

East Hertfordshire District Council

EY proposal for increases to the scale fee 2019/20 & rationale

We are proposing an increase to the scale fee for 2019/20. This document outlines our proposal, rationale and further contextual information.

We believe it is important that the audit fee you pay recognises the changes that have occurred within the audit market and the expectations that our regulators rightly have of us. The background to these areas were set out in the 10 February 2020 letter from Janet Dawson, EY's lead partner for our government and public sector assurance team. They are also recognised by PSAA Ltd themselves in their own letter to councils.

Our proposal

| PSAA Set Scale Fee (fee letter) | Our Proposed Scale Fee | Increase | % Increase |
|---------------------------------|------------------------|----------|------------|
| £40,295 | £67,244 | £26,949 | 67% |

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|---|----------------|
| Comprising: | |
| <u>Additional fee for increase in client in risk</u> | £11,878 |
| <u>Additional fee for increase in regulatory compliance</u> | £14,739 |
| <u>Additional fee for client readiness and technology</u> | £322 |
| Total additional fee | £26,949 |

Rationale

The Council's statement of accounts is an important mechanism for telling local residents and taxpayers how their money is spent. Both officers and the audit committee have statutory responsibilities to ensure that the accounts tell the correct story of the Council's financial year. The role of the independent statutory audit is to form an opinion on the truth and fairness of the accounts. By reporting their work and findings to the audit committee, it helps to enable members to discharge their responsibilities. The auditor's ongoing engagement with officers throughout the year helps officers to discharge their responsibilities to prepare a materially accurate set of accounts.

In order for us to deliver an audit and provide the assurance that you, your members, your residents and taxpayers and other stakeholders take from our auditor's report we believe that we need to be fairly remunerated for the detailed work we are required to complete. Particularly as the volume and complexity of the work has increased, expectations on audit quality have grown, there is more need to use specialist inputs, recruitment and retention has become a massive challenge and the need to better use technology.

Changes since the last PSAA tender in 2017

Volume and complexity of work

Compared to three years ago the volume and complexity of audit work required has increased significantly. There are two main reasons for that.

The first relates to the sector itself. Financial reporting and decision making in local government continues to become increasingly complex, for example from the growth in commercialisation, speculative ventures and investments. This has also brought increasing risk about the financial sustainability and going concern of bodies given the current status of the sector. Audit committees need more robust assurance than ever.

In addition, the profession at large has been subject to ongoing scrutiny from regulators and reviews (I've mentioned these before – Kingman, Brydon and Redmond), which mean an evolving landscape. One of the biggest messages from the FRC, in its capacity as the profession's regulator, has been around the extent of challenge and corroboration auditors undertake and the extent to which this is documented on their files, i.e. rather than just confirming information obtained from the audited body to support an entry in the accounts, auditors should be challenging the audited body and seeking third party evidence to corroborate what the audited body has provided. This is what tends to be called professional scepticism and while clearly it has always been a requirement, the changes have been about making it much more structured and documented.

Relevant examples of the changes include:

- The biggest change is the expected level of auditor challenge on management's significant estimates and judgements. This includes things like provisions, accruals and the most striking example is on asset valuations. The extent of auditor challenge and testing has grown significantly. Previously we would read the valuers report and agree to your working papers. We are now required to demonstrate our challenge of management's use of its own expert by engaging directly with the expert, or using our own expert to challenge your expert. We read, assess and evaluate the valuation report and associated working papers and then select samples of assets to challenge your assumptions and test base data such as agreeing floor areas back to original documentation and challenging the designation of land and buildings. For social housing we even compare valuations to similar recent sales in the local market. The work we are required to do on the pensions liability falls into this category too. We now also engage our own expert to challenge the work of management's expert.
- Ensuring that the information provided by the Council is complete and valid. This is what we now call Information Provided by the Entity or IPE testing. Previously finance staff would run reports off their ledgers and provide the report as a working paper to support the accounts. Now, we are required to gain assurance over the IPE as a way of mitigating the risk of fraud and helps provide assurance over the completeness of information. This tends to be a combination of testing a sample of items in the population of IPE and sitting down with a finance officer to watch them input parameters into the ledger and generate the actual report. IPE is comprehensive for the Council.
- Group accounts – The FRC has highlighted from its inspection's deficiencies in the audit of group accounts and in particular the involvement of the group auditor in the work of a component auditor. Since 2017 we have enhanced our approach to group accounts, mandating a higher

level of engagement with component auditors and developing a more comprehensive approach to documenting the work of the group auditor. These changes have increased the number of procedures we undertake on a group audit.

The volume of work required has been steadily increasing and there is an element of catch-up in our fee increase. This is in line with other sectors where we are also agreeing increases to audit fees. Just by way of comparison, for an audit of the size/complexity of the Council, the corporate audit benchmark is a rate per hour of £100+. We estimate that the audit East Herts will take around 838 hours to deliver, which still equates to a lower rate per hour than the corporate benchmark.

