

RESPONSE TO THE INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT (THE BRYDON REVIEW)

SUBMITTED BY AUDIT SCOTLAND, ON BEHALF OF THE AUDITOR GENERAL FOR SCOTLAND AND THE ACCOUNTS COMMISSION FOR SCOTLAND

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INTRODUCTION

1. Audit Scotland has noted with interest your call for views on the quality and effectiveness of audit. We have significant experience and knowledge of audit in the Scottish public sector (SPS) which already encompasses many of the features you are considering applying in the private sector. We believe we are in a position to offer insights that you may find helpful in your considerations.
2. Our comments are intended to provide a high level summary of the key features of audit in the SPS that may be of interest to you. However, we would be pleased to provide you with further information on any aspect of our response.

CONTEXT

3. As an indication of scale Audit Scotland, on behalf of the Auditor General for Scotland and the Accounts Commission, is responsible for almost 300 audits of public bodies that collectively spend more than £40 billion of public money a year. Audits include Scottish central government bodies, councils, health boards, and colleges, as well as more diverse entities such as charities, companies limited by guarantee, and two public interest entities, with total audit fees of more than £20 million. Many of these include group accounting and increasingly, those bodies are finding new ways to collaborate and work with each other in partnership to deliver public services.
4. Some of the larger more significant audits include the Scottish Government (£34 billion net expenditure), NHS Greater Glasgow & Clyde (£4.6 billion gross expenditure), Glasgow City Council (£2.7 billion gross expenditure) and Scottish Water (£1.4 billion revenue).

PUBLIC SECTOR AUDIT MODEL - OVERVIEW

5. SPS bodies do not appoint their own auditors. Statutory responsibility for appointing auditors rests with:
 - The Auditor General which is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit most of the the SPS except local government.
 - The Accounts Commission which is an independent public body of 12 members appointed by Scottish Ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.

6. Audit Scotland's principal statutory function is to provide services to the Auditor General and Accounts Commission.
7. Legislation provides for the auditors appointed by the Auditor General and Commission to be either members of staff of Audit Scotland or eligible accountancy firms. The current appointments are split 65% to Audit Scotland's inhouse audit practice and 35% between six private firms (Deloitte, KPMG, EY, Grant Thornton, Scott-Moncrieff and Mazars).

PUBLIC SECTOR AUDIT MODEL – KEY RELEVANT FEATURES

Scope of public audit

8. A [Code of Audit Practice](#) is prepared by Audit Scotland and approved by the Auditor General and Accounts Commission. It outlines the responsibilities of appointed auditors and it is a condition of their appointment that they follow it. SPS audit as described in the Code is a combination of: specific legal requirements; professional requirements; best practices as applied to public interest entities in the private sector; and the requirements arising from the Code. It is designed to ensure that public audit adds value for audited bodies, the public and their elected representatives.
9. The principles of public audit are based on:
 - the independence of auditors from the bodies that they audit
 - a wider scope which reaches beyond the financial statements. Our 2016 Code of Audit Practice requires auditors to consider financial sustainability, financial management, value for money and governance and transparency. In the local government sector, these four audit dimensions contribute in part to an overall assessment and assurance on best value, which is a specific audit requirement under the Local Government in Scotland Act 2003
 - public reporting of audit findings and recommendations.
10. The Code requires the audit of the financial statements to be undertaken in accordance with international standards on auditing in the UK (ISAs). Auditors are also required to follow practice note 10 which applies certain ISAs in a public sector context. Audit Scotland provides technical support to appointed auditors to inform their professional judgement and promote consistency.
11. In the wider audit scope areas, the application of ISAs has been interpreted to meet the additional requirements of audit in the SPS.
12. Audit appointments are made for a five year period. The Code of Audit Practice is therefore reviewed at least every five years, and we are considering the implications from the recent reviews of auditing and regulation in the corporate sector for our new Code to apply from 2021. This will include the findings of the Brydon Review.

