Technical Bulletin 2022/4

Technical developments and emerging risks from October to December 2022

Prepared by Audit Scotland for appointed auditors and audited bodies in all sectors

14 December 2022

Contents

1: Introduction

Contact: Paul O’Brien, Pobrien@audit-scotland.gov.uk

Purpose

The purpose of Technical Bulletins from Audit Scotland’s Professional Support is to provide auditors appointed by the Auditor General and Accounts Commission with:

- information on the main technical developments in each sector during the quarter
- information on professional matters during the quarter that are expected to have applicability to the public sector
- summaries of responses to requests from auditors for technical consultations with Professional Support.

Appointed auditors are required by the Code of Audit Practice to pay due regard to Technical Bulletins. The information on technical developments is aimed at highlighting the key points that Professional Support considers auditors in the Scottish public sector require generally to be aware of. It may still be necessary for auditors to read the source material if greater detail is required in the circumstances of a specific audited body. Source material can be accessed by using the hyperlinks, where provided.

Any specific actions that Professional Support recommends that auditors take are highlighted in green.

Technical Bulletins are also published on the Audit Scotland website and therefore are available for audited bodies and other stakeholders to access. However, hyperlinks to source material indicated with an asterisk (*) link to files on Audit Scotland’s SharePoint* and are only accessible by auditors.

Highlighted items

The following table highlights a selection of items in this Technical Bulletin:

Highlighted items		
Professional Support has published guidance on planning 2022/23 annual audits [see paragraph 1]	Audit Scotland has issued guidance to supplement specific areas in the Code of Audit Practice [see paragraph 6]	The Auditor General has issued a briefing on the challenges and risks faced by Scotland's public finances [see paragraph 7]
Professional Support has published guidance on risks of misstatement in the 2022/23 annual accounts of local government bodies [see paragraph 9]	The Scottish Government has permitted flexibilities to help fund the local government pay award for 2022/23 [see paragraph 13]	The Scottish Government has issued a consultation draft of revised statutory guidance on accounting for capital grant [see paragraph 16]
CIPFA/LASAAC has issued an update to the accounting code for England and Wales [see paragraph 18]	CIPFA has issued revised guidance on audit committees for local authorities [see paragraph 21]	Professional Support has issued a report on a review of the 2021/22 IARs of health boards [see paragraph 32]
The FRC has issued a report on creating an audit environment that enables professional scepticism and challenge [see paragraph 37]	The FRC has issued a report on drivers and barriers to auditors exercising professional scepticism [see paragraph 40]	The FRC has issued a revised ISA (UK) 600 on group audits [see paragraph 44]
The IAASB has issued an exposure draft of proposed revisions to ISA 500 on audit evidence [see paragraph 56]	The FRC has issued a report on audit quality inspections of local audits in England [see paragraph 59]	The IAASB has issued guidance on the impact on ISAs of an amendment to IAS 1 [see paragraph 62]
The FRC has issued a report on disclosures related to net zero targets [see paragraph 66]	The FRC has issued a report that sets out the attributes of a good annual report and accounts [see paragraph 69]	The FRC has issued a report on a review of the corporate reporting of companies [see paragraph 78]

2: All sectors

Contact: Paul O'Brien, Pobrien@audit-scotland.gov.uk

Guidance on planning 2022/23 annual audits

1. Professional Support has issued guidance to assist all appointed auditors in planning their 2022/23 annual audits of public bodies. The guidance supplements the Code of Audit Practice (2021) and sets out the range of core annual audit activity and related outputs required for 2022/23, and the timescales for completing the audit in each sector.

2. Auditors should comply with the guidance when planning, performing and reporting their 2022/23 audits. The guidance is accessible by auditors with other supporting materials on SharePoint* but it is also freely available from the Audit Scotland website.

3. The largest component of core annual audit activity is the audit of a public body's annual accounts. However, the audit of the annual accounts has a wider scope than the private sector, and requires conclusions on aspects of public bodies' arrangements and performance. In local government, public audit includes considering arrangements to secure Best Value and community planning and publishing performance information. Auditors also provide important intelligence to the Auditor General, Accounts Commission and Audit Scotland in areas where they are best placed to do so.

4. 2022/23 year is the first year of the new five-year audit appointments. Audit Scotland's policy is not to compromise on audit quality or the wellbeing of audit teams, but that timescales are negotiable. The guidance is intended to strike the right balance in 2022/23 between ambitions for public audit and the capacity for auditors to carry out the work to the appropriate high quality. Target audit completion dates are considered to be stretching but achievable for the majority of audits.

5. The following table provides a summary of the key changes from last year, along with the paragraphs of the guidance in which further information is provided:

Nature of change	Paragraph
The level of expected fees below which auditors may negotiate an increase to auditor remuneration by up to 20% has increased to £35,000.	13
The target date for submitting Annual Audit Plans to Audit Scotland for central government and health has moved back one month to 31 March.	20
Guidance has been provided on the new requirement of the Code of Audit Practice to report key audit matters in the Annual Audit Report.	55 to 57

Nature of change	Paragraph
The target submission dates for the audited annual accounts have been brought forward for local government (30 September) and health (30 June).	61
Guidance has been added on specific wider-scope audit work required on climate change.	76 to 81
Guidance has been added on considering risks related to cyber security.	82 to 85
Guidance has been updated to reflect the new approach to auditing Best Value.	94 to 118
Guidance on grant claims and returns has been updated to reflect that any returns not on the approved list should be treated as non-audit services.	123 to 124
The target submission dates for the Annual Audit Reports have been brought forward for local government (30 September) and health (30 June).	211

Supplementary guidance on areas of the Code of Audit Practice

6. Audit Scotland has issued guidance to supplement specific areas in the Code of Audit Practice. The three areas, and a brief summary of the supplementary guidance related to each, are set out in the following table:

Area	Summary of supplementary guidance
Wider scope of public audit	The guidance sets out example questions at Appendix 1 to assist auditors when carrying out their risk assessment and planning their wider scope audit work.
Criteria to be used when identifying a less complex body	The wider scope audit in a less complex body may be limited to concluding on its financial sustainability. A body with gross revenue, gross assets and gross liabilities less than £10.2m is likely to be less complex. A body should not be treated as less complex where the: • auditor identifies any wider scope risks beyond financial sustainability • body has been subject to a statutory report in the previous year that related to wider scope issues • body is of strategic importance to the Auditor General or Accounts Commission. The guidance requires auditors to: • assess whether a body is less complex as part of planning each year, and document their assessment • explain in the Annual Audit Plan that the body is judged to have met the criteria to be treated as less complex • confirm in the Annual Audit Report that the audit was completed under the less complex body arrangements.

