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Kate Dalby
Financial Reporting Council
By Email

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Dear Kate,

PROPOSED REVISIONS TO ISA (UK) 250 SECTION A AND ISA (UK) 250 SECTION B

I welcome the opportunity to comment on your consultation on the exposure draft for the revised *ISA (UK) 250 – Consideration of Laws and Regulations in the Audit of Financial Statements* and *ISA (UK) 2X0 Special Considerations for Audits of Public Interest Entities – Communicating and Reporting to an appropriate authority outside the entity*.

My comments are focussed solely on what I believe to be the relevant questions within your invitation to comment document. Where I have not responded to a question in the document, I have no further comments to add.

ISA (UK) 250 – Consideration of laws and regulations in the audit of financial statements

I am broadly supportive of the principle of revising ISA (UK) 250 to integrate more closely into the risk assessment model required by *ISA (UK) 315 – Identifying and Assessing the Risks of Material Misstatement* where non-compliance gives rise to a risk of material misstatement of the financial statements. In my view, this can be adequately addressed by auditors in considering inherent risk factors arising from non-compliance with laws and regulations linked to pre-existing risks of material misstatement such as going concern or completeness of liabilities. However, I am concerned with the potential expansion in scope of auditors' responsibilities arising from the proposals, particularly the extent of work in relation to disclosure of non-compliance with laws and regulations which are not quantitatively material to the financial statements or linked to pre-existing risks of material misstatement. The proposed standard as drafted has the potential to significantly add to the regulatory burden on preparers and auditors in the public sector with no clear benefit to financial reporting or audit quality.

I am also concerned as to how the proposed standard will interact with the responsibility of auditors in the public sector context to report on wider matters, particularly regularity in accordance with Part 2 of *Practice Note 10: Audit of financial statements and regularity of public sector bodies in the United Kingdom*. The regularity opinion provides a recognised and well understood mechanism with the UK Parliament and other stakeholders for reporting on matters relating to regularity of spend in the public sector.

Furthermore, the auditor's wider responsibilities for matters relating to non-compliance with laws and regulations in the local government sector already provide a robust established mechanism for reporting and acting on instances of non-compliance with laws and regulations which are relevant to the financial

statements.

I am therefore of the view that the current proposed revisions to ISA (UK) 250 are not in the public interest for application in the public sector. I would not consider that the increase in the audit and regulatory burden required by the proposed revisions is justified, given that there are pre-existing mechanisms, in the form of the regularity opinion, or statutory responsibilities in respect of non-compliance with laws and regulations in the local government sector, for the auditor to consider and report on matters concerning non-compliance with laws and regulations which are of primary interest to Parliamentary and other stakeholders.

Question 1 – Do you agree that the proposals in ISA (UK) 250 appropriately address the public interest?

Integration of risk assessment

I am supportive of the general principle adopted by the proposed standard that where a law or regulation is identified where non-compliance with that law or regulation has the potential to lead to a material misstatement in the financial statements, then the auditor should consider the risks surrounding non-compliance with such laws and regulations in accordance with *ISA (UK) 315 – Identifying and Assessing the Risk of Material Misstatement*.

Such an approach is beneficial as it has the potential to provide for a more risk-based consideration of the impact of non-compliance with laws and regulations whilst integrating more closely into the audit risk assessment model adopted by firms.

Regulatory burden

The explicit requirement set out in paragraph 5-1b of the exposure draft for the auditor to identify other laws and regulations with which compliance may be fundamental to the operating aspects of the business or to an entity's ability to continue its business where non-compliance may lead to a material misstatement in the financial statements, has the potential to significantly add to the regulatory burden on both preparers and auditors in the public sector.

I consider that there is a risk here that the proposed revisions to the standard may introduce what are effectively new risks of material misstatement relating solely to the disclosure of non-compliance with laws and regulations in the financial statements. Whilst I understand the need to consider risks of material misstatement from non-compliance with laws and regulations which may impact directly on the financial statements, for example in relation to going concern, valuations and the existence/ completeness of liabilities, the standard as currently drafted may lead to non-disclosure or inappropriate disclosure of the non-compliance itself being considered as a risk of material misstatement to be considered by the auditor.

As noted in paragraph A10-4 of the exposure draft, the auditor should consider qualitative factors when considering whether a non-compliance with laws and regulations is material. Applying qualitative materiality judgements in the context of disclosure of non-compliance with laws and regulations is potentially highly subjective and may lead to a lack of a clear definition on the boundary of the revised standard.

This is particularly significant for some public sector entities which have a large volume of laws and regulations which are fundamental to their operations. The current reporting framework in the public sector, already provides for disclosure of significant instances of non-compliance with such laws and regulations within the annual report rather than the financial statements. The auditor's responsibilities for considering such information under *ISA (UK) 720 – The Auditor's Responsibilities Relating to Other Information* already provides an adequate framework for the auditor to consider such disclosures with extending this to a financial statements type consideration and risk assessment.