Quality framework

13. Audit Scotland, in supporting the commissioners of the audit, has a range of measures in place to ensure the quality of audit work. A new [Audit Quality Framework](#) was established in 2017 which sets out how Audit Scotland provides the Auditor General and Accounts Commission with robust, objective and independent quality assurance over the work of both Audit Scotland's inhouse audit practice and the firms. This includes arranging for independent quality reviews carried out by the Institute of Chartered Accountants Scotland (ICAS). Audit Scotland undertakes surveys of audit quality which help to indicate if there are

any issues arising between the appointed auditor and the audited body that either require immediate attention or that should be taken into account at the next round of appointments.

Reporting

14. Auditors produce two main types of audit report for each body annually:

- The short-form Independent Auditor's Report complies with ISA (UK) 700 and is used to express the opinion on the financial statements and other opinions on specified parts of the other information published with the financial statements
- A long form Annual Audit Report, published on the Audit Scotland website, where auditors report their conclusions on wider scope responsibilities concerned with how the body is being run, and recommendations for improvement.

15. The Auditor General and the Controller of Audit can make statutory reports to the Scottish Parliament and Accounts Commission respectively on significant matters arising from the audit. These are available to the public. The Auditor General and Commission also publish reports on national performance audits.

BRYDON REVIEW QUESTIONS

Question 1: For whose benefit should audit be conducted? How is it of value to users?

In common with company law, SPS legislation does not specify for whose benefit public audit is undertaken. However, the Auditor General, the Accounts Commission and Audit Scotland set out in the Code that the collective aim is to provide independent assurance to the people of Scotland that public money is spent properly and provides value for money.

The work undertaken by appointed auditors is therefore carried out for the public, including their elected representatives, and in their interest. Audit reports are addressed, in the case of local government, to the elected members of the audited bodies and the Accounts Commission, and in the case of all other public sector bodies to the board members, the Auditor General and the Scottish Parliament. All audit reports (and plans) are made available to the public from the Audit Scotland website.

The wider scope of SPS audit provides the public with assurance on the financial statements and on the governance of the public body and the use of public money. SPS audit also supports improvement by making recommendations and encouraging good practice. There are escalation processes if a public body fails to respond to significant issues reported by the auditor. The Cotroller of Audit can make a statutory report to the Accounts Commission on any local government issue and the Auditor General can make a statutory report to the Public Audit and Post Legislative Scrutiny Committee of the Scottish Parliament. When combined with the political process and an active press, this provides a public means of holding organisations to account and encouraging improvement.

There is a specific provision in Section 101 of the Local Government (Scotland) Act 1973 which provides for the 'right of an interested person to inspect and object to the [unaudited] accounts' of local government bodies during a short specified period. Auditors are required to consider such objections including holding a meeting with the objector.

Audit Scotland also operates a non-statutory process whereby members of the public can raise matters of concern with us in respect of audited bodies at any time.

Question 2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?

Audit in the SPS is designed to enhance the degree of confidence of intended users in the audited body and not only the financial statements. To that end, the Code of Audit Practice sets out four audit dimensions that frame the wider scope audit work into identifiable audit areas: governance and transparency, financial sustainability, financial management and value for money. The financial statements audit is the foundation and source for much of the audit work necessary to support the judgements and conclusions made by appointed auditors on these dimensions, but the assurance provided extends beyond the contents of the financial statements. These dimensions are used to report where auditors are adding value or having an impact.

In local government, councils have a statutory duty to make arrangements to secure Best Value, which is defined as continuous improvement in performance while maintaining an appropriate balance between quality and cost. Auditors of councils have a statutory duty to be satisfied that such arrangements have been properly made, and Audit Scotland has provided guidance to assist auditors undertake that duty. This considers matters such as leadership, contribution to sustainable development, and equal opportunities arrangements.

Question 3: Should UK law be amended to provide greater clarity regarding the purpose of an audit, and for whom it is conducted? If so, in what way?

No response submitted to a question which pertains to the private sector.

Question 4: Do respondents consider there is an expectation gap?

The responsibilities of auditors in the SPS are made clear through legislation, the Code, and the wording of audit reports.

Despite the wider audit scope, and arguably because of it giving rise to increased expectations, our experience suggests there can still be a gap between what we do as public sector auditors and what the public think and expect. This is discussed further at our response to question 5.

Question 5: If so, how would respondents characterise that gap?

