

# Regulatory Compliance and Quality Review Programme

Annual report 2014

**The Audit Commission's role is to protect the public purse.**

**We do this by appointing auditors to a range of local public bodies in England. We set the standards we expect auditors to meet and oversee their work. Our aim is to secure high-quality audits at the best price possible.**

**We use information from auditors and published data to provide authoritative, evidence-based analysis. This helps local public services to learn from one another and manage the financial challenges they face.**

**We also compare data across the public sector to identify where services could be open to abuse and help organisations fight fraud.**

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# Introduction

- 1 The Audit Commission appoints external auditors<sup>i</sup> to some 900 principal local government, criminal justice and health bodies in England. Appointed auditors' responsibilities are set out in the Audit Commission Act 1998. They must carry out their work and exercise their powers under the Commission's statutory [Codes of Audit Practice](#) (the Codes)
- 2 The Commission also appoints external auditors to some 10,000 parish and town councils and other bodies such as internal drainage boards, referred to as smaller bodies in this report. These bodies are subject to a separate limited assurance audit.<sup>ii</sup>
- 3 Legislation has been published by the government which will close the Commission by the end of March 2015 and establish a new local public audit regime<sup>iii</sup>. All contracts for audit and related services currently let by the Commission will be transferred to a transitional body hosted by the Local Government Association for their remaining duration. The management of the contracts, including monitoring compliance with requirements, will become the responsibility of this body on 1 April 2015.
- 4 Until our close, we remain committed to maintaining an audit regime that delivers audit work of good quality.

i These 2012/13 principal body audits were undertaken by BDO LLP (BDO), Deloitte LLP (Deloitte), Ernst & Young LLP (EY), Grant Thornton UK LLP (GT), KPMG LLP (KPMG), Mazars LLP (Mazars) and PricewaterhouseCoopers LLP (PwC).

ii The 2012/13 limited assurance audits were undertaken by BDO, GT, Mazars, and PKF Littlejohn LLP (PKFL).

iii The Local Audit and Accountability Act 2014 can be seen [here](#).

# Background

5 The Commission monitors the performance of all its audit firms. The results of our monitoring provide audited bodies and other stakeholders with assurance that high-quality audits are being delivered. We define audit quality as compliance with our regulatory requirements and with professional standards. Our objectives are to:

- provide assurance that the firms have put in place systems and processes to deliver audit work of good quality; and
- provide information to inform the audit appointments we make.

6 This report summarises the results of the quality review process for 2014.

7 There were two strands to our 2014 monitoring:

- audit quality - applying our annual quality review programme (QRP) to the audit work undertaken for the year ending 2012/13; and
- regulatory compliance - reporting quarterly on audit suppliers' compliance with our 2013/14 regulatory requirements as set out in the [Codes](#) and [Standing Guidance for Auditors](#) (the Standing Guidance).

8 The audit quality and regulatory compliance monitoring in the principal audit regime incorporated a range of measurements and checks comprising:

- the results of firms' compliance with 17 key indicators relating to [Standing Guidance](#) requirements;
- a review of firms' systems to ensure they comply with the Commission's regulatory requirements;
- a review of the firms' latest published annual transparency reports;
- the results of reviewing a sample of 258 of firms' own internal audit quality monitoring reviews (QMRs) of financial statements; Value for Money (VFM) conclusions; Whole of Government Accounts (WGA) and Health Quality Accounts (HQA); certification of claims and returns (certification); and housing and council tax benefit subsidy claims (HB COUNT) audit work;
- an assessment as to whether we could rely on the results of each firm's systems for quality control and monitoring;
- a review of the Financial Reporting Council's (FRC) published report on the results of its inspection of the firm's audits in the private sector;
- the results of the inspection of 17 of our firms' files by the FRC's Audit Quality Review team (AQR) as part of our commissioned inspection programme. The scope of the AQR inspections covered audit of the financial statements and VFM conclusion work; and
- a review of each firm's client satisfaction surveys for 2012/13 work.

9 In the limited assurance regime, the measurements and checks comprise:

- the results of firms' compliance with five key indicators relating to [Standing Guidance](#) requirements;

- a review of firms' systems to ensure they comply with the Commission's regulatory requirements;
- the results of reviewing a sample of 195 firms' own internal QMRs of annual return audit work;
- the results of 20 of our own reviews of annual return audit work;
- an assessment as to whether we could rely on the results of each firm's systems for quality control and monitoring; and
- a review of each firm's client satisfaction surveys for 2012/13 work.

