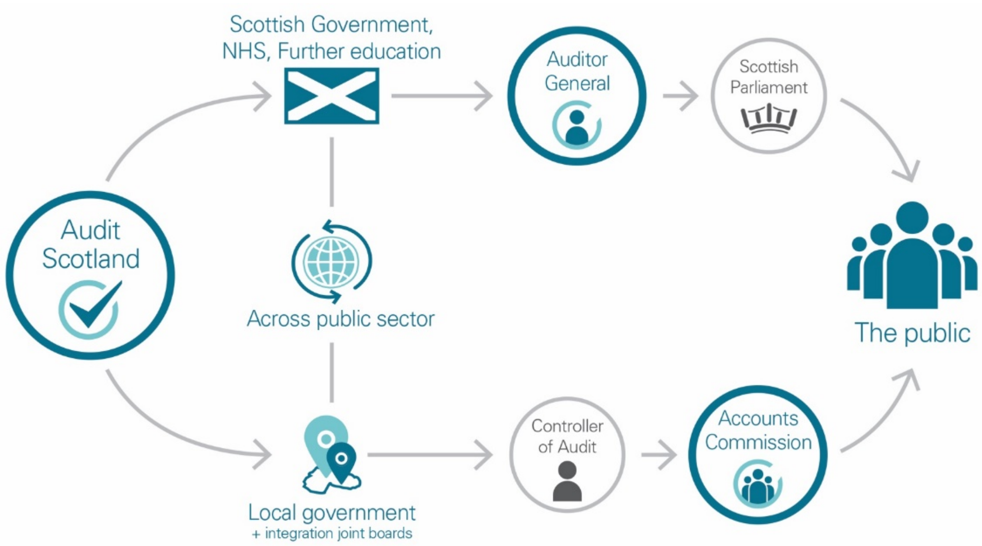
# Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- The Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.

- The Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.

- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.




# About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money

- reporting our findings and conclusions in public

- identifying risks, making clear and relevant recommendations.

# Introduction

## Introduction

1. Audit Scotland, the Auditor General for Scotland and the Accounts Commission for Scotland have noted with interest your proposed measures aimed at improving the audit, corporate reporting, and corporate governance of large companies in the UK.

2. We welcome moves to improve audit quality, but are aware that the consultation paper does not consider the application of the proposals to public sector audit. We consider it likely that the public sector will be impacted by changes that may result from these proposals. We are the public audit bodies for the Scottish public sector, and are well placed to offer information that you may find helpful in your considerations. We have responded only to those questions where we believe we have a particular insight to offer.

## Scottish public sector audit context

3. The statutory basis for the public audit regime in Scotland is set out in legislation devolved to the Scottish Parliament. Scottish public audit is fundamentally different to private sector audit and includes: independent appointment of auditors; independent fee-setting arrangements; wider audit scope; and comprehensive audit quality monitoring and reporting arrangements.

4. We are responsible for over 200 audits of bodies in the Scottish public sector with total audit fees of over £20 million. Public bodies in Scotland within our audit regime are a range of central government bodies, local authorities, health boards, and colleges as determined by devolved legislation. Some of these bodies are also charities, companies limited by guarantee, pension funds, and public interest entities. Collectively these bodies spend over £40 billion of public money each year. Some of the larger more significant bodies include the Scottish Government (£34 billion net expenditure), NHS Greater Glasgow & Clyde (£4.6 billion gross expenditure), Glasgow City Council (£2.7 billion gross expenditure), Strathclyde Pension Fund (£21 billion fund value) and Scottish Water (£1.4 billion revenue).

5. Auditors are independently appointed to audit these public bodies by the Accounts Commission and by the Auditor General, supported by Audit Scotland. In most cases, staff in Audit Scotland's inhouse audit practice are appointed as auditor but private sector accountancy firms are appointed to around a third of the bodies.

6. All of our audits are governed by a Code of Audit Practice. The scope of audit assurance set out in the Code extends beyond the audit of the financial statements. The wider audit scope includes information published with the financial statements, and in separate information returns, as well considering and reporting on the effectiveness of the financial and governance arrangements that each body has in place.

7. We have a range of measures in place to ensure that high quality audits are delivered by all audit providers. Central to the arrangements is the Audit Quality Framework which sets out how Audit Scotland provides the Accounts Commission and Auditor General with independent quality assurance over the work of both Audit Scotland's inhouse audit practice and the firms.