Area	Summary of supplementary guidance
Best Value	The guidance assists auditors to integrate Best Value with the wider scope annual audit work.

Briefing on public finances

7. The Auditor General has issued a briefing on the challenges and risks faced by Scotland's public finances. The briefing:

- focuses on the pressures facing the Scottish budget in 2022/23 and in the medium term, and the implications for public services
- informs and supports scrutiny of proposed spending and tax plans
- emphasises the need for reform to public services.

8. Some key messages from the briefing are summarised in the following table:

Key message	Considerations
Rising costs and increasing demands mean that the Scottish Government has to manage its position to avoid the risk that it overspends on the 2022/23 budget.	The current high level of inflation means that the Scottish Government faces higher public-sector pay and other costs, at the same time as it faces increasing demand for support from people impacted by the cost-of-living crisis. Any overspend by the Scottish Government in 2022/23 could be clawed back from the 2023/24 budget.
The Scottish Government has limited ability to make changes to balance the 2022/23 budget, and will face difficult choices setting the 2023/24 budget.	Within the year, much of the Scottish budget is committed, which means that there is limited flexibility available to the Scottish Government in the short term. In setting the 2023/24 budget, the Scottish Government needs to balance short-term necessities with longer-term priorities.
The pace and scale of reform required across the public sector needs to increase.	Immediate events and financial pressures must not distract from the immediate need for broader reform. In the past, the Auditor General has highlighted an implementation gap between the Scottish Government's ambitions for reform and delivery on the ground.

3: Local government sector

Contact: Paul O'Brien, Pobrien@audit-scotland.gov.uk

TGN on risks of misstatement in 2022/23

9. Professional Support has published Technical Guidance Note (TGN) 2022/8(LG) to provide auditors with guidance on risks of misstatement in the 2022/23 annual accounts of local government bodies. The TGN is accessible by auditors on SharePoint*, along with supporting material, and is also available from the Audit Scotland website.

10. The TGN is intended to inform auditors' judgement when identifying and assessing the risks of material misstatement. The TGN supplements the Code of Audit Practice and auditors are expected to pay it due regard and use it as a primary reference source when performing 2022/23 audits. Auditors should advise Professional Support of any intended departures from the guidance.

11. The TGN comprises a number of modules as summarised in the following table:

Module	Risks of misstatement area	Purpose
Overview	Areas that are pervasive to the financial statements as a whole	Explains the appropriate related accounting treatment and sets out the action auditors should undertake to evaluate whether the body has followed the required treatment
1 - 9	Specific classes of transactions, balances and disclosures in the financial statements.	
10	Audited part of the Remuneration Report	Explains the requirements and sets out the action auditors should undertake
11	Statutory Other Information (e.g. Management Commentary and Annual Governance Statement)	Sets out the procedures for considering the Statutory Other Information
12	Integration joint boards	Provides guidance on the application of the above modules to these specific bodies
13	Pension fund accounts	
14	Section 106 charities	

12. The risks of misstatement reflect areas of complexity, subjectivity and uncertainty. They have been updated to reflect new requirements and risks which emerged during the 2021/22 audits that remain applicable. A separate note* summarises the main changes from 2021/22.

Flexibilities to fund 2022/23 pay award

13. The Scottish Government has sent a letter* to the Convention of Scottish Local Authorities (CoSLA) setting out permitted flexibilities to help fund the local government pay award for 2022/23. The flexibilities are intended to enable local authorities to replace Capital Financed from Current Revenue (CFCR) or other revenue reserves with the additional capital grant in 2022/23 and 2023/24 to allow the release of such revenue resources for use towards the pay award.

14. The flexibilities are summarised in the following table:

Area	Use of additional capital grant
Early Learning & Childcare funding (ELC)	To be substituted for existing ELC revenue funding currently ring-fenced to support capital projects. The grant award letter is to be amended to permit the release of ring-fenced revenue funding.
Affordable Housing Capital Programme	To be used to substitute for revenue reserves earmarked for the capital programme for affordable housing in order to release those reserves.
CFCR in Housing Revenue Account (HRA)	To be substituted for CFCR for HRA capital investment, allowing an equal amount of reserves to be released from the HRA.

15. Other flexibilities requested by CoSLA (such as using capital receipts to meet the pay award and using capital grant towards redundancy costs) are not currently permitted.

Draft revised statutory guidance on accounting for capital grant

16. The Scottish Government has issued a consultation draft* of statutory guidance which will adapt Finance Circular 3/2018 for 2022/23 and 2023/24 to permit local authorities flexibilities in the use of the additional capital grant. This is necessary to allow the above permitted flexibilities.

17. The flexibilities and the required accounting treatment are summarised in the following table:

Use of grant	Accounting
Fund loans fund repayments	The element of capital grant applied to the repayment of the principal of loans will be held within the General Fund and used to meet the loan repayments. Any capital grant not utilised by 31 March requires to be transferred from the General Fund to either the Capital Grants Unapplied Account or the Capital Adjustment Account.

Use of grant	Accounting
Replace reserves currently earmarked for capital investment in affordable housing in order to release an equivalent amount for use towards the pay award	Once the grant is utilised to meet capital investment in affordable housing it will be transferred from the General Fund to the Capital Adjustment Account.
Fund capital investment in the housing capital programme	The capital grant may replace housing CFCR or other revenue reserves which will generate a surplus on the Housing Revenue Account which may be released to the General Fund for use towards the pay award. Once the grant is utilised it will be transferred from the General Fund to the Capital Adjustment Account.

