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External audit reports
The role of the audit committee

Introduction

This paper is intended to support audit committee members when they scrutinise and challenge the effectiveness of their organisations' arrangements to manage finances and secure value for money (VFM).

In the context of ongoing financial pressures and change in the NHS, the need for strong financial and governance arrangements is particularly important. The audit committee has a crucial role in scrutinising these arrangements. Auditors provide a key independent source of information for audit committee members, and the public, in determining and reporting on the financial statements, VFM arrangements and other matters.

As reported in the recent National Audit Office (NAO) report, *Local auditor reporting in England*[1], there has been in an increase over recent years in the number of audit reports containing qualified conclusions on VFM arrangements and an increase in qualified clinical commissioning group (CCG) regularity opinions. As recommended in the NAO report, 'local public bodes should take prompt and effective action in response to weakness in arrangements to secure VFM. This includes effective scrutiny and challenge by those charged with governance to hold the executive to account'[1].

By providing an overview of external auditor reports and auditors' additional powers and duties, this short paper aims to be a helpful reference guide to support audit committee members.

[1] NAO, *Local auditor reporting in England 2018*, January 2019

Responsibilities of audit committees

There is a statutory requirement for every NHS organisation to have an audit committee to 'support the board and accounting officer by reviewing the comprehensiveness and reliability of assurances on governance, risk management, the control environment and the integrity of financial statements'[2].

The audit committee performs a crucial role in the governance of NHS organisations, with members responsible for scrutinising the risks and controls affecting the business. The committee must 'ensure that the organisation operates effectively and meets its statutory and strategic objectives and provides assurance that this is the case'[3].

There are a number of documents produced by NHS organisations setting out how they have managed their resources – a key one being the annual report and accounts. This presents the story of the organisation's activities during the previous financial year. The accounts present the financial position and performance while the annual report sets out what the organisation has done, and is doing, in order to meet its objectives and to demonstrate that it is adding value to its members, patients, public and other stakeholders. The form and content of the annual report and accounts must meet specific requirements. For NHS trusts and CCGs the requirements are set out in the Department of Health and Social Care's *Group accounting manual*[4]. Foundation trusts must meet the requirements set out in the *NHS foundation trust annual reporting manual*[5].

The annual report and accounts include the governance statement. This statement focuses on the stewardship of the organisation and draws together evidence on governance, risk management and control. It sets out how the accounting officer discharged his/ her responsibility to maintain a sound system of internal control, explaining how the board, audit committee and other board committees charged with governance responsibilities work, as well as declaring significant internal control issues affecting the organisation.

The audit committee is required to review the draft annual report and accounts before it is submitted to the board for scrutiny and approval. Audit committees are encouraged to review the financial position and governance issues throughout the year, not only at year-end. Further guidance is provided in the HFMA briefing *How to review and scrutinise the numbers during the year*[6].

Auditors' responsibilities

Auditors are central to the audit committee's role as they provide both assurance and insight into the management arrangements within the organisation. Throughout the year internal and external audit provide a number of reports, which audit committee members can draw from. This briefing focuses on those provided by external audit.

The *Local Audit and Accountability Act* 2014[7] (the Act) sets out the framework for local external audit for local authorities and NHS bodies in England. As required by the Act, the Comptroller and Auditor General must prepare a *Code of audit practice*[8] (the Code) setting out what auditors are required to do to meet their statutory responsibilities. In accordance with the Code, and its associated guidance[9], auditors provide independent assurance that local bodies are spending and accounting for public money properly.

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[2] HM Treasury, *Audit committee handbook*, April 2016
[3] HFMA, *NHS audit committee handbook*, March 2018
[4] Department of Health and Social Care, *Group accounting manual 2018/19*, December 2018
[5] NHS Improvement, *NHS foundation trust annual reporting manual*, February 2019
[6] HFMA, *How to review and scrutinise the numbers during the year*, October 2017
[7] *Local Audit and Accountability Act,* 2014
[8] NAO, *Code of audit practice*, April 2015
[9] NAO, *Guidance and information for auditors*, various dates

As well as complying with the Code, auditors also have to meet the requirements of the International Standards of Auditing (ISAs)[10]. As set out in the ISAs, the external auditor is required to produce a number of reports such as: the audit plan; a report to those charged with governance; audit report(s); the annual audit letter; and the audit completion certificate.

The **audit plan** covers both the work on the audit of the financial statements and arrangements to secure VFM. It sets out the auditor's view of significant risks at the start of the year. It should facilitate timely discussions between the auditor, management and those charged with governance. The auditor will keep the audit plan under review, providing updates throughout the year, and therefore support committee members to provide ongoing scrutiny and challenge.