We know from our 'matters of public concern' process that members of the public sometimes do not understand that auditors cannot prevent things from happening or cannot comment on policy matters. This is difficult to address other than continuing to be clear and unapologetic about the role of audit and what it does and does not do. A particular misunderstanding is that auditors cannot force public bodies to take action. As well as raising questions on the governance of the organisation itself, lack of action can result in questioning the effectiveness of audit. In the SPS, we find that our power to report in public, when combined with the escalation processes outlined at question 1, is helpful in encouraging action.

We find that members of the public contact us on matters that are outwith our remit altogether, and we refer them to other relevant agencies (e.g. Scottish Public Services Ombudsman, Scottish Information Commissioner, Standards Commission for Scotland). Creating an awareness among the public of available options other than audit, including better 'sign-posting' of who best to contact in different circumstances, may lead to more informed expectations.

The issue of materiality can also give rise to an expectation gap. For example, auditors design their testing to detect material misstatement or irregularity due to fraud or error. Materiality extends to several million pounds in most public sector bodies while public expectation of what is a material or significant fraud is likely to be considerably lower, particularly when this concerns public money. Given the primary responsibility for prevention and detection of fraud and corruption rests with public bodies themselves, our 2016 Code requires auditors to evaluate a body's arrangements for the prevention and detection of fraud and corruption, and report in the Annual Audit Report. We are currently considering how we could support auditors to target this work better to focus on high risk areas.

There can also be a gap between the audit view of materiality and the level of local interest or concern surrounding a specific service which impacts on people. For example, the closing of after-school clubs due to budget reallocation would be a policy decision and would not be material in terms of the money involved. However, it is the sort of issue that is raised with us through our 'matters of concern' process. In these circumstances we explain the role of external audit and its limits, but this can be hard for service users to accept.

In our view, there is scope for a public debate on the level of assurance wanted from the auditor and the cost of that assurance – more assurance could be provided, but the cost may outweigh the benefit.

Question 6: Is there also a significant ‘delivery’ or ‘quality’ gap between auditors’ existing responsibilities in law and auditing standards, and how those responsibilities are currently met?

Audit Scotland has robust arrangements in place to monitor, report on and improve audit quality, including independent assessment by ICAS. Our Audit Quality Framework ([Quality Framework](#)) sets out the most comprehensive QA arrangements of any public sector audit body in the UK, covering all audit providers, including private firms, and all types of audit. The annual Audit Quality Report is in the public domain ([Annual Quality Report](#)). Other aspects of the approach to quality include:

- Officers and members to raise any concerns they have directly with the engagement lead at any time during the appointment.
- An anonymised audited body survey is undertaken, and generally shows consistently high levels of satisfaction
- There is a complaints procedure available should a user have a concern about the quality of audit.

There is no evidence from the above of a significant quality gap, although isolated failures of quality do occur.

Question 7: What should be the role of audit within wider assurance?

In the SPS, external audit plays a significant role within a wider assurance framework. Board members, and elected members in local government, have an important governance and scrutiny role in individual public bodies. Boards and councils are ultimately responsible for governance and ensuring necessary actions are taken in response to audit findings. The auditor’s role is to report audit findings and judgements clearly and unambiguously, and make recommendations for improvement.

The Public Audit and Post Legislative Scrutiny Committee of the Scottish Parliament and the Accounts Commission play an important role in the SPS scrutiny and assurance framework. Statutory reports to these bodies by the Auditor General and the Controller of Audit provide a means of escalating auditors’ findings to hold public bodies to account.

Audit Scotland also works with other organisations in a wider SPS assurance framework. For example, the Accounts Commission, supported by Audit Scotland, chairs the Strategic Scrutiny Group (SSG) which is made up of other scrutiny bodies from across the public sector (e.g. education, housing etc) to make their work on local government more co-ordinated, better targeted and more proportionate to identified risks.

Q8: Can the level of assurance that an audit provides legitimately vary in different circumstances, for example depending on the business sector in question, and the nature of the entity’s business risks?

We have in the past considered whether it would be appropriate for reduced audit coverage in the financial statements of small audited bodies. Although we did not apply such an approach, we have reduced expectations for coverage of the four wider scope audit dimensions for such bodies.