Update to accounting code

18. The CIPFA/LASAAC Local Authority Code Board has issued an update to the Code of Practice on Local Authority Accounting in the UK (accounting code). The update applies to England and Wales from 2021/22 until 2024/25.

19. The key change in the update is a temporary relief so that local authorities in England and Wales are not required to report the gross book value and accumulated depreciation for infrastructure assets. Where a local authority chooses to apply this temporary relief, the update requires information to be disclosed to explain an authority's rationale for this decision.

20. The scope of the update does not currently apply to Scottish local authorities as Finance Circular 9/2022 already overrides the relevant disclosure requirement (see Technical Bulletin 2022/3 – paragraph 11). However, the override lasts until 2023/24 and the application of the update to Scotland may be reconsidered in respect of 2024/25.

Revised guidance on audit committees

21. The Charted Institute of Public Finance and Accountancy (CIPFA) has issued revised guidance* on audit committees for local authorities. The revised guidance builds on the 2018 edition but targets the guidance at committee members and those who support them.

22. The Delivering Good Governance in Local Government Framework lists undertaking the core functions of an audit committee, as identified in this guidance, as a key element of an authority's governance arrangements.

23. The guidance comprises the following discrete sections:

- CIPFA audit committees position statement.
- Guidance for committee members in local authorities.

- Guidance for members of police audit committees.
- A supplement aimed at those who support the committee.

24. There are also various appendices including a self-assessment checklist.

25. The position statement represents CIPFA's view on the audit committee practice and principles that local authorities in the UK should adopt. Some key elements are summarised in the following table:

Element	Summary of statement
Purpose of the audit committee	The purpose of audit committees is to provide an independent and high-level focus on the adequacy of governance, risk and control arrangements in the local authority.
Independence	The audit committee should be independent of executive decision making and able to provide objective oversight.
Core functions	Specific functions should include: • being satisfied that the authority's Annual Governance Statement properly reflects the risk environment, and any improvement actions required, and demonstrate how governance supports the achievement of the authority's objectives • supporting the maintenance of effective arrangements for financial reporting • considering the arrangements in place to secure adequate assurance across the authority's full range of operations and collaborations with other entities • overseeing the authority's internal audit function • considering the opinions, reports and recommendations of external audit.
Effective Chair	Key personal skills for an effective audit committee chair include: • promoting apolitical open discussion • unbiased attitudes, and treating auditors, the executive and management fairly • the ability to challenge the executive and senior managers when required.
Membership	The members should be trained to fulfil their role. CIPFA recommends that each audit committee should include at least two co-opted independent members.

Element	Summary of statement
Operation	To discharge its responsibilities effectively, the committee should: • meet at least four times a year • be able to meet privately and separately with the external auditor and with the head of internal audit • report regularly on its work to those charged with governance • report annually in public on how the committee has complied with the position statement • annually self-assess its performance. • evaluate its impact and identify areas for improvement.

4: Central government sector

Contact: Neil Cameron, NCameron@audit-scotland.gov.uk

2022/23 discount rates

26. HM Treasury has issued PES (2022)08* to announce changes in the discount rates for general provisions, post-employment benefit liabilities, leases, and financial instruments as at 31 March 2023.

General provisions

27. The nominal discount rates to be applied as at 31 March 2023 for discounting general provisions recognised under IAS 37 are set out in the following table:

Category	Period	Percentage
Short term	Within 5 years	3.27%
Medium term	Between 5 and 10 years	3.2%
Long term	Between 10 and 40 years	3.51%
Very long term	More than 40 years	3.0%

28. As nominal rates do not take inflation into account, cash flows require to be inflated separately. There is a rebuttable assumption that the inflation rates specified in the paper will be used (unless other rates are clearly more applicable). The specified rates are:

- 7.4% for up to one year from the year end
- 0.6% between one and two years
- 2% for after two years.

Post-employment benefits

29. The discount rates for post-employment benefits are set out in the following table:

Use	Rate from 31 March 2023
Real rate used for valuing unfunded pension scheme liabilities and early departure provisions	1.7%

Use	Rate from 31 March 2023
Nominal rate for unwinding discount on liabilities (interest)	4.15%
Rate used for funded pension schemes	Based on returns from AA corporate bonds at 31 March

Financial instruments

30. The financial instrument discount rates to be applied at 31 March 2023 are set out in the following table:

Type		Rate
Nominal rate when financial instrument is not linked to an inflationary index		1.9%
Real rate when financial instrument indexed to RPI	In excess of RPI:	
	Until February 2030	(1.3%)
	From February 2030	(0.2%)

Leases

31. Where a body cannot determine the interest rate implicit in the lease, they are required to use a nominal lease discount rate of 3.51%. This is relevant for transition to IFRS 16 and for new leases that commence or are remeasured between 1 January 2023 and 31 December 2023.

5: Health sector

Contact: Neil Cameron, NCameron@audit-scotland.gov.uk

Review of 2021/22 IARs

32. Professional Support has issued a report* to set out findings from a review of the 2021/22 Independent Auditors' Report (IARs) of health boards. The review evaluated compliance with the model forms of IAR and application guidance provided to auditors.

33. A summary of review findings is provided at Section 1 of the report and specific areas for improvement are highlighted at Section 2. In addition, Section 3 addresses findings in respect of disclosures in the Remuneration and Staff Report that impacts on the ability of users to understand the IAR.

34. The review found a very good level of compliance with the application guidance. However, the following areas for improvement were identified by the review:

- An auditor at one health board used the board-only model instead of the model for group accounts.
- Two audit providers at six boards added around a page of text to the model wording. Each case related to the explanation of the extent to which the audit could detect irregularities. One audit provider did not consult with Professional Support on the amendments.