## Overall performance

**10** In our principal and limited assurance audit regime, our monitoring of compliance with the [Codes](#) and the [Standing Guidance](#) uses a green, amber, and red scoring scheme.

**11** We also use similar scoring in the principal audit regime to assess the overall quality of audit work for key aspects of the audit covering: financial statements audit work; whole of government accounts returns; VFM conclusion; health quality accounts; certification and HB COUNT audit work.

**12** The combined regulatory compliance and audit quality performance for each principal audit firm is detailed in Table 1.

**Table 1: Combined regulatory compliance and audit quality performance scores**

Green	Amber	Red
BDO	GT	
Deloitte	KPMG	
EY*	PwC	
Mazars*		

\*new firms for 2012/13

**13** In the limited assurance regime, we assess the overall quality of audit work on a four point scale, consistent with the scale used in our principal audit regime for individual file reviews. This scale is:

- ‘Improvements required which are individually or collectively significant’;
- ‘Acceptable overall with improvements required’;
- ‘Acceptable with limited improvements required’; and
- ‘Good, no improvement required’.

**14** The audit quality performance for each limited assurance audit firm is detailed in Table 2<sup>i</sup>.

<sup>i</sup> We do not combine regulatory compliance and audit quality performance in the limited assurance regime.

**Table 2: Audit quality performance scores**

<b>Good, no improvement required</b>	<b>Acceptable with limited improvements required</b>	<b>Acceptable overall with improvements required</b>	<b>Improvements required which are individually or collectively significant</b>
	BDO	PKFL*	
	GT*		
	Mazars		

\*new firms for 2012/13

**15** The results of the monitoring programme show that audit quality has been maintained in the year following transfer of staff from the Commission’s Audit Practice to firms, and the introduction of new firms to our regimes.

**16** We are satisfied that the risks of audit failure remain low; that all firms are meeting the Commission's regulatory requirements; and that all firms are continuing to produce work to an acceptable standard.

**17** The firms' individual annual audit quality and regulatory compliance reports, along with their regulatory compliance reports, are available to view on the [audit quality](#) pages of our website.



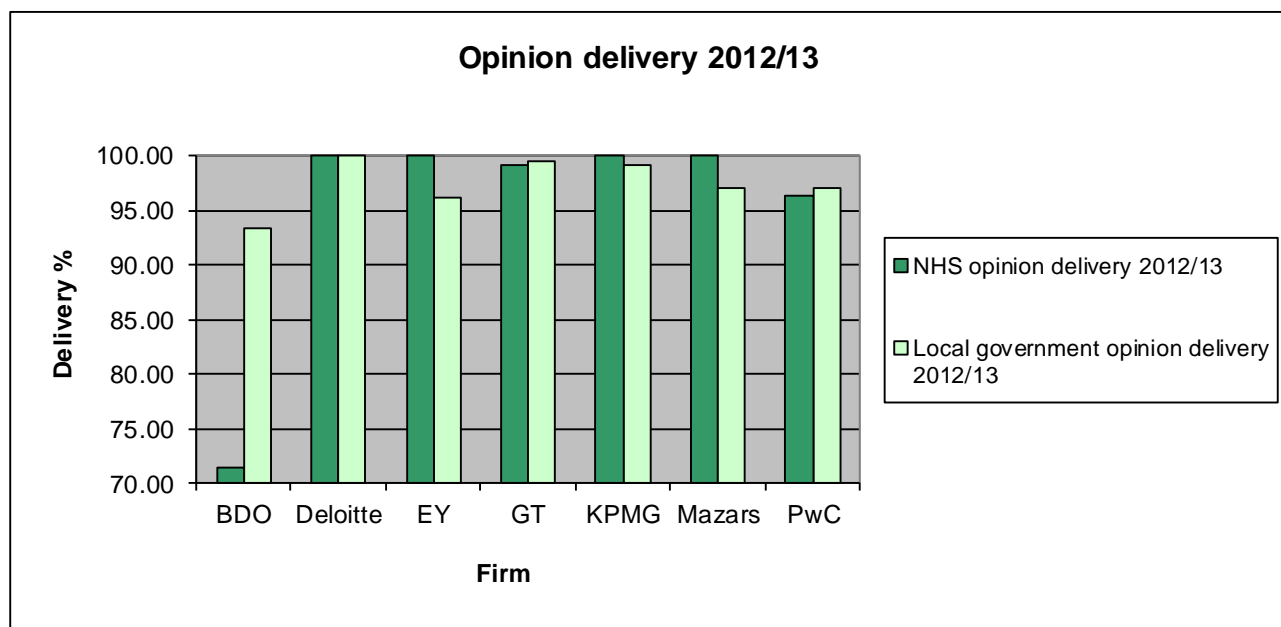
## Regulatory requirements- principal audits