The **report to those charged with governance** (the ISA 260 report) sets out findings from external audit work and aims to ensure that those charged with governance are aware of, and have considered, any issues arising from the audit before approving and adopting the annual report and accounts. There is no requirement to publish this report - it is up to the local organisation to determine whether it wishes to publish its audit committee papers, including the report to those charged with governance.

Before the auditor signs the audit report, they will ask those charged with governance to review and discuss a **letter of representation** signed by the accountable officer. In some cases, the chair of the audit committee will also sign the letter representing those charged with governance. This is a formal letter to the auditors covering matters the auditors want confirmation on such as:

- areas where those charged with governance or management have had to make a judgment
- that the representations made by management are accurate and reasonable
- that those charged with governance agree that errors identified by the auditors should be adjusted in the accounts or left unadjusted.

The **annual audit letter** also sets out the audit findings. As set out in the *Group accounting manual*[4], the annual audit letter must be made public. Many foundation trusts are not provided with an annual audit letter, with reporting obligations met through issuing the enhanced audit report which is publicly available. However, where one is issued, it should be made publicly available.

The **audit completion certificate** 'closes' the audit for the audit period covered, confirming that the audit has been completed in accordance with the Code[8] and marking the point when the auditor's responsibilities have been discharged.

External audit reports

At the completion of the audit, the auditor will issue an audit report which covers the opinions and conclusions set out in **exhibit 1**. If the auditor's report contains a qualified opinion or conclusion, then it is a 'non-standard' report.

'Materiality' and 'significance' are key terms referred to in external audit reports. An item is considered to be material if, individually or in aggregate, it could reasonably be expected to influence the economic decisions of users, if those decisions are made based on the contents of the financial statements. Materiality is based on the auditor's professional judgement which will take into account the size and nature of the items, as well as surrounding circumstances.

As set out in the Code, the concept of 'significance' applies to the auditor's wider responsibilities that are not addressed by the auditor's assessment of materiality for the audit of the financial statements. A matter is significant if, in the auditor's professional view, it is reasonable to conclude that the matter would be of interest to the audited body or the wider public'[8].

[10] Financial Reporting Council, *2016 auditing standards*, June 2016

Exhibit 1: External audit opinions and conclusion

Opinion on the financial statements

Auditors give an opinion on whether the financial statements are prepared properly, free from material error and give a 'true and fair' view of the organisation's financial position. The opinion is qualified if the auditor disagrees with an item's accounting treatment or has been unable to obtain sufficient supporting evidence. An unqualified opinion is often called a clean opinion.

There are different types of qualified opinions depending on the impact of the issue in question on the financial statements. Qualifications can be issued as 'except' for opinion based on limitation of scope or disagreement; an adverse opinion or a disclaimer of opinion.

In giving the opinion, specific reporting is required for the following:

- an **emphasis of matter** is used when auditors need to draw attention to a particular aspect of the accounts, but which does not affect their true and fair opinion
- From 2017/18 auditors report any going concern issues **as a material uncertainty relating to going concern**, rather than previously as an emphasis of matter. This will include fulfilling the requirement to report where the auditor has concerns about the organisation preparing its financial statements on a 'going concern' basis i.e. it can reasonably expect to continue to function for the foreseeable future, usually regarded as at least the next 12 months.

In 2017/18, no NHS organisation received a qualified opinion on its financial statements. For 18% of organisations (79 trusts and 1 CCG), a material uncertainty relating to going concern was reported. For 1% of organisations (4), an emphasis of matter was included on the basis that the body would cease to exist the following year, due to reorganisation[1]. It has been many years since a qualified opinion has been given on a local NHS organisation's financial statements. Usually any issues identified by the auditor likely to result in a qualification, are amended prior to the completion of the audit.

Opinion on regularity (CCGs only)

Auditors give an opinion on whether or not a CCG's income and expenditure is in accordance with laws and regulations. The regularity opinion is qualified if a CCG overspends against its financial spending limit or incurs unlawful expenditure. If the regularity opinion is qualified, the governance statement and the accountable officer's statement should also refer to the issue that caused the qualification.

In 2017/18, 39% of CCGs received a qualified opinion on the regularity of their statements. These were all in relation to the failure to meet expenditure limits[1].

Conclusion on the arrangements to secure value for money in the use of resources

Auditors give a conclusion on whether or not arrangements are in place to secure value for money. If auditors are not satisfied that proper arrangements are in place, the qualified conclusion will either be issued on an 'except for' or an 'adverse' basis:

- **Except for** conclusions relate to weaknesses in arrangements in specific areas, such as poor financial planning or failure to manage a significant contract properly
- **Adverse** conclusions relate to weaknesses so widespread or extensive in their impact that the auditor is not satisfied that proper arrangements are in place, such as where financial planning failures are so significant that the organisation is in severe financial difficulty, or there are serious weaknesses in the quality of key services.[1]

In 2017/18, 38% of NHS bodies received a qualified conclusion on arrangements to secure value for money. Of those, 72% were 'except for' qualifications and 28% were 'adverse' qualifications. The majority of the qualified conclusions were due to financial performance and financial sustainability issues[1].