35. The review also identified other issues where it may not have been clear to users what statements had been audited. For example, in some cases:

- auditors did not precisely match the titles of the financial statements or other reports to those titles used by the board
- the board had not accurately or clearly identified the parts of the Remuneration and Staff Report that had been audited. This issue had previously been highlighted in Technical Bulletin 2022/2 (paragraph 9).

36. Auditors should ensure the areas for improvement are addressed for their IARs in 2022/23.

6: Professional matters

Contact: Paul O'Brien, Pobrien@audit-scotland.gov.uk

Report on professional scepticism and challenge

37. The Financial Reporting Council (FRC) has issued a report that sets out the key attributes of a high-quality audit environment that enable professional scepticism and challenge.

38. Professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. A fundamental attribute of an auditor's mindset and behaviour is exercising professional scepticism and challenge as these are the foundations of a high-quality audit. The inconsistent application of scepticism and challenge results in the poor application of professional judgement.

39. The paper considers four key elements of an environment that enable scepticism and challenge. They are summarised in the following table:

Element	Requirements	Achieved by	Example of actions
Learning environment	An auditor needs to be equipped with the skills and expertise necessary to exercise professional scepticism and challenge the management of an audited entity.	Professional qualification and ongoing learning and development, including on-the job coaching.	Training in behaviours and mindset alongside technical training. Audit-based learning and coaching, built into an auditor's workload. Training in soft skills such as critical thinking and handling difficult conversations.
Culture	An audit firm needs to encourage auditors to display scepticism and challenge.	A culture that promotes and nurtures these behaviours including the elimination of barriers.	Communication of expected behaviours using a variety of formats. Promoting 'speaking up'. A culture of continual improvement and learning from mistakes. Engagement with employees to become advocates of desired behaviours.

Element	Requirements	Achieved by	Example of actions
Audit firm operating model	An audit firm needs to enable auditors to apply scepticism and challenge in their day-to-day audit work through the firm's operating model and processes.	Appropriate resources and processes at the audit firm including 'hot' reviews and a culture of consultation.	Sufficient and appropriate resources on every audit with strong project management. Effective use of specialists, experts and central technical teams to provide challenge in the most complex areas.
Ecosystem	Other parties in the ecosystem, including the audit committee and management at the audited entity, also play a part in enabling this mindset and behaviour.	Management and those charged with governance at the audited entities supporting these behaviours.	An engaged audit committee that supports the audit team with challenges. Management at the audited entity providing quality and timely information and engaging with the auditors to facilitate challenge.

Report on drivers and barriers to professional scepticism

40. The FRC has issued a report which is the output of research they commissioned to understand the drivers and barriers to auditors exercising professional scepticism and adequately challenging management. The research was carried out to inform the report on scepticism referred to above.

41. The research identified some key factors that encourage professional scepticism and effective challenge. Importantly, the most powerful drivers are dependent upon how staff and teams are influenced by more senior auditors (i.e. partners, directors and senior managers). Some of those factors are summarised in the following table:

Factor	Drivers
Teaching and embedding desired auditor behaviour	Bringing the specific behaviours to life through case studies and training highlighting the desired behaviours explicitly and explaining what they mean in practice. Training in soft skills, e.g. critical thinking and handling difficult conversations. Having the time and space to coach auditors by working collaboratively with them, sharing feedback, and identifying opportunities for them to be exposed to instances of scepticism and challenge in real-time work situations.
Consistently communicating and prompting desired audit behaviour	An ongoing, consistent commitment to scepticism and challenge is continually communicated and reinforced. An overall culture of continual improvement is implemented.

Factor	Drivers
Role modelling desired audit behaviour	Partners, directors and senior managers: • act as leaders in relation to scepticism and challenge, modelling these behaviours themselves • create opportunities for audit managers and junior level auditors to see them doing so in action • continually reasserting the behaviours in communications and feedback.

42. The research also highlighted the factors that can impede firms from establishing a culture that encourages auditors to consistently display the desired behaviours. They are summarised in the following table:

Factor	Barriers
Workplace environments that support desired auditor behaviour	Environments that discourage or fail to promote open, collaborative working practices. Cultural hierarchies that do not allow manager and junior level auditors to raise challenge upwards. This can be caused by a lack of transparency around the rationale behind decisions and ineffective feedback processes that do not give audit managers and junior auditors room to grow.
Resources to enable desired auditor behaviour	Time, workload, and resourcing pressures that squeeze out the time and space needed for auditors to be able to exercise scepticism and challenge, and apply the critical thinking needed for good judgement.
Alignment of reward and recognition with desired auditor behaviour	Inconsistencies in the extent to which the behaviours are explicitly linked to remuneration, reward, progression, and feedback.

43. Alongside these key drivers and barriers, the research also identified opportunities for audit firms to strengthen professional scepticism and effective challenge. These included effectively embedding hybrid working practices. Central to ensuring this is utilising virtual channels for informal as well as formal discussion between audit teams.

Revised standard on auditing group financial statements

44. The FRC has issued revised ISA (UK) 600 on audits of group financial statements. The revised ISA is effective for audits of periods beginning on or after 15 December 2023 (i.e. 2024/25 audits of public bodies), but early adoption is permitted.

Scope

45. The revised ISA (UK) 600:

- expands on the application of other relevant standards to an audit of group financial statements (a group audit)
- deals with special considerations that apply to a group audit, including those circumstances when component auditors are involved.

46. Group financial statements include the financial information of more than one entity or business unit through a consolidation process. This term refers to the:

- preparation of consolidated financial statements
- presentation of combined financial statements
- aggregation of the financial information of entities or business units such as branches or divisions.

47. ISA (UK) 600 (adapted as necessary) may also be useful in an audit of financial statements other than a group audit when the audit team includes individuals from another firm.

Group auditor

The audit team for a group audit comprises:

- the group auditor, which is the group engagement partner and members of the audit team
- component auditors (i.e. an auditor who performs audit work related to a component for purposes of the group audit) where the group auditor determines their involvement.