**18** Our monitoring of auditors' compliance with the [Codes](#) and the [Standing Guidance](#) focuses on 17 key indicators. These include the target dates for issuing audit opinions on the financial statements and VFM conclusions; issuing assurance reports on the whole of government accounts returns; producing annual audit letters; and sending us specified information and returns.

**19** We are pleased to note that 92 per cent of the indicators were scored as green, where the requirement was either fully met, or met within a specified tolerance.

**20** The delivery of audit opinions against the targets dates are shown in Exhibit 1.

**Exhibit 1: Delivery of audit opinions at local government and NHS bodies**



**21** Auditors met the majority of our target dates for issuing the audit opinion (98.5 per cent for NHS and 98.2 per cent for local government). Where they were not met, the delays were mainly for reasons that were outside the auditor's control, such as delays at audited bodies in producing financial statements.

**22** BDO could not deliver two NHS opinions until a significant irregularity had been investigated by a third party. Due to its limited portfolio, the firm's overall delivery of NHS opinions was therefore lower than the other firms.

**23** The results of satisfaction surveys issued by firms for 2012/13 audit work showed that, on the whole, audited bodies were satisfied with their auditor. However, one area that requires improvement in the regime is the timely resolution of objections, from local government electors, by auditors.

**24** In addition, one auditor appointment was revoked in year as the firm did not comply with our requirements on auditor independence. The firm has an action plan in place to address weaknesses identified.

# QRP results- principal audits

## Overall QRP results

**25** Three key areas for improvement, as identified last year<sup>i</sup>, continue to require improvement across the regime. These were for auditors' to:

- review, challenge and consider the reasonableness of management's documents and assumptions with respect to evidence obtained for the VFM conclusion, particularly in relation to increasing funding gaps at local government organisations;
- improve the quality of evidence on file to support key audit judgements; and
- ensure compliance with our specified methodology for HB COUNT certification work.

**26** The rest of this report summarises the results of our work on each of the main parts of the QRP.

## Financial statements audit work

**27** Auditors of listed companies have a statutory duty to produce an annual transparency report, giving information about the firm's governance and its arrangements for ensuring the quality of its work. All the firms in our principal audit regime are covered by this requirement and our review of the transparency reports did not highlight any significant issues of note.

**28** The FRC's public reports provide an objective reality check on the self-assessments included in the firms' transparency reports. The FRC's summary report on its 2013/14 inspections of the work of the big four and 'other significant' audit firms concluded that there was 'an improvement on prior years'<sup>ii</sup>

**29** The FRC has identified a number of key issues which, profession wide, should be addressed in order to improve audit quality. Key issues included:

- a need for a greater level of robust challenge of management's key assumptions and other judgements;
- a need for an improvement in the auditing of IT controls, including an improvement in firms' policies and the testing of controls in practice; and
- insufficient consideration of the appropriateness of providing non-audit services, especially when an entity becomes an audit client.

**30** The results of the FRC reviews on a sample of ten Commission engagements for 2012/13 concluded that although one required significant improvement, the audits had been performed to an acceptable standard overall.

<sup>i</sup> Audit Commission: [Annual Regulatory Compliance and Quality Review Programme: Annual Report 2013](#).

<sup>ii</sup> FRC Audit Quality Inspections Annual Report 2013/14, published 28 May 2014.

**31** We reviewed a sample of all firms' quality monitoring reviews (QMRs) of financial statements audits. While these identified scope for improvement, there were no systematic concerns about the overall quality of work.

## Whole of government accounts returns

**32** Whole of government accounts (WGA) cover the whole of the public sector. Auditors appointed by the Commission have a statutory duty to review and report on the WGA returns prepared by local government bodies and police authorities. We specify the procedures that appointed auditors need to follow when receiving and reporting on the WGA return. For each firm we reviewed a sample of the quality monitoring reviews of auditors' WGA returns.