Question 9. Are the existing boundaries between internal and external audit clear?

The function of internal audit is well-established in the public sector, and is supported by Public Sector Internal Audit Standards. We consider that existing boundaries are clear to those that undertake internal and external audits, and that this clarity is reinforced by their respective roles being evident through participation in audit committees. However, the distinction may not be so well understood by parties not directly involved, particularly the general public. The Accounts Commission's recent report [Safeguarding Public Money](#) explains the role of internal audit in the local government sector.

Question 10. To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

The restriction in ISA (UK) 610 on direct assistance by internal audit is applied in the public sector, i.e. the work of internal audit is not directed by external audit. However, where there are areas of common interest, reliance may be placed on the work of internal audit, at which point external audit must carry out work to be assured as to the competency of the internal audit function, undertake review of the audit work to place reliance on it, and determine what further audit work is required to ensure the full financial period has been covered.

There may be merit in revisiting the prohibition on internal audit directly assisting external auditors to bring the UK back into line with the international standard.

Question 11. Do current eligibility requirements for external auditors focus too much on independence at the potential expense of market innovation and the quality of the audit product?

Independence of the auditor from the body being audited is a fundamental tenet of public audit in Scotland. We have no evidence that it hinders market innovation and are firmly of the view that it enhances audit quality and builds public trust.

Question 12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?

In the public sector, audited bodies already report an assessment of the effectiveness of key elements of the governance framework, and an opinion on the level of assurance that the governance arrangements can provide, in the governance statement that accompanies the financial statements. The governance statement is currently part of the 'other information' that is read, but there may be merit in considering whether it should be subject to audit.

Question 13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

In evaluating an audited body's financial management, the Code of Audit Practice is clear that auditors should conclude and report on whether the body has arrangements to ensure systems of internal control are operating effectively. As an illustration, the following is wording used to report on the above in the Annual Audit Reports of Audit Scotland's inhouse audit practice:

Systems of internal control

1. As part of our audit we identify and inspect the key internal controls in those accounting systems which we regard as significant to produce the financial statements. Our objective is to gain assurance that NHS XXX has sound systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.
2. Our findings from the review of systems of internal controls were included in the management report/letter presented to the Audit Committee on DD/MM/2019. We concluded that the controls tested were operating effectively. No significant internal control weaknesses were identified during the audit which could affect NHS XXXX's ability to record, process, summarise and report financial and other relevant data to result in a material misstatement in the financial statements. [OR summarise briefly if significant control weaknesses were found and our conclusions on the audit].

Question 14: Auditors are currently required to report to audit committees their views on the effectiveness of relevant internal controls for listed and other relevant entities. Should auditors be required to report publicly these views?

Auditors report to audit committees their views on the effectiveness of relevant internal controls. This is both in the Annual Audit Report and in person at those committees. All key outputs are brought into the public domain, ultimately by way of the Audit Scotland website, although often the bodies themselves post agendas and papers in advance of audit committee meetings. Statutory reports by the Auditor General and Accounts Commission are also reported publically.

Question 15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?

Practice note 10 considers the application of ISA (UK) 570 to the public sector. In general, if the body's operational activities are to be transferred elsewhere in the public sector, the going concern basis of accounting is likely to remain appropriate. The appropriateness of the going concern basis of accounting tends to be less of an issue in the public sector.

However, going concern is a relatively short-term concept looking forward 12 to 18 months from the end of the financial year. The Code of Audit Practice extends the requirements of ISA (UK) 570 to consider financial sustainability and looks forward to the medium (two to five years) and longer term (longer than five years) to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered. Auditors report their conclusion on financial sustainability in the Annual Audit Report which facilitates more context and graduated reporting.

Question 16: Should there be greater transparency regarding identified “events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern”?

No response submitted to a question which pertains to the private sector.

Question 17: Should directors make a statement about the sustainability of the entity’s business model beyond that already provided in the viability statement?

No response submitted to a question which pertains to the private sector.

Question 18: Should such a statement be subject to assurance?

No response submitted to a question which pertains to the private sector.