48. The responsibilities of the group auditor are summarised in the following table:

Area	Responsibility
Audit strategy and group audit plan	Establishing the overall group audit strategy and group audit plan. Determining the involvement of component auditors.
Direction, supervision and review	Directing and supervising component auditors and reviewing their work.
Evaluating conclusions	Evaluating the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.
Audit evidence	Determining that audit evidence has been obtained to support the conclusions and for the auditor’s report on the group financial statements to be issued.

Area	Responsibility
Responding to risks of material misstatement	Determining an appropriate approach to planning and performing audit procedures to respond to the assessed risks of material misstatement in the group financial statements.
Components	Determining the components at which audit work will be performed.

Component auditors

49. Detection risk in a group audit includes the group auditor not detecting that a component auditor has not detected a misstatement that could cause a material misstatement in the group financial statements. Accordingly, paragraph 8 of ISA (UK) 600 requires involvement by the group auditor in the work of component auditors.

50. Paragraph 29 requires the group auditor to communicate with component auditors about their respective responsibilities and the group auditor's expectations.

51. When a component auditor is also performing an audit of the component financial statements, the group auditor may be able to use that audit work. In addition, component auditors may adapt their audit work to also meet the needs of the group auditor. In any event, the requirements of ISA (UK) 600 apply.

Materiality

52. Paragraph 35 requires the group auditor to determine:

- component performance materiality. This is set to reduce aggregation risk to an appropriately low level. Aggregation risk is the probability that the aggregate of misstatements exceeds materiality for the financial statements as a whole. Generally, aggregation risk increases as the number of components increases
- the threshold above which misstatements identified in the component financial information are to be communicated to the group auditor.

Consolidation process

53. Paragraph 38 requires the group auditor to take responsibility for further audit procedures to respond to the risks of material misstatement of the group financial statements arising from the consolidation process. This includes:

- evaluating whether all components have been included in the group financial statements
- evaluating the consolidation adjustments and reclassifications
- evaluating whether management’s judgments made in the consolidation process give rise to indicators of possible management bias

- responding to risks of material misstatement due to fraud arising from the consolidation process.

Communication from component auditors

54. Paragraph 45 requires the group auditor to request the component auditor to communicate relevant matters, including those summarised in the following table:

Area	Matters to be communicated
Financial information	Identification of the financial information on which the component auditor has been requested to perform audit procedures.
Performance of work	Confirmation that the component auditor has performed the work requested.
Laws or regulations	Instances of non-compliance with laws or regulations.
Misstatements	Misstatements identified by the component auditor that are above the threshold.
Fraud	Fraud involving component management or employees who have significant roles in the system of internal control.
Conclusions	The component auditor's overall findings or conclusions.

55. The group auditor is required to:

- evaluate whether communications with the component auditor are adequate for the group auditor's purposes
- determine whether it is necessary to review additional component auditor audit documentation
- determine if any additional audit procedures are to be performed, and by which auditor.

Proposed revisions to international standard on audit evidence

56. The International Auditing and Assurance Standards Board (IAASB) has issued an exposure draft of proposed revisions to ISA 500 on audit evidence. Comments on the proposals in the exposure draft should be submitted through the IAASB website by 24 April 2023.

57. The objectives of the proposed revisions are to:

- clarify the purpose and scope of ISA 500 and explain its relationship with other standards
- develop a principles-based approach to considering and making judgments about information to be used as audit evidence and evaluating whether sufficient appropriate audit evidence has been obtained

- modernize ISA 500 to be adaptable to the current business and audit environment, including the increased use of technology
- emphasize the role of professional scepticism.

58. Some key proposals in the exposure draft are summarised in the following table:

Area	Extant ISA 500	Proposals in exposure draft
Purpose and scope	Extant ISA 500 explains what constitutes audit evidence, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence.	The exposure draft retains this principles-based approach and proposes that ISA 500 serve as an overarching standard that deals with the auditor's responsibilities relating to audit evidence when designing and performing audit procedures.
Technology		There are various changes in application material to enable auditors to apply the standard in an evolving audit environment with the increasing use of technology. For example, the application material: • clarifies that the auditor may use manual or automated tools and techniques (paragraph A3) • explains how the use of automated tools and techniques may affect auditor bias, including automation bias (paragraphs A22 and A23) • uses examples that draw attention to the use of technology (2, 5, 6 and 10 in the Appendix).
Definition of audit evidence	ISA 500 defines audit evidence as information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.	The proposed revised definition at paragraph 7(b) reflects that information (input) needs to be subject to audit procedures to become audit evidence (output). The term "information intended to be used as audit evidence" is used to describe the input. Paragraph A34 provides application material that explains the concept of information intended to be used as audit evidence.

Area	Extant ISA 500	Proposals in exposure draft
Sufficiency and appropriateness of audit evidence	ISA 500 refers to the sufficiency (quantity) and appropriateness (quality) of audit evidence.	The exposure draft retains the concepts of appropriateness and sufficiency, but more supporting application material has been added. For example, paragraph A13 explains that the appropriateness of audit evidence is affected by the: • relevance and reliability of information intended to be used as audit evidence • effectiveness of the design of audit procedures applied to the information • auditor's application of those audit procedures.
Persuasiveness of evidence		The exposure draft introduces the concept of persuasiveness. Application material explains the factors that may affect the persuasiveness of audit evidence. Paragraph A9 lists the following factors: • The information intended to be used as audit evidence, including the auditor's consideration of the attributes of relevance and reliability of the information. • Whether the information is from a single source or from multiple sources. • The design and performance of audit procedures, i.e. whether they are appropriate and have been properly applied. • Whether there are inconsistencies between multiple pieces of audit evidence.
Professional scepticism	ISA 500 requires the auditor to design and perform audit procedures that are appropriate in the circumstances	Paragraph 8 of the exposure draft reinforces the exercise of professional scepticism by requiring auditors to design and perform audit procedures in an unbiased manner. Paragraph A20 has been added to explain that this involves not being biased toward obtaining audit evidence that may corroborate the existence of risks of material misstatement or management's assertions, or toward excluding audit evidence that may contradict the existence of risks or such assertions.
Attributes of relevance and reliability		Paragraph 9(b) requires auditors to consider the attributes of relevance and reliability that are applicable in the circumstances. Paragraphs A54 to A62 describe the attributes. For example, paragraph A56 lists the following attributes in considering the degree to which information is reliable:

Area	Extant ISA 500	Proposals in exposure draft
		• The information is free from bias and error; reflects all of the underlying conditions, events, and circumstances; and has not been inappropriately altered. • The source actually generated the information, has the competence and capability to generate the information, and can be trusted. If the accuracy and completeness attributes are applicable, paragraph 10 requires auditors to obtain audit evidence. Paragraphs A63 to A65 explain the circumstances in which the auditor may consider accuracy and completeness to be applicable, and how audit evidence may be obtained.
Management expert	If information has been prepared using the work of a management's expert, the auditor is required, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, to: • evaluate the expert's competence, capabilities and objectivity • obtain an understanding of their work • evaluate the appropriateness of the work as audit evidence.	Paragraph 11 of the exposure draft adds a requirement for the auditor to obtain an understanding about how the information prepared by the expert has been used by management in the preparation of the financial statements. The current requirement to evaluate the appropriateness of the expert's work has been removed as it was deemed redundant. The current conditionality requirement ("to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes") was considered unnecessary and has been deleted from the exposure draft.
Stand back		Paragraph 13 introduces a new "stand back" requirement for the auditor to evaluate whether sufficient appropriate audit evidence has been obtained. The 'stand back' requirement also emphasizes the exercise of professional scepticism by requiring the auditor to consider all audit evidence obtained.

Quality reviews of local audits in England

59. The FRC has issued a report that sets out findings from the 2021/22 audit quality inspections of major local audits in England (which include the larger health and local government bodies).

60. The following table provides a summary of the key areas where the FRC considers that improvements in audit quality are required, and which potentially have relevance to public audit in Scotland:

Area	Summary of key findings
Urgently improve financial statements review procedures and the evaluation of identified misstatements	The review identified the following failures to detect material errors in the audited financial statements: • Cash deposits were overstated by £1.7 billion caused by an error in accounts preparation. • Loss on disposal of non-current assets was overstated by £45 million caused by an incorrect audit adjustment. Also, the failure to evaluate the impact of unadjusted audit differences on each line item in the financial statements led to operating expenses being materially misstated.
Ensure there is sufficient justification to support modification of an audit opinion	The audit opinion on the financial statements was modified due to an inability to obtain sufficient appropriate evidence over inventory as a result of the auditor being unable to attend the stock counts. However, alternative procedures were performed over part of the inventory with no issues arising, and the residual balance was not material.
Improve the quality of audit procedures over pension asset valuation	Insufficient evidence was obtained on the valuation of investment assets. The primary substantive procedure was to compare valuations obtained from the custodian to those provided directly by fund managers, but there was insufficient evidence that they were independent. Insufficient evidence was obtained to rely on the valuation controls at fund managers. The service auditor reports were not properly evaluated. There was no evidence that audit procedures were performed to test the accuracy of the return on investments.
Improve the evaluation of assumptions used in investment property valuations	There was insufficient evaluation and challenge of key assumptions used in the valuation of investment property.
Improve the quality of audit procedures over the valuation and classification of financial assets	There was insufficient consideration and challenge of the financial model supporting the valuation and classification of a long-term debtor. There were insufficient procedures on whether financial assets should be classified as short-term investments or cash equivalents.

Area	Summary of key findings
Enhance audit procedures over expenditure	There was no testing of the completeness and accuracy of source data when performing substantive analytical procedures. Weaknesses were identified in the supporting evidence obtained when testing employee benefits, particularly where differences between amounts paid and supporting records were identified. No roll-forward procedures were undertaken when testing the operating effectiveness of controls at an interim date.
Enhance the testing of journal entries	Incorrect date ranges were entered into the firm's journals software when running reports. Journals recorded in the 20-day period after the year end were tested as that was the expected closedown period. The period tested should have been three months to align with the actual closedown period. Journal entries with the characteristics identified by the auditor were not tested for appropriate business rationale or authorisation.
Improve testing performed over business rates	Material debtors and creditors were not appropriately tested. A sufficiently precise expectation was not set when performing substantive analytical procedures over business rates income. Insufficient evaluation of key assumptions was used by the management expert when valuing the provision for appeals.
Audit methodology on going concern	The IAR contained a material uncertainty in relation to going concern, but the assessment focused on financial sustainability rather than the principle of service continuity. Standardised work programmes should be suitably tailored to the sector, including the continued provision of service approach.

61. Examples of good practice identified included the following:

- The audit team's fraud risk assessment demonstrated a good understanding of the sector and financial pressures at the local authority. Owing to the incentive for management to manipulate its reserves position, the audit team identified fraud risks for revenue expenditure funded from capital under statute, minimum revenue provision and the flexible use of capital receipts.
- The audit team appropriately evaluated the competence, capabilities and experience required to audit a highly specialised property. It engaged an auditor's expert to provide support in testing the valuation, which enhanced the team's audit evidence in this higher-risk area.
- The audit team's testing of yields when evaluating assumptions used in investment property valuations included evaluation of the comparators used by management's valuer against third-party market data.

- The audit team demonstrated rigour when challenging the assumptions made in setting the business rates appeals provision, in particular by benchmarking to other local authorities. The audit opinion was ultimately qualified as the auditor was unable to obtain sufficient appropriate audit evidence over the amount of the provision.

- The audit team robustly followed up on errors identified in its additions testing by extending its sample and challenging management to recognise a prior-year adjustment.

- The audit team consulted with an internal panel of senior public sector specialists on the audit procedures performed over a subsidiary whose financial performance had deteriorated in the year. There was clear evidence of challenge by the audit team in areas such as the disclosure of events after the balance sheet date and parent company guarantees.