Quality standards & compliance

In July 2016 the FRC set a new target for firms that 90% of FTSE350 audits inspected should require no more than limited improvements. In July 2019 the FRC extended the 90% quality target to all audits inspected and set a new target for audit firms, that for 2020/21 onwards, 100% of audits inspected should require no more than limited improvement. We see no difference between audits that are in scope for FRC review and those that are not. The FRC target has raised the bar considerably in terms of quality standards and compliance and this is reflected in the additional time and inputs to delivering audits, in particular, the time of senior members of the audit team including additional quality review in the form of:

- Pre-issuance review of the accounts – This also applies to an MLA or an audit with a higher risk profile. This will be a separate independent manager or above, with a high degree of technical financial reporting expertise and they will review the draft accounts and final account for compliance with the CIPFA Code. Since 2017 we have introduced a more comprehensive approach to involving the pre-issuance reviewer in the audit and mandated an approach to documentation.
- Hot reviews of audit quality – We have developed an Audit Quality Support Team (AQST) who carry out hot reviews of audit files to ensure that teams are meeting the quality standards we expect. The AQST input to the audit in real time, enabling teams to make any improvements before they reach the conclusion stage of the audit.
- Consultation on modifications to auditor reports – Since 2017 our consultation processes have increased in their rigour and thoroughness as council accounts and activities become more complex, leading to more potential modified auditor reports.
- Increase in infrastructure to support the audit practice – We have increased significantly the IT and people infrastructure to enable us to meet all the increased regulatory requirements. For example, we now have an online risk management tool that enables us to document all consultations, involve the right senior members of our professional practice directorate (PPD) and manage the consultation process effectively.

As a result of the FRC raising the bar our cost of compliance to maintain our licence to practice within local public audit, and as a firm within the profession, has doubled since 2017. I have outlined some of the changes above, but this also includes investment in firm-wide risk management, professional practice development and regular training to maintain our quality at the highest level as it currently is in the PSAA contract and to ensure it is sustainable in the future.

We strongly believe that audited bodies gain value from our high-quality standards and compliance. These arrangements enable our teams to ask better questions which drive finance teams to provide

better answers and ultimately, deliver greater assurance to your stakeholders in respect of your financial reporting requirements.

Need for specialist inputs

There is now an expectation that audit teams will use of specialists to address special audit considerations on the more judgemental and complex items disclosed in a council's accounts. For example, we now use specialists to support the audit team in the work on the valuation of property, the net pension liability and new ventures such as PFIs, joint ventures and groups.

We also use specialists to support our work on the value for money conclusion and since 2017, as council activities have become more commercial and riskier, this has included using specialists from our Forensics service line who bring extensive experience of due diligence, contracting, procurement and risk management.

All our specialists are experienced and trained in their area of expertise and increase the cost of the audit.

In my experience, our specialists add value to finance teams by highlighting the specific aspects of the subject matter that the finance teams themselves can use to challenge their own expert. For example, where we have used our specialist to challenge a valuer on an approach to valuing schools this has thrown up issues around land values, which finance teams have then used to challenge the valuer in the next year.

Recruitment and retention of staff

I've talked before about the pressure on auditors to consistently meet high quality standards and the flak they can get if things go wrong at audited bodies (the fear of the Public Accounts Committee!). For the local government audit market, the additional pressure of an unsustainable timetable for financial reporting and audit has undermined the ability of firms such as ours to retain experienced public sector specialists and invest in public sector specialist teams and skills for the longer term. To develop a sustainable specialist team requires sustained investment over a five to ten-year cycle, to recruit, train and develop sufficient staff. We and other firms in the sector face intense competition for the best people, with appropriate public sector skills, as a result of a shrinking resource pool. We need to remunerate our people appropriately to maintain the attractiveness of the profession, provide the highest performing audit teams and protect audit quality. We can only do this if we are being remunerated fairly for the work we do.

Our ability to invest in staffing also gives us the flexibility to make sure we can put together the right time at the right time for the specific audit need.

Your finance team benefits from our ability to provide you with a team trained and experienced in public sector audit and with a good understanding of local government finance. I know from experience that well trained and specialist auditors transfer their financial reporting knowledge to your teams, they provide insights into emerging issues and provide a sounding board on finding solutions to financial reporting problems.



Investment in technology and maximising its use

An element of PSAA tender requirements was the extent that suppliers would be innovative and forward thinking in their use of technology. Our PSAA bid was based on our ability to apply a digital audit. We have invested over £300 million to drive advancements in our suite of digital audit products, to help achieve more efficiencies to our audit approach. However, in our view the sector has failed to invest in digital and IT systems and therefore are unable to meet the standards required of an increasingly data-driven audit. This has led to increasing costs to deliver some of our audits which were not reflected in our bids for PSAA contracts. Your finance team has embraced the EY Client Portal and tends to service our request for data to enable use of analytics generally well.

The finance team benefits from our ongoing investment in technology as it reduces the time they need to spend dealing with audit queries and auditors. They have embraced the EY Client Portal as it has reduced some of the burden of providing supporting working papers to the accounts. They are also now familiar with our use of data analytics and incorporate our data needs into their closedown plans. We continue to develop our technical capabilities and are now using bots to undertake reviews of pdf invoices for example. Unfortunately, we are not able to implement our capabilities as fast as we had assumed in our response to the original ITT.

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