Question 19: Who might be capable of giving such assurance?

No response submitted to a question which pertains to the private sector.

Question 20. Is there a case for a more forward-looking audit? What would be the main benefits and risks?

See response to question 15 in respect of how public audit looks forward in assessing financial sustainability. The benefit is placing auditors in the position to provide assurance on the effectiveness of the financial planning systems in identifying and addressing risks to financial sustainability; the appropriateness of the arrangements put in place to address any identified funding gaps and whether the body can demonstrate that these arrangements are working; and whether the body can demonstrate the affordability and effectiveness of funding and investment decisions it has made. Or alternatively, where assurance cannot be given, the benefit is to highlight risks and uncertainties associated with forward plans and service delivery, and recommend remedial action.

Although outweighed by the benefits, we acknowledge there are potential risks (albeit they have not crystallised in practice) that:

- The audited body may come to rely on the work carried out by the auditor in place of carrying out their own work.
- Stakeholders may perceive the assurance on sustainability more widely than is appropriate (e.g. treat it as a guarantee of continued operational existence).
- Auditors may caveat their conclusions to such an extent as to render them meaningless. This issue would be picked up by Audit Scotland’s quality assurance activity and discussed with the auditor to ensure improvement.

Question 21: Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

The profile and importance of narrative information has grown significantly in recent years. Recent revisions to ISAs to improve auditors' work effort in this area has only been partially successful. It may be that the current 'read requirement' is insufficient, and that a requirement to audit such information should be considered.

Question 22. If so, what information might usefully be subject to audit or another form of assurance and why?

There is merit in considering whether (at least part of) the financial information in the governance statement and strategic report should be audited – much like the audited part of the remuneration report.

Question 23: Do respondents agree that the value and quality of the audit product should be considered separately from the effectiveness of the audit process?

We agree that effectiveness (i.e. compliance with standards) should be considered separately from the value and quality of the product (i.e. audit impact), but they are not mutually exclusive and auditors should be expected to aim for an optimal balance between the two in order to deliver a high quality audit. For example, a very strong focus on impact with less attention on collecting/documenting evidence or in contrast focussing on compliance/deadlines at the expense of exercising professional scepticism should both be avoided.

Through the rigorous internal and external QA processes we have in place, we are conscious of the difference between good compliance and an effective audit. There may be an audit which can demonstrate a positive impact on an audited body, e.g. improved financial reporting, actions implemented to improve systems of internal control, etc and yet for there to be weaknesses in audit documentation and thus score more poorly from a QA perspective than a fully-compliant audit that had no real impact.

However, while demonstrating compliance with standards is relatively straight-forward, we have found that demonstrating impact (or capturing examples of impact) to be more challenging.

Question 24: Do respondents consider that emphasis placed by auditors on 'completing the audit file' for subsequent FRC inspection can eclipse the desired focus on matters requiring the exercise of considered judgement?

In view of the wider Code, and the interaction with officers and audit committee members, there is a strong desire to focus on matters which require the exercise of considered judgement, and within deadline. This has to be balanced with the desire to complete the audit file well, for subsequent QA inspection. High quality audit cannot be assured through rules and standards alone, but it remains important to document significant judgements and the evidence on which they are based, particularly for wider scope audit areas such as financial sustainability.

Question 25: What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?

The binary opinion has the advantages of clarity and simplicity which would be lost if there was a switch. However, retaining the binary opinion along with a more graduated approach to reporting key audit matters would have benefits. ISA (UK) 701 applies to only a couple of Scottish public bodies. However, auditors of the other public bodies report key audit matters in the Annual Audit Report which allows the inclusion of more context, nuance, and graduated reporting.

In the public sector, the need to modify opinions, or include an emphasis of matter paragraph, does arise albeit rarely. We have found these to be well understood by stakeholders.

Question 26: Could further narrative be disclosed alongside the opinion to provide more informative insights?

We provide informative insight through Annual Audit Reports. They are presented at committee/Board meetings and are ultimately in the public domain.

Question 27: What would prevent such disclosures becoming boiler plated?