Guidance on impact on ISAs of IAS 1 amendment

62. The IAASB has issued guidance on the impact on ISAs of an amendment to IAS 1 Presentation of Financial Statements. The amendment requires entities to disclose their material accounting policy information, instead of significant accounting policies. It is effective for reporting periods beginning on or after 1 January 2023, with early application permitted.

63. The guidance advises auditors to evaluate how management has addressed the effect of the amendments to IAS 1 on the entity’s disclosures about accounting policies. This includes understanding the effect of these amendments on the entity’s financial reporting processes.

64. Various ISAs contain requirements that are relevant to the auditor’s work on disclosures in the financial statements. The guidance clarifies that the amendments to IAS 1 do not impact the principles-based requirements of the ISAs.

65. However, relevant references in the IAR to significant accounting policies will need to be revised to material accounting policy information. Professional Support will revise the model forms of IAR in all sectors from 2023/24 to refer to material accounting policy information.

Report on net zero disclosures

66. The FRC has issued a report on the disclosures entities should make on net zero or other greenhouse gas reduction commitments. The report focuses on three elements that the FRC considers that users want to understand from net zero disclosures.

67. Each element is explained in the following table, along with disclosures to be considered at both a basic and advanced level:

Level	Commitments	Impacts	Performance
	Level of ambition, and scope, nature and timing of the commitment	**How the commitment impacts strategy, business model, assumptions, uncertainties, risks and opportunities**	**How performance is being measured and high-quality data ensured, and the actions management is taking**
Foundational - providing a basic understanding of the commitment, including high-level targets, timelines and impacts	Types of greenhouse gases included Scopes of emissions included Type of reductions committed to Timelines for commitment Extent and nature of planned offsets Information on any exclusions or limitations to the commitment	Strategy for achieving net zero Risks and opportunities of the commitment framed to the business in a balanced way Estimates of potential future costs Explanation of uncertainties and assumptions in a manner consistent with financial statements	Frameworks and methodologies for setting targets and measuring progress Targets set Progress to date, and whether in line with expectations An understanding of the expected trajectory Explanation of relevant metrics
Advanced - providing updates on progress, refinements of goals, and more detailed information on impact and accountability	Consideration of whether the commitment will be updated, for example, a new approach or a more ambitious target	Updated views on impact and financing requirements Transition plans Quantitative estimates or additional scenario analysis helpful for users	Information on leading performance indicators Consideration of whether any external assurance would be appropriate

68. The report explains that effective processes and governance underpin commitments and plans, and lead to better disclosures. Robust systems and controls will enable entities to better understand their progress, and achieve their net-zero commitments over the longer term. The report sets out four stages summarised in the following table:

Define the commitment	Assess the impact	Measure progress	Refine the approach
What will be reduced and over what time period? What operation can be reduced, and what offsets can be used? What interim targets need to be set? How will goals be communicated internally?	How will the business model and strategy need to change? What resources are needed? What gaps are there? What new policies need to be put in place on business travel or new supplier relationships? How will the commitment embed into decision making? How much will it cost?	What internal targets and measures need to be in place? Are the systems, controls and processes in place to measure and monitor progress? Is there access to sufficient data? What internal review processes are needed? How do measures link to individual objectives?	What lessons have been learned to date? Are there areas that could be improved on? Do any commitments need to be redefined? Is any external review needed? How will lessons be shared with the wider workforce?

Report on a good annual report and accounts

69. The FRC has issued a report that sets out the attributes of a good annual report and accounts (ARA). In setting out these attributes, the FRC use a principles-based framework that identifies corporate reporting principles and effective communication characteristics. The report also provides examples to illustrate the underlying principles.

70. An assumption that underpins the report is that a good ARA must comply with the relevant legal, regulatory, financial reporting and code requirements. However, preparing a high-quality ARA is more than just a compliance exercise.

Materiality

71. Materiality is the bedrock of corporate reporting. It is the primary tool that helps entities to focus on key matters. Materiality informs the breadth and depth of what needs to be included in the ARA.

72. Materiality applies to all transactions, balances and disclosures (numerical and textual) in the ARA, not just those transactions affecting the financial statements. What is material in any part of the ARA will be determined by quantitative and qualitative factors as well as their nature or context.

73. A transaction, balance or disclosure would be considered quantitatively material if the size of its impact is likely to influence users' decisions or their perception of the entity's performance or future prospects. Determining whether something is quantitatively material is a matter of judgement, but the benchmark used should be the most appropriate in the context of the business and of greatest value and interest to the users.

74. Where auditor materiality is disclosed in the auditor's report, users are likely to assume that the entity has used a similar quantitative materiality in their approach to the preparation of the financial statements. When this is not the case, the entity may wish to disclose details of their assessment.

75. Qualitative factors are those factors other than size. Determining whether something is material as a result of a qualitative factor is also a matter of judgement.

Corporate reporting principles

76. Corporate reporting principles are the overarching qualitative characteristics of a good ARA. They are summarised in the following table:

Characteristics	Guidance
Accuracy	An accurate ARA is free from material misstatement and error. Accuracy depends on the quality of the underlying data supporting both financial and non-financial information. Appropriate disclosure is vital to explain estimation uncertainty which usually requires quantification of the key assumptions and a sensitivity analysis. Entities are encouraged to disclose the sources of significant facts and claims made in narrative reporting. Language used in narrative reporting needs to be specific, not open to misinterpretation by users, and balanced.
Connected and Consistent	An ARA is connected when information on related subject matter is linked together so that users can understand how the elements interact. ARAs should be consistent both internally and with other public information produced by the entity. Narrative reports should discuss the material transactions and balances reported elsewhere in the ARA. Information in narrative reports should be consistent with the information presented in the financial statements.
Complete	Completeness reflects the breadth, rather than depth, of information. Achieving completeness is not a tick box exercise and materiality should be applied to determine what must be disclosed. An ARA should include all the positive and negative material information needed by a user to understand the financial performance and position, development, and future prospects.
On-time	Although the FRC encourages entities not to compromise quality by compressing reporting timetables, long lead times between the balance sheet date and the date of publication reduce the usefulness of the ARA.