**33** We were satisfied from the results of the reviews that the evidence on audit files was sufficient to support auditors' reports.

**34** Two key areas for improvement identified last year, in relation to improving the documentation setting out the work planned on the WGA return and why it is required; and ensuring full compliance with the Commission's WGA instructions were, on the whole, addressed this year. Auditors have also maintained the timeliness of submitted assurance reports from last year.

## Value for money conclusions

**35** Auditors are required by the Code to give a value for money (VFM) conclusion as to whether the audited body has put in place proper arrangements for securing economy, efficiency and effectiveness in its use of resources. For each firm we reviewed a sample of the quality monitoring reviews of auditors' VFM conclusions.

**36** We were satisfied from the results of the reviews that the evidence on audit files was sufficient to support auditors' VFM conclusions. However, there is a need for further review, challenge and consider the reasonableness of management's documents and assumptions with respect to evidence obtained for the VFM conclusion, particularly in relation to increasing funding gaps at local government organisations; and there continues to be scope for improving the documentation on VFM conclusion audit files of risk assessments and subsequent auditor judgements.

## Health quality accounts

**37** The quality account is an annual report to the public by providers of NHS healthcare<sup>i</sup> which includes performance indicators and commentary on the health services they have delivered. The primary purpose of the quality account is to encourage boards and leaders of healthcare organisations to assess quality across all the healthcare services they offer. The Department of Health asked the Commission to make arrangements for auditors to provide assurance on NHS trusts' 2012/13 quality accounts.

**38** Where applicable, for each firm we reviewed a sample of the quality monitoring reviews of auditors' work on NHS trust's quality accounts. Overall, we were satisfied with the standard of evidence supporting auditors' work.

<sup>i</sup> All NHS and foundation trusts must produce an annual quality account. The Commission requires these to be reviewed by the auditors of NHS acute and mental health trusts only.

## Certification of claims and returns for grant-paying bodies including HB COUNT certification work

**39** Certification work is not an audit, but a different type of assurance engagement. Audit Commission auditors certify local authorities' claims and returns to provide assurance to grant-paying bodies that claims for grants and subsidies comply with terms and conditions, or that information in financial returns is reliable. Certification work is done at the request of authorities, when a grant-paying body requires auditor certification as part of a scheme's terms and conditions. This involves applying prescribed tests that are designed to give reasonable assurance that claims and returns are fairly stated and agree with specified terms and conditions.

**40** The most complex claims certified by auditors are local authority claims for housing and council tax benefit subsidy from the Department for Work and Pensions (DWP). Auditors are required to undertake this work using the Commission's guidance and tools which are agreed annually with the DWP. HB COUNT sets out the approach and work needed to certify the subsidy claim form and includes a requirement to test a sample of cases to check that benefits have been awarded in accordance with benefit regulations and that subsidy has been properly claimed

**41** For each firm we reviewed a sample of the quality monitoring reviews of certification work to assess whether the auditor had followed our prescribed tests. We found that suppliers complied with our requirements on the whole, but there is scope for improving compliance with our certification instructions in specific areas.

**42** In particular, this year the quality review process has again highlighted differences in auditor awareness of some aspects of the HB COUNT approach, specifically around the documentation of the establishment of the validity of applicable amounts within housing benefit claims, and testing of the claim in line with agreed certification instructions.

## Regulatory requirements- limited assurance audits

43 The limited assurance approach for smaller bodies comprises three key elements:

- a compliance check against the requirements of an annual return;
- a high level analytical review of financial and other information requested by the auditor; and
- a review of the bodies annual governance statement.

44 This work leads to the issue of a limited assurance audit opinion on the annual return and a certificate of closure. Given the low-risk, high-volume work undertaken, our focus for these audits in previous years has been on ensuring delivery of limited assurance opinions by the deadline and relying on firms' own quality review arrangements.