8. Auditors produce two main types of audit report for each body annually both of which are made publicly available:
   - The short-form Independent Auditor's Report (long form for PIEs) complies with ISA (UK) 700 and is used to express the opinion on the financial statements and other opinions on specified parts of the other information published with the financial statements.
   - A long form Annual Audit Report required by the Code of Audit Practice where auditors report their conclusions on wider scope responsibilities, as well as (for non-PIEs) a description of the most significant assessed risks of material misstatement and how each was addressed.

9. Audit Scotland also produces national performance audit reports on behalf of the Commission and Auditor General including reports which provide an overview of the matters arising from the audits in each sector.

## Contact details

10. We hope you find our joint response helpful. In order to be concise, we have attempted to keep our answers brief, but if you would like further information, please contact Paul O'Brien, Senior Manager (Professional Support) at pobrien@audit-scotland.gov.uk.

# Response

## Selected questions and responses

**Extending the definition of Public Interest Entities**
**6 Should the Government seek to include large third sector entities as PIEs beyond those that would already be included in the definitions proposed for large companies? If so, what types of third sector entities do you believe should be included and why?**
**7 What threshold for 'incoming resources' would you propose for the definition of 'large' for third sector entities? Is exceeding £100m too high, too low or just right?**
**8 Should any other types of entity be classed as PIEs? Why should those entities be included?**

There are two bodies within our public audit regime that, although they do not fall within the Companies Act, meet the current PIE definition by virtue of having bonds listed on the London Stock Exchange. The first is Aberdeen City Council which holds a bond of substantial value. While we believe that our standard audit arrangements, including the independent appointment of auditors and robust quality monitoring, are no less stringent than a PIE audit and would provide sufficient assurance, we recognise that investors expect a recognised industry-standard PIE audit to be carried out.

However, the other body falls within the PIE definition by virtue of holding a very small amount (below the 'clearly trivial' threshold) of listed war bonds inherited from a previous local authority. We consider that application of the additional PIE regulation to be disproportionate given the minor sums involved. We therefore request a de minimis to be set, at least for public bodies, so that PIE status is not triggered for trivial sums of listed debt.

Some of the public bodies within our audit regime, such as registered charities, could fall within an extension of the PIE definition to include larger third sector entities if it was applied to devolved Scottish legislation. We would not be supportive of such an outcome as we consider our existing arrangements to be analogous to a PIE audit but proportionate, appropriate, and specifically tailored to provide assurance on public funds.

**Stronger internal company controls**
**12.Is there a case for strengthening the internal control framework for UK companies? What would you see as the principal benefits and disbenefits of stronger regulation of internal controls?**
**13.If the control framework were to be strengthened, would you support the Government's initial preferred option (Table 2)? Are there other options that you think Government should consider? Should external audit and assurance of the internal controls be mandatory?**
**14.If the framework were to be strengthened, which types of company should be within scope of the new requirements?**

Reporting requirements for public bodies are set by the relevant authorities for standard-setting in the public sector. All public bodies within our audit regime currently report an assessment of the effectiveness of key elements of their governance framework (including but not limited to internal control) on an annual basis in a governance statement that accompanies the financial statements. Auditors express a formal opinion in the Independent Auditor's Report on whether the governance statement has been prepared in accordance with applicable requirements

In addition, our auditors report a conclusion on the effectiveness of the governance arrangements in the long form Annual Audit Report as part of our wider scope audit (rather than a formal opinion in the Independent Auditor's Report), along with recommendations for improvement. The audit of the financial statements is the foundation and source for the majority of the audit work necessary to support the conclusions made. We consider this reporting to be proportionate and that it provides adequate assurance. We suggest that a similar approach, where auditors of companies include in the Independent Auditor's Report a conclusion on the effectiveness of arrangements for internal control based on the work carried out for the audit of the financial statements, would provide useful assurance to stakeholders.

We do not consider that a formal audit opinion on the effectiveness of internal control would add meaningfully to the assurance that our auditors currently provide. We believe that auditors would have to

## Selected questions and responses

gather more evidence and carry out more audit procedures to be able to support such an opinion. We do not consider that the additional assurance would be commensurate with the inevitable additional audit cost that would be entailed. We also consider that a focus on internal control could detract from our wider evaluation of governance as a whole.