Characteristics	Guidance
Unbiased	Information is unbiased if it is balanced. A balanced ARA should refer to both positive and negative aspects of performance, position and future prospects as well as the risks and opportunities the entity faces. The ARA as a whole should present an open and honest account of the entity's activities and performance and future prospects.
Navigable	ARAs on websites should be navigable which means they should include detailed contents pages, navigation panes, clear titles and descriptions, specific cross references and hyperlinked cross references. They should also be searchable to enable users to perform text searches for specific words and phrases.
Transparent	Any significant judgements should be disclosed. Additional disclosures over and above stated requirements may be necessary for users to fully understand certain transactions. Audited and unaudited information should be clearly labelled.

Effective communication principles

77. Communication principles focus on how information should be delivered to users. They are summarised in the following table:

Characteristics	Guidance
Company-specific	An ARA should provide insights into decision making, and explain the business model in jargon-free language. Key judgements and estimates should be explained with details of how the figures would change if they were altered. Entities should replace boilerplate disclosure with information that is tailored to their specific circumstances.
Clear, concise and understandable	A clear, concise and understandable ARA: • uses straightforward language and short sentences • uses specialist terms only where necessary and makes sure they are used consistently • focuses on content that is important to stakeholders • excludes irrelevant information • does not repeat information clearly shown in diagrams, tables or other narrative • defines specialist terms and acronyms in a glossary • uses diagrams, images and tables only if it makes the information easier to understand.

Characteristics	Guidance
Clutter free and relevant	Irrelevant material obscures the important information that users need to make informed decisions and judgements. If rolling forward last year's publication, preparers should: • review the draft carefully and remove information that is no longer relevant • include relevant disclosures required by amended requirements or new circumstances.
Comparable	A comparable ARA contains metrics that are calculated consistently year on year, clearly defined, and reconciled to GAAP measures. If there has been a significant change to the calculation of a metric, the entity should: • describe the change • explain why it results in more reliable and relevant information • restate the comparatives.

Report on corporate reporting 2021/22

78. The FRC has issued a report on the outcomes of reviews of the corporate reporting of companies in the year to 31 March 2022. This report sets out the FRC's view of:

- the current state of corporate reporting in the UK
- the elements of better-quality reporting
- shortcomings that require improvement.

79. Cash flow statements is highlighted in the report as an area of considerable concern. The report advises entities to ensure that

- reported cash flows are consistent with amounts reported elsewhere in the annual report and accounts
- non-cash items are excluded from the statement and adjustments for material non-cash transactions are disclosed
- classification of cash flows, cash and cash equivalents comply with relevant definitions and criteria in the standard
- cash flows are not inappropriately netted.

80. The report also explains the FRC's expectations for 2022/23 accounts. These are shaped by their findings, as well as developments in reporting requirements and the business environment. Expectations that also apply in the public sector are summarised in the following table:

Area	Expectation
Risks	Unambiguous description in the narrative reporting of risks facing the entity, their impact on strategy, business model, cross-referenced to relevant detail in the reports and accounts.
Impact of climate change	Specific, balanced and well-integrated information about the impact of climate change in narrative reporting, and appropriate reflection of material climate-related commitments, risks and uncertainties in the financial statements.
Impairment	Impairment disclosures that assign values to, and explain how, the key assumptions used have been determined.
Judgements and estimates	Clear disclosure of significant judgements and key assumptions underlying major sources of estimation uncertainty, including information about the sensitivity of reported amounts.
Financial instruments	Transparent disclosure of the nature and extent of material risks arising from financial instruments, including significant assumptions made in the measurement of expected credit losses.
Objectives of accounting standards	Specific information that meets the disclosure objectives of the relevant accounting standards and not just the specific disclosure requirements. Additional information (beyond the standards' requirements) should be included where needed to understand the impact of particular transactions, events or circumstances.
Inflation	Clear explanation of the nature of significant inflationary features in revenue, supply, leasing and other financing contracts, and their effect on the financial statements.
Materiality	Clear, concise and understandable disclosure that omits immaterial information.

7: Fraud and irregularities

Contact: Anne Cairns, acairns@audit-scotland.gov.uk

This chapter contains a summary of fraud cases and other irregularities facilitated by weaknesses in internal control at audited bodies that have recently been reported by auditors to Professional Support.

Auditors should consider whether weaknesses in internal control which facilitated each fraud may exist in their audited bodies and take the appropriate action.

Expenditure

School funds

81. A head teacher embezzled over £5,300 from a school fund.

Key features

The teacher fraudulently used the school fund purchase card, which was held in the name of another member of staff, for personal purchases. The teacher also falsified an invoice to disguise the payment of a personal membership fee, and misappropriated school fund concert cash that had been entrusted to the teacher.

The fraud was identified after concerns were raised regarding misappropriation of the school fund purchase card.

Subsequent investigations identified that high value items purchased from the school fund could not be located on the school premises. These items were subsequently recovered from the teacher's home.

The fraud was possible as due to the seniority of the teacher; the actions were not challenged by other staff. In practice, there was no segregation of duties.

The council has:

- revised school fund procedures
- introduced random sampling of purchase card transactions
- provided fraud awareness and procurement training to school staff.

The case has been reported to the Procurator Fiscal. The teacher resigned following the instigation of disciplinary proceedings.

Items to the value of £1,600 have been recovered.

Page intentionally blank

Technical Bulletin 2022/4

Technical developments and emerging risks from October to December 2022

Audit Scotland's published material is available for download on the website in a number of formats. For information on our accessibility principles, please visit:
www.audit-scotland.gov.uk/accessibility

For the latest news follow us on social media or
subscribe to our email alerts.

AUDIT SCOTLAND

Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
Phone: 0131 625 1500 Email: **info@audit-scotland.gov.uk**
www.audit-scotland.gov.uk

AS.4.0