In contrast with the Independent Auditors Report which is tightly worded in compliance with ISA (UK) 700, the Annual Audit Report is much more free-form and expansive. The Code sets out the high-level objectives and contents of the Annual Audit Report, but the wording is left to the discretion of each appointed auditor.

Question 28: To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?

We have not experienced any issues with producer-led audit. The role of the Auditor General and Accounts Commission in approving the Code of Audit Practice mitigates against producer-led audit.

Question 29. What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?

We draw a distinction between non-compliance with those laws and regulations which determine amounts in the financial statements and non-compliance with other laws and regulations. For the latter, auditors evaluate the adequacy of the body's arrangements for compliance rather than whether each individual requirement is met.

In most parts of the public sector (other than local government), there is a statutory requirement for auditors to express an opinion in the Independent Auditor's Report on whether, in all material respects, expenditure was incurred and income applied in accordance with applicable enactments and guidance issued by the Scottish Ministers (generally referred to as the regularity opinion).

Question 30. Does a perceived inconsistency between company law and accounting standards as regards distributable reserves inhibit auditors from meeting public expectations? How might greater clarity be achieved?

No response submitted to a question which pertains to the private sector.

Question 31. Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?

No response submitted to a question which pertains to the private sector.

Question 32. How do auditors discharge their obligations relating to whether the entity has kept adequate accounting records? Are the existing statutory requirements effective in setting the bar for auditors at a high enough level?

Although not a statutory requirement in the public sector, the Code of Audit Practice requires auditors to report by exception if adequate accounting records have not been kept. Auditors have, on an exceptional basis, reported a modified conclusion where there has been concern about the adequacy of accounting records.

However, because this is a matter reported by exception, auditors generally only report if they find something under normal audit testing, i.e. there are no procedures with the sole objective of checking the adequacy of accounting records. There may be merit in requiring auditors to provide positive assurance on the adequacy of accounting records, rather than merely report by exception. The benefits of additional assurance would have to be balanced against any additional cost.

Question 33. Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?

Examples of open dialogue in the public sector are as follows:

- The Annual Audit Report, at the conclusion of every audit, is available in the public domain for users to see.
- In many cases the auditor presents both audit reports at a public meeting of a committee/board.
- As mentioned above a user of local government accounts can raise an objection on the unaudited accounts and be heard by the auditor at a hearing.
- Members of the public can raise matters of concern with Audit Scotland.
- Statutory reports which are presented to a committee of the Scottish Parliament are subject to scrutiny and discussion by committee members. Those Members of the Scottish Parliament are representatives of their constituents, who, ultimately are stakeholders in the public services concerned.
- We communicate our work and findings to the public and media via news releases, media relations, social media and other channels.

Question 34. Should more of the communication and resulting judgments that occur between the auditor and the audit committee be made transparent to users of the financial statements?

The Annual Audit Report includes matters drawn to the attention of audit committees. Consequently, those judgements are transparent in the public sector.

Question 35: Should there be enhancements to the extended audit report, such as an obligation to update on key audit matters featured in the previous audit report?

Key audit matters are included in the Annual Audit Report. We would expect auditors to include an appropriate update to follow up on key audit matters.

Question 36. Do you believe that users' expectations of auditors' role in fraud detection are consistent with the requirements in UK law and auditing standards? If not, should auditors be given greater responsibility to detect material fraud?

Within the context of auditing the financial statements, auditors' main focus is on identifying fraud that has caused a material misstatement. Auditors should carry out that role with an appropriate level of professional scepticism. As highlighted in the response to question 5, public expectation of what is a material or significant fraud is likely to be of much lower value than that defined as a material misstatement in auditing standards. Auditors could do more work to actively seek out fraud, but given the often-sophisticated actions taken to cover up fraud, the additional effort may not in any event result in a proportionate level of benefit.

The primary responsibility for the prevention and detection of fraud lies with public bodies themselves. Hence the approach in the SPS, as part of the wider audit scope, is to focus on the audited body's arrangements for preventing and detecting fraud. This involves auditors assessing whether the arrangements are operating effectively, and recommending improvement when they are not. Auditors therefore go beyond misstatements in the financial statements, and therefore reduce the expectation gap, but do not eliminate it. Given the recent debate concerning the auditor's responsibilities on fraud, we are reviewing the requirements for our next Code of Audit Practice.