**Scope of audit**

**37.Do you agree with the Government's approach of defining the wider auditing services which are subject to some oversight by the regulator via the Audit and Assurance Policy?**

**38.Should the regulator's quality inspection regime for PIE audits be extended to corporate auditing? If not, how else should compliance with rules for wider audit services be assessed?**

**39.What role should ARGA have in regulating these wider auditing services? Should its role extend beyond setting, supervising and enforcing standards?**

We agree that there are benefits of having a wider range of information audited beyond the financial statements. We also agree that the new regulator is best placed to oversee the provision of these wider audit services for companies. However, we do not believe that the decision on whether to audit other information should be left to directors. It is likely that the better run companies with strong corporate governance will opt to have the information audited. However, it may be that the very companies that would benefit most from the independent assurance provided by audit may be least likely to take advantage of it. We therefore suggest that a certain minimum level of prescription be set out in legislation.

For the bodies within our public audit regime, the scope of the audit set out in our Code of Audit Practice is wider than just the financial statements. It includes information published with the financial statements (e.g. in the management commentary and governance statement) and separate information returns (e.g. local authority grant claims). However, the scope is wider than simply 'information'; it includes auditors evaluating, concluding and reporting in the Annual Audit Report on the effectiveness of the *arrangements* that each body has in place for key areas such as financial management, financial sustainability, governance and transparency, and value for money. We consider that a similar approach for companies would provide valuable assurance to stakeholders on the systems that underpin each entity's operations.

**Principles of corporate auditing**

**40.Would establishing new, enforceable principles of corporate auditing help to improve audit quality and achieve the Government's aims for audit? Do you agree that the principles suggested by the Brydon Review would be a good basis for the regulator to start from?**

**41.Do you agree that new principles for all corporate auditors should be set by the regulator and that other applicable standards or requirements should be subject to those principles? What alternatives, mitigations or downsides should the Government consider?**

We are supportive of enforceable principles of auditing and agree that the principles suggested by the Brydon Review would be a good basis from which to start. We also agree that principles should be set by the regulator and that other applicable standards or requirements should be subject to those principles.

On points of detail, we offer the following observations on two of the principles suggested by Brydon:

- The seventh principle is "Auditors ask the directors to report any material information that may legitimately be disclosed to assist the understanding of users of an audit report, and, if necessary, disclose it themselves." We believe the scope of this principle should be wider than just the audit report and that it should cover users' understanding of the full annual report and accounts.
- The eighth principle is "Auditors provide appropriate challenge to management, assessing critically information and explanations received for signs of over-optimism, judgmental bias or possible fraud". In our experience, management can also be overly pessimistic and consider that this should also be reflected.

**Tackling fraud**

## Selected questions and responses

**42 Do you agree with the Government's proposed response to the package of reforms relating to fraud recommended by the Brydon Review? Please explain why.**

We agree that directors of PIEs should be required to report in a statement on the steps they have taken to prevent and detect material fraud as this should encourage them to enhance their focus on the prevention and detection of fraud and the risks of fraudulent financial reporting. We believe that supporting guidance for directors will be necessary to assist them carry out that duty in a consistent and helpful manner.

We also agree with the proposal that auditors of PIEs should report on the nature and extent of the work they performed on the directors' statement. However, we believe there is merit in going further than simply confirming 'factual accuracy'; auditors could usefully report on whether they consider the steps to be satisfactory in the circumstances of the entity.

We agree that auditors should report on the steps they took to detect any material fraud and assess the effectiveness of relevant controls as this complements the responsibility placed on directors. However, reporting should be clear that primary responsibility rests with directors and any steps taken by auditors are supplementary.

However, we believe that the above requirements should extend to all large companies, rather than just PIEs as currently proposed.

Under our public audit regime, auditors report conclusions on whether the public body has established appropriate and effective arrangements for the prevention and detection of fraud and corruption. This involves auditors assessing whether the arrangements are operating effectively, and recommending improvement when they are not.

We agree that an accessible case study register of corporate frauds be maintained to enable auditors to learn from such cases. We have a similar arrangement in place. When our auditors are advised by internal audit of a fraud or suspected fraud involving the misappropriation of assets, the auditor reports the case to Audit Scotland. Audit Scotland then disseminates information to all other auditors who consider whether any action is required in relation to their own audit appointments. We disseminate the information firstly as part of a quarterly technical bulletin and also in an annual fraud report which is available from our website.

We note that the Government proposal is for auditors to collectively seek to take forward a fraud register. However, in line with Brydon's recommendation, we consider that role would be better undertaken by the regulator.