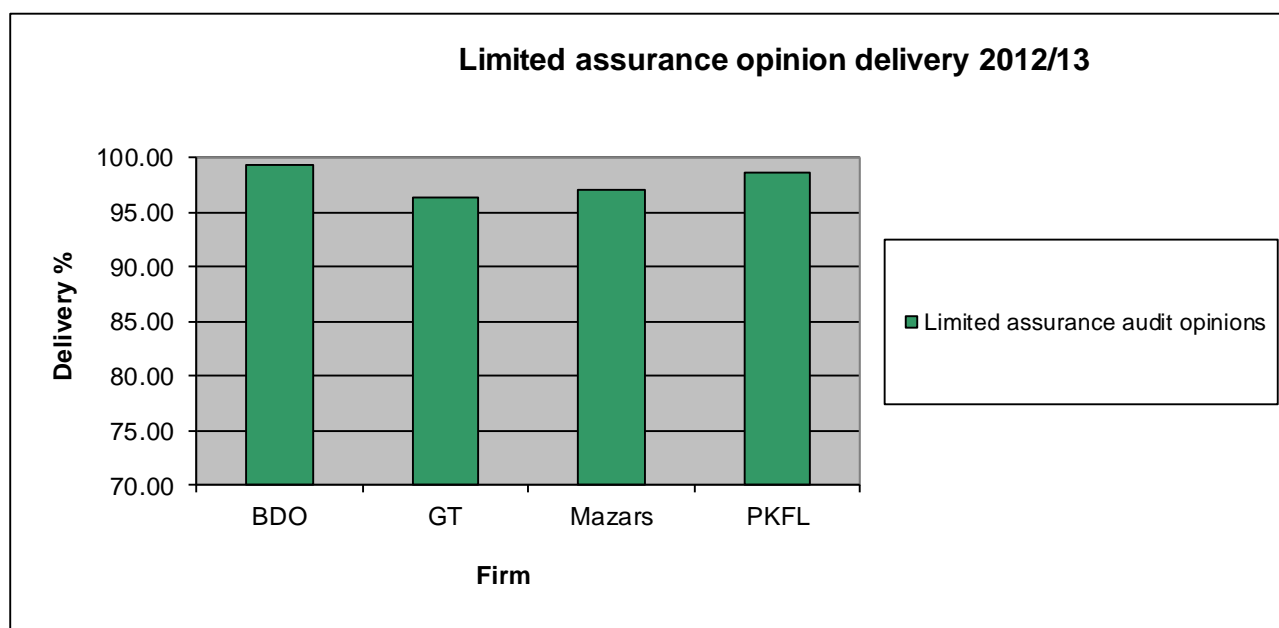
45 However, as we had two new audit firms<sup>i</sup> in our limited assurance regime for the delivery of 2012/13 audits, we undertook our own reviews of a sample of limited assurance audits at each firm, in addition to relying on firms' internal arrangements.

46 In the limited assurance regime, our monitoring of auditors' compliance with the [Codes](#) and the [Standing Guidance](#) focuses on five key indicators. These include the target dates for issuing audit opinions on the annual return; and sending us accurate information and returns.

47 We are pleased to note that 90 per cent of the indicators were scored as green, where the requirement was either fully met, or met within a specified tolerance.

48 The delivery of audit opinions against the targets dates are shown in Exhibit 2.

### Exhibit 2: Delivery of limited assurance audit opinions



<sup>i</sup> GT and PKFL.

**49** Auditors met the majority of our target dates for issuing the limited assurance audit opinion (97.9 per cent overall). In addition the results of satisfaction surveys issued by firms for 2012/13 audit work showed that, on the whole, audited bodies were satisfied with their auditor.

**50** However, one area that requires improvement in the regime is the quality and accuracy of data returns submitted to the Commission.

## QRP results- limited assurance audits

### Limited assurance audit work

**51** Our reperformance of a sample of the internal reviews did not highlight any weaknesses in any of the firms' internal QRMs and we were able to rely on this work in addition to our own reviews.

**52** Some minor improvement points were raised across all firms, both as part of the internal QMRs and from our own reviews. The more significant improvement points raised included not always having clear explanations on file of the conclusions reached when forming an audit judgement; and not fully understanding our Standing Guidance requirements for the approval of new Engagement Leads.

**53** Although there is scope for improvement, there were no systematic concerns about the overall quality of limited assurance audit work.



## Responses to QRP findings and next year's QRP

**54** All the audit firms have made arrangements to report the QRP findings to a suitable management group. Action plans are in place to address both organisation-wide and audit team issues. We will follow up significant recommendations as part of next year's QRP.

**55** We intend to continue with our regulatory compliance reports for all suppliers. Where required, we will make visits to firms.

**56** Our programme for next year will include:

- reviews of audit work by the FRC;
- reliance on the results of firms' QMRs; and
- client satisfaction surveys following completion of the 2013/14 audits.

**57** Our aim is to work with firms to ensure that our regulatory requirements continue to be met and that the risks of audit failure remain low.