Question 37. Do existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors?

In our view, they do not as the focus is on misstatement caused by fraud. As above, a new responsibility to evaluate counter-fraud arrangements would broaden the audit role and enhance the mindset.

Question 38. Would it be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection?

We believe it should be possible to devise such a test.

Question 39. Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?

For the reasons set out above, we believe auditors should have this responsibility. As an illustration, the following wording is included in the Annual Audit Report used by Audit Scotland's inhouse audit practice:

Standards of conduct for prevention and detection of fraud and error

- 3.** Audited bodies are responsible for establishing arrangements for the prevention and detection of fraud, error and irregularities, bribery and corruption and to ensure that their affairs are managed in accordance with proper standards of conduct by putting proper arrangements in place.
- 4.** We have reviewed the arrangements in place to maintain standards of conduct including the LIST (some examples, Staff Handbook and Civil Service and Members' Codes of Conduct). There are established procedures for preventing and detecting any breaches of these standards including any instances of corruption.
- 5.** We have concluded that the board has appropriate arrangements in place for the prevention and detection of fraud, error and irregularities, bribery and corruption. We are not aware of any specific issues that we need to bring to your attention.

Question 40. Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

No response submitted to a question which pertains to the private sector.

Question 41. If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?

No response submitted to a question which pertains to the private sector.

Question 42. Should company law make auditors potentially liable, or otherwise accountable, to all stakeholders who reasonably rely on their audit work and their published auditor's report?

There are no statutory restrictions on auditor liability in the SPS. However, the Code of Audit Practice states at paragraphs 119 and 120 that:

“119 While the results of audits will be made available to the public, the appointed auditors' duty of care in respect of the audit of the bodies covered by this Code extends only to:

- local government bodies – the audited body, the Accounts Commission, the Controller of Audit and Audit Scotland
- all other bodies – the audited body, the Auditor General, Audit Scotland and the Scottish Parliament (under statute, most audited financial statements require to be laid before the Parliament).

120 Although reports may be addressed to members or managers, they are prepared solely for the use of the bodies referred to above. Appointed auditors do not undertake to have responsibilities to members, directors, accountable officers, managers or the Scottish ministers in their individual capacities, or to third parties.”

Consequently, Independent Auditors Reports in the SPS include a 'Bannerman paragraph' worded as follows:

“This report is made solely to the parties to whom it is addressed in accordance with Part VII of the Local Government (Scotland) Act 1973/Public Finance and Accountability (Scotland) Act 2000 and for no other purpose. In accordance with paragraph 120 of the Code of Audit Practice, we do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.”

Question 43. How might quality of the audit product be improved if the approach to liability was altered, and what reform might enable the most favourable quality improvements?

No response submitted to a question which pertains to the private sector.

Question 44: To what extent (if any) are firms unable to obtain the desired level of professional indemnity insurance to minimise the risk of being unable to meet a significant claim relating to their statutory audit work? How significant is this risk for both the largest firms and other firms undertaking audits of Public Interest Entities?

No response submitted to a question which pertains to the private sector.

Question 45: How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

Audit Scotland's inhouse audit practice has set up a dedicated team to explore how data analytics can be used to enhance audit quality and deliver a more efficient audit. Although at a relatively early stage, initial pilot work suggests that improvements to audit quality through providing enhanced assurance are possible. Data analytics provides the opportunity to review entire populations of transactions and also to focus testing on higher risk transactions. New visualisation tools can also be used to present audit findings.

Early findings suggest that data analytics will not be practical or cost-effective to apply to all audits (for example, smaller or less complex audits). Availability of scarce digital skills has also limited our ability to progress as fast as we would like.

Question 46: In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

We are not yet in a position to answer this question.

Question 47. Are there aspects of current audit procedures or output that are no longer necessary or desirable?

No response submitted to a question which pertains to the private sector.

Question 48. Given that a zero-failure regime is not attainable (and arguably not desirable) how should the Review calibrate the value of audit in relation to the limitation of potential failure?

No response submitted to a question which pertains to the private sector.

Question 49. Does today's audit provide value for money?