Audit Scotland also coordinates the participation of public bodies in Scotland in the National Fraud Initiative. This is a counter-fraud exercise which matches data within and between other public bodies to identify potentially fraudulent transactions or claims and errors.

Audit Scotland also carries out other thematic work where particular fraud risks emerge. For example, this includes emerging fraud risks caused by COVID-19 and red flags in procurement fraud. We suggest that the regulator could carry out a similar role for companies.

**True and fair requirement**
**44.Do you agree that auditors' judgements regarding the appropriateness of any departure from the financial reporting framework proposed by the directors should be informed by the proposed Principles of Corporate Auditing? What impact might this have on how both directors and auditors assess whether financial statements give a true and fair view?**

We believe it is important to draw a clear distinction between:

- a need for directors to provide disclosures beyond those specified by an accounting standard; and
- where it is necessary to depart from a relevant requirement in an accounting standard.

In our view, only the latter case represents a 'true and fair' override.

Although we understand that the principles of auditing could be used to inform judgement in determining whether additional disclosures are required, it is less clear how they could be used to judge the appropriateness of a departure, i.e. 'true and fair' override.

## Selected questions and responses

**Audit of Alternative Performance Measures and Key Performance Indicators linked to executive remuneration**

**45 Do you agree that the need for specific assurance on APMs or KPIs, beyond the scope of the statutory audit, should be decided by companies and shareholders through the Audit and Assurance Policy process?**

We consider that APMs in the annual report and accounts should be accompanied by appropriate disclosures, explaining why they provide useful information, how they are calculated and how they can be reconciled to the most comparable IFRS measure.

In respect of KPIs, Scottish local authorities are required to publish statutory performance information set by the Accounts Commission. The KPIs are broadly based on performance rather than restricted to remuneration. Auditors of local authorities have a statutory duty to be satisfied that each local authority has made arrangements for collecting, recording and publishing the information. Auditors report a conclusion on the arrangements in the long form Annual Audit Report. Although the KPIs are not audited, and no formal opinion is expressed, we consider the assurance provided to stakeholders is proportionate. We suggest a similar arrangements-focussed approach could be adopted by the auditors of all PIEs, with the option for the information to be audited to still be available.

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**A professional body for corporate auditors**

**48 Do you agree that a new, distinct professional body for corporate auditors would help drive better audit? Please explain the reasons for your view**

**49 What would be the best way of establishing a new professional body for corporate auditors that helps deliver the Government's objectives for audit? What transitional arrangements would be needed for the new professional body to be successful?**

**50.Should corporate auditors be required to be members of, and to obtain qualifications from, professional bodies that are focused only on auditing?**

**51.Do you agree that a new audit professional body should cover all corporate auditors, not just PIE auditors?**

We agree there are benefits in a wider audit scope involving appropriate additional training and certification of auditors for the information concerned. However, we are not yet convinced that the consultation makes a compelling case for the creation of a new professional body which we believe would be both costly and disruptive. There is an argument that a more judicious first step would be for existing accountancy bodies to serve new entrants to the profession, as well as maintaining their role as providers of approved qualifications, monitoring continuous professional development, and as supervisory bodies in relation to auditors of the financial statements. The creation of a new body could then be considered at a later stage if it is judged that that initial step is not successful.

Whatever the approach, we consider it very important that the impact on public audit is expressly considered and that communication channels, perhaps with the Public Audit Forum, be opened so that we may be actively involved in the debate.

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**Independent Auditor Appointment**

**54 Do you agree with Sir John Kingman's proposal to give the regulator the power to appoint auditors in specific, limited circumstances (i.e. when quality issues have been identified around the company's audit; when a company has parted with its auditor outside the normal rotation cycle; and when there has been a meaningful shareholder vote against an auditor appointment)?**

**55. To work in practice, ARGA's power to appoint an auditor may need to be accompanied by a further power to require an auditor to take on an audit. What do you think the impact of this would be?**

**56.What processes should be put in place to ensure that ARGA can continue to undertake its normal regulatory oversight of an audit firm, when ARGA has appointed the auditor?**

We recognise that the independent appointment of auditors is perceived as a radical step in the private sector, but it is the well-established approach in the Scottish public sector. All audit appointments within our audit regime are made independently of the audited body. The independent appointment of auditors is a key strength of public sector audit in Scotland and is an important safeguard against conflicts of interest which may compromise auditor judgement.