I also highlight the potential impact of the revised standard on local government audit. Local Authorities are subject to a wide range of legislation. It could be argued that compliance with their statutory duties and laws and regulations relevant to these is a fundamental part of their operations. The proposed standard therefore

has the potential to significantly add to the pre-existing challenges within the local audit market by requiring auditors to risk assess the potential for non-compliance with a wider range of laws and regulations to consider whether such instances of non-compliance are adequately disclosed in the financial statements.

Notwithstanding the clear guidance to only identify risks of non-compliance with laws and regulations arising from the risk assessment procedures set out in paragraph 12 of the proposed standard, we would consider that the above matters create a significant new regulatory burden to audit in the public sector and would be surfaced solely by performing procedures set out in paragraph 12 of the proposed standard.

Interaction with the regularity opinion

The scope of laws and regulations considered by the true and fair and regularity opinions provided by the auditor under the proposed standard will not be concurrent, as the scope of laws and regulations being considered under each standard are as follows:

- True and Fair opinion under ISA (UK) 250: Laws and regulations which have an effect on the determination of material amounts and disclosures in the financial statements and other laws and regulations with which compliance may be fundamental to the operating aspects of the business or to an entity's ability to continue its business.
- Regularity opinion under Practice Note 10, Part 2 (2-5): Frameworks of authorities are external frameworks, specific to the audited entity, with which the audited entity's transactions must conform. These frameworks are set up by bodies able to issue and/or enforce the authorities for that entity.
 - Practice Note 10, Part 2 requires the auditor to only consider those external frameworks which are specific to the entity and not the general scope of laws and regulations that the entity might be subject to (e.g., health and safety law).
 - Practice Note 10, Part 2, uses the concern of an 'authority' rather than 'laws and regulations'. Consequently, certain authorities, such as HM Treasury's *Managing Public Money* might be regarded as government guidance rather than a law or regulation where there is a statutory requirement for compliance under ISA (UK) 250.

We are therefore concerned that under the proposals there will be a complex relationship between the work that is required under ISA (UK) 250 (revised) and the work that is required on regularity under Practice Note 10 and an expansion to the current scope of work beyond that tailored to the public sector. Under the revised standard the auditor will need to consider:

- Laws and regulations within the scope of ISA (UK) 250 but which do not form part of the framework of authorities governing regularity (in particular those which do not affect transactions recognised in the financial statements);
- Laws and regulations within the scope of ISA (UK) 250 and which form part of the framework of authorities; and
- Elements of the framework of authorities which are in scope of the regularity opinion but are not laws and regulations as defined in ISA (UK) 250.

The proposed ISA (UK) 250 would require the auditor to consider laws and regulations which are not specific to the entity and therefore not currently within the scope of the auditor's responsibilities on regularity. Furthermore, the auditor would still need to consider compliance with non-statutory government authorities, such as framework agreements with Departments or HM Treasury's *Managing Public Money* with the scope of the regularity opinion.

Additionally, the scope of risk assessment work for both opinions is different even where there is overlap in the scope of laws and regulations considered. Under the proposed ISA (UK) 250, the risk assessment performed would be applying the principles of ISA (UK) 315 and would be focussed on considering risks of

material misstatements to the financial statements and risk of non-compliance with laws and regulations, where the non-compliance is sufficiently material to warrant disclosure in the financial statements. The scope of the auditor's risk assessment on regularity in the public sector follows a different workflow to the true and fair opinion which reflects the different focus on risks of irregular transactions (transactions not in accordance with the framework of authorities) that are already reflected within the financial statements.

The proposed revisions to ISA (UK) 250 therefore introduce the potential for two separate risk assessment activities to have to be performed in relation to a single set of laws and regulations. This has the potential for introducing a lack of clarity in the purpose of the risk assessment activity and some duplication of audit effort.

I therefore consider that differences in scope of ISA (UK) 250 and Practice Note 10, Part 2 on regularity has the potential to create confusion both to auditors and to wider stakeholders in the public sector as to where the auditor is considering non-compliance with laws and regulation. It also has the potential to increase the audit burden with no clear public benefit, given that the existing mechanism of the regularity opinion is well understood by stakeholders and designed to be responsive to the assurance that they are seeking from the auditor.

We consider that significant amendments will be required to be made to Practice Note 10 to clearly explain the relationship between the auditor's responsibilities under the revised ISA (UK) 250, and the auditor's responsibilities for regularity.

Interaction with other auditor responsibilities in local government

The Local Audit and Accountability Act 2014 includes provisions (s.27) for local government electors to make objections to auditors relating to matters affecting the financial statements of local authorities which they consider to be unlawful. Under the current standard, it is permissible for the auditor when considering such an objection to conclude that non-compliance with laws and regulations has not materially affected matters in the financial statements.