This is a difficult question to answer as it depends on a value judgement on the price society is prepared to pay for independent audit assurance. In Audit Scotland we consider that audit and assurance costs of £28 million, covering the financial and performance audit of public expenditure of £43 billion, is reasonable value for money. Audit Scotland's budget, and our fee regime (see [fee strategy](#)), are approved by a committee of the Scottish Parliament.

Audit Scotland sets an expected fee for each audit carried out under appointment that assumes the body has well-functioning controls, an effective internal audit service, and an average risk profile. This assures the independence of public sector audit and limits the ability of individual bodies to adversely impact on audit quality by reducing audit fees. Auditors then negotiate a fee with the audited body during the planning process. The fee may be varied by up to 10% above the expected fee to reflect the circumstances and local risks within the body. If local circumstances require a fee higher than the permitted range, auditors must notify Audit Scotland and obtain approval. This helps to ensure any increased fee is justified.

We do receive some complaints, mainly from the smaller audited bodies, that fees are too high, but our dialogue with audited bodies and other stakeholders indicates general acceptance that audits provide reasonable value for money.

Question 50. How should the cumulative costs of any extension of audit (whether stemming from this Review or other drivers of change) be balanced against the likely benefits to users?

No response submitted to a question which pertains to the private sector.

Question 51: What use do shareholders currently make of audit reports? Are they read by shareholders generally? What role does AI play in reading and analysing such reports?

Annual Audit Reports are presented to audit committees and the level of engagement is mixed. There is less attention paid to the Independent Auditors Report unless there is a modified opinion (which is rare).

Question 52: Would interaction between shareholders and auditors outside the AGM be practical and / or more desirable?

No response submitted to a question which pertains to the private sector.

Question 53: How could shareholders express to auditors their *ex ante* anxieties to help shape the audit plan? Should shareholders approve planning matters for each audit, including scope and materiality?

The Code of Audit Practice is revised and re-issued at least every five years. This is subject to full public consultation so that stakeholders can contribute to shaping the scope of the audit overall.

A member of the public can raise an objection on the unaudited accounts of a local government body and expect to be heard by the auditor at a hearing.

The annual audit plan prepared by auditors documents how they intend to meet their responsibilities, in the light of their assessment of risks and wider scope responsibilities. These plans are communicated to and discussed with audit committees.

Question 54: What assurance do shareholders currently obtain other than from audit reports?

No response submitted to a question which pertains to the private sector.

Question 55. In what way would it be possible for auditors to report on the culture of the entity whose financial statements are being audited?

Part of the audit role in respect of the audit of Best Value is to assess and report on whether the council has a culture of continuous improvement which is clearly linked to the corporate plan and the strategic priorities of the council. The Best Value characteristics covered by the audit include commitment and leadership.

Question 56. How can auditors demonstrate that appropriate scepticism has been exercised in reaching the judgments underlying the audit report?

The challenge may be in judging what is an 'appropriate' level of scepticism. Too little challenge and the audit integrity is undermined, too much challenge and the audits become inefficient. However, there should be greater incentives to exercise scepticism and greater rewards (financial and otherwise) for doing so. A culture which perhaps has a tendency to prize meeting deadlines, being under-budget, and keeping the 'client' happy may need to be rebalanced in favour of one where scepticism and robust challenge are the overriding drivers.

Question 57. Should the basis of individual auditors' remuneration be made available to shareholders?

In the interests of transparency, Audit Scotland shares information on how expected audit fees are constructed with audited bodies and includes it on our website.

Question 58. Do respondents view audit costs as generally too high, about right or insufficient?

See response to question 49.

Question 59. Would users of financial statements wish more detail on the make-up of audit fees?

Although we take steps to control the level of audit fees, we tend to focus on whether required outputs have been delivered on time and to required quality rather than the number of days input. While the overall level of audit fees should be disclosed, we are unclear of the benefits to users of disclosing more detail on how they are made up.

Question 60. Is the profitability of the audit function sufficient to sustain a high-quality audit industry?

We have experienced a good level of competition in our tendering exercises for SPS audit work. We currently appoint 3 of the Big Four and 3 mid-tier firms.