## Selected questions and responses

Statutory responsibility for appointing external auditors rests with the Accounts Commission (local government) and the Auditor General for Scotland (most of the remainder of the public sector). Auditors are appointed following a rigorous procurement process that is independent of the individual audited bodies. The auditors appointed are a combination of members of staff in Audit Scotland's inhouse audit practice and accountancy firms (currently Deloitte, KPMG, EY, Grant Thornton, Azets Audit Services and Mazars).

Audit appointments are usually made for a five-year period though this can be extended (and has been extended due to the impact of COVID-19). Only the Commission and Auditor General have the power to dismiss an auditor or change an audit appointment.

We are unique in the UK public sector in that we use an 'appointments' model, i.e. appointed auditors 'sign off' their audits in their own name (either the firm or individual in the inhouse audit practice). This is distinct from the model whereby work is sub-contracted to firms but 'sign-off' responsibilities are retained by the head of the relevant national audit agency. We believe our model promotes accountability, is more efficient, and creates incentives for a higher quality audit.

We agree that ARGA should have the power to appoint auditors to companies. However, we do not consider that the circumstances should be limited or that the impression should be given that it is a punitive measure. For example, companies should be able to voluntarily request that ARGA appoint its auditor and ARGA should take steps to encourage such requests.

**Market opening measures**

**61 Should the 'meaningful proportion' envisaged to be carried out by a Challenger be based on legal subsidiaries? How should the proportion be measured and what minimum percentage should be chosen under managed shared audit to encourage the most effective participation of Challenger firms and best increase choice?**

**62 How could managed shared audit be designed to incentivise Challenger firms to invest in building their capability and capacity? What, if any, other measures, would be needed?**

**63.Do you have comments on the possible introduction in future of a managed market share cap, including on the outlined approach and principles? Are there other mechanisms that you think should be considered for introduction at a future date?**

Due to the independent appointment of auditors in the Scottish public sector (explained in our response to questions 54 to 56), we can directly ensure that 'challenger firms' can be given a meaningful proportion of the audits and therefore we do not have the problem of the Big Four dominating the market that exists in the private sector. Of the six audit firms we currently appoint as auditors, half are from the Big Four (Deloitte, KPMG and EY) and half are from challenger firms.

We do not use either a joint audits or managed shared audits approach, and we have no immediate plans to do so though we will monitor developments.

However, many of the companies that are subsidiaries of public bodies appoint their own auditors. We are therefore familiar with the auditors of group entities being different from the auditor of the parent and this can present challenges and inefficiencies.

**Monitoring of audit quality**

**70 What types of sensitive information within AQR reports on individual audits should be exempt from disclosure?**

**71 In addition to redacting sensitive information within AQR reports on individual audits, what other safeguards would be required to offer adequate protection to the entity being audited whilst maintaining co-operation with their auditors?**

A team within Audit Scotland, independent from the inhouse audit practice, arranges for AQRs to be carried out by The Institute of Chartered Accountants of Scotland (ICAS). Under current arrangements, the conclusions of ICAS are reported publicly at a summary level which identifies the individual assessments achieved by each auditor (good, limited improvement required, improvement required, and significant improvement required) but does not identify the individual audit. This is supplemented by reporting the most significant areas for improvement arising from the AQRs and other internal monitoring arrangements. We are very supportive of greater transparency and are currently discussing whether, and if so how, to disclose more information in public.

## Selected questions and responses

In our experience, audit committees are generally very engaged in discussions on AQR reports. However, it is important that they are properly supported and educated in understanding the AQR results and how they should be interpreted. For example, ‘significant improvement required’ does not necessarily call into question the appropriateness of the expressed audit opinions. The absence of such support creates the risk of inadvertently undermining confidence in the audit process rather than increasing it.

**Establishing the regulator**
**75 Do you agree that ARGA should have regard to these regulatory principles when carrying out its policy-making functions? Are there any other regulatory principles which should be included?**

We would find it very helpful if ARGA's regulatory principles included provisions requiring it to consider the implications for public audit when setting auditing standards in the UK. This would bring ARGA into line with the International Audit and Assurance Standards Board which includes additional considerations specific to public sector entities in its international standards.

**Independent Supervision of the Auditors General**

Although the Auditor General for Scotland does not currently undertake statutory audit work under the Companies Act, that could be the case in the future. We therefore consider that consideration of amended supervision arrangements should not focus solely on the Comptroller and Auditor General, and that discussions should involve all four Auditors’ General in the UK.

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