Under the proposed revisions to the standard, the auditor would be required to consider whether such matters have been adequately disclosed in the financial statements, even in the circumstances where these matters do not directly lead to other risks of material misstatement. Given that such matters have been directly raised by an elector, who is considered a user of financial statements, it may be difficult for the auditor to conclude that such matters are not qualitatively material to the financial statements. The consequence of this will be a delay to the conclusion of the audit until the objection is resolved, which would further exacerbate the current local audit backlog.

Furthermore, s.28 of the Local Audit and Accountability Act 2014 provides for the auditor to apply to the court for a declaration that an item of account is contrary to law with further legal consequences where such a declaration is made. Therefore, any material non-compliance with laws and regulations which the auditor identifies could be considered through this statutory mechanism.

I consider that the currently proposed revisions to ISA (UK) 250 would require significant supplementary guidance to explain how they interact with these existing statutory obligations on the auditor in local government. Given that the existing statutory mechanism for considering and reporting on non-compliance with laws and regulations in the local government sector is well established and may be utilised by auditors and electors, I do not consider that supplementing this with further requirements under ISA (UK) 250 would be in the public interest within this sector.

Considering adequacy of disclosures

Paragraph 22-1 of the Exposure Draft includes a new requirement for the auditor to consider the adequacy of disclosure of non-compliance with laws and regulations in the financial statements when concluding on

whether a material misstatement of the financial statements exists in respect of said non-compliance. In my view, this requirement could lead to the auditor requesting management to include additional disclosures of non-compliance with laws and regulations which are not specific requirements of the financial reporting framework.

I do not consider that it is appropriate for auditing standards to be used as a mechanism for making changes to financial reporting requirements and any such disclosure requirements should be mirrored for preparers. This is particularly relevant in the public sector where there are pre-existing mechanisms for disclosure of matters relating to compliance with laws and regulations within the annual report. If there is a drive for changing in the reporting requirements in this space, it should be driven through the financial reporting framework in the first instance.

There is also a public sector consideration here for circumstances where such a disclosure may be prejudicial to national security or commercial interest. In such circumstances, it would be wholly inappropriate for such matters to be disclosed either within the financial statements or within the auditor's report. The current Exposure Draft does not cater for such circumstances.

Question 2 - Do the proposed requirements in paragraphs 12-2–12-3 support auditors to be able to identify those laws and regulations with which non-compliance may have a material effect on the financial statements?

I would consider that the proposed requirements in paragraphs 12-2-12-3 are appropriate to support auditors to be able to identify those laws and regulations with which non-compliance may have a material effect on the financial statements. I particularly note that there is a reasonable degree of overlap here between these procedures and the equivalent risk assessment procedures required to be performed by the auditor to identify the framework of authorities to support the regularity opinion under Part 2 of Practice Note 10.

ISA (UK) 2X0 – Considerations for Audits of Public Interest Entities – Communicating and Reporting to an Appropriate Authority Outside the Entity

Question 7 – Do you agree that the proposals in ISA (UK) 2X0 appropriately address the public interest?

I am supportive of the changes outlined in the revised ISA (UK) 2X0. The proposed changes are likely to ease the audit burden for Public Interest Entity (PIE) audit teams and provide a better mechanism for determining whether a matter is reportable.

Question 8 – Do you agree with the proposed scope of ISA (UK) 2X0 being limited to public interest entities, or do you believe that the requirements of ISA 2X0 should also apply to additional entities?

I note that the requirements within the standard are helpful to the auditors of entities other than PIEs, who identify matters which may be reportable to their regulator. This is particularly relevant to the charity sector. I would therefore be supportive of extending the scope of the standard to the charity sector, with guidance included that the principles of the standard may be applied within further entities where the auditor identifies matters which might be reported to a regulator, or another appropriate authority outside of the entity.

Question 11 – Have appropriate enhancements been made to the application material?

Paragraph 17b extends reporting requirements for certain matters, such as viability and modified audit opinions beyond PIEs and to entities with 'close links' to PIEs. In the public sector context, this could be interpreted as extending these requirements to Departments and throughout their Departmental groups. This

is due to the fact that small companies in the central government sector which meet the PIE definition, e.g., as a result of holding listed debt, could fall within the group boundary of the relevant Department and therefore would have a 'close link' to the relevant Department under the definition given in the current proposed standard.

We would therefore recommend that application guidance should be added either to exempt these requirements for public sector entities or to explain that the discharge of such requirements in the public sector is usually achieved through the auditor's other reporting responsibilities. It may be that Practice Note 10 could be a more suitable vehicle for such guidance.

I hope that you find this helpful in setting out our concerns with the current exposure draft for the revised *ISA (UK) 250 – Consideration of Laws and Regulations in the Audit of Financial Statements* and our support for the current exposure draft for the revised *ISA (UK) 2X0 – Special Consideration for audits of Public Interest Entities – Communicating and Reporting to an Appropriate Authority Outside the Entity*.

We are of course happy to engage with you further on this as the process of revising ISA (UK) 250 and ISA (UK) 2X0 continues.

Yours sincerely,

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National Audit Office