External audit additional reporting powers

External auditors also have a range of statutory powers to issue reports or recommendations that require NHS organisations to publicly consider the matters reported to them and publish their response (**exhibit 2**). These additional powers are important tools for the auditor and enable him/ her to bring attention to issues and ensure prompt action.

Exhibit 2: External audit additional powers and duties

Public interest report

(*Section 24, Schedule 7(1)(1) Local Audit and Accountability Act 2014)* for NHS trusts and CCGs *and Schedule 10(3) National Health Service Act 2006* for foundation trusts*)*

Addressed to the public, a public interest report is issued when the external auditor considers there is a matter which they need to draw explicitly to the public's attention. They can be published at any time. The public interest report imposes additional requirements on the organisation, including holding a public meeting to consider the report and publishing a formal response. Public interest reports can be made at any time throughout the year.

Statutory recommendation (not applicable to foundation trusts)

(Section 24, Schedule 7(2) Local Audit and Accountability Act 2014)

Addressed to the NHS trust or CCG, a statutory recommendation is issued when the external auditor needs to make a formal recommendation to take action. The action required will be about issues such as failing to deliver planned cost savings or failure to address weaknesses highlighted by independent reviews. Recommendations require formal, public consideration and response. They are often referred to as Schedule 7 recommendations. A statutory recommendation can be made at any time during the year.

Section 30 referral (not applicable to foundation trusts)

(Section 30 Local Audit and Accountability Act 2014)

Addressed to the Secretary of State, the auditor is legally required to make a section 30 referral where the organisation is about to, or has entered into, a transaction that the auditor believes is unlawful. For example, a CCG exceeding its expenditure limit[11] or an NHS trust failing to meet the break-even duty[12].

In 2017/18, a number of section 30 referrals were issued, with 42% of CCGs referred because they had exceeded their expenditure limits and 50% of NHS trusts referred for failure to meet the break-even duty[1].

Schedule 10 referral (only applicable to foundation trusts)

(Schedule 10(6) National Health Service Act 2006)

Addressed to the regulator, a section 10 referral is legally required when an NHS foundation trust is about to make a decision or enter into a transaction that the auditor believes would be unlawful.[1]

Auditors follow an integrated audit approach. What they find in one part of the audit will inform the different elements of the audit report. There are links between additional reporting powers and the opinons given by the auditor. For example, if a CCG breaches its expenditure limits, it will be referred to the Secretary of State as a section 30 referral and receive a qualified regularity opinion. The auditor will also consider the impact on the VFM conclusion.

[11] Department of Health and Social Care, *DHSC group accounting manual 2018 to 2019 Chapter 2: CCG appendix*, December 2018
[12] NHS Improvement, *Statutory breakeven duty: a guide for NHS trusts*, April 2018

Acting on audit reports

A non-standard report from the external auditor is a public, independent warning sign that that must be taken seriously and acted upon. This is an important role of the audit committee in the stewardship of taxpayers' funds. This is echoed in the findings and recommendations of the NAO report on local auditor reporting[1] and the recent Public Accounts Committee report recommending that 'Departments should set out, by the end of September 2019, clear expectations of how local bodies should respond to weaknesses reported by local auditors in 2018/19, including the potential consequences for local bodies who fail to improve'[13].

As highlighted in the NAO report, 'a significant proportion of local bodies may not fully understand the main purpose of the auditor's conclusion on arrangements to secure value for money and the importance of addressing those issues'[1] with half of bodies saying the auditor's report is not bringing new issues to local public bodies attention. The NAO points out this is not the aim of the audit report, with its primary function being to provide assurance to the public. The organisation, through the audit committee, should be well informed of issues and assurances throughout the year by management, internal and external audit.

Where issues are communicated by auditors - during the year for example through audit planning reports, as part of a qualification or by audit recommendations - audit committee members must ask themselves whether they are providing appropriate challenge on actions taken by the organisation to address the issues. To do this, they need to:

a) understand the audit risks and qualification and consider whether it is consistent with their understanding of the organisation
b) review current and proposed actions being taken to address the issue(s)
c) follow up and challenge on an ongoing basis whether agreed actions are being undertaken and are sufficient.

The NHS long term plan commits to 'reducing year-on-year the number of trusts and CCGs individually in deficit, so that all NHS organisations are in balance by 2023/24'[14]. It also sets a clear expectation that a collaborative approach should be used to achieve it. The scale of the challenge should not be underestimated. Audit committee members have an important role in seeking assurances and providing challenge on plans, they should also understand how their organisation fits into the wider system position. Auditors only report on individual statutory bodies, therefore it is important that the audit committee looks at how it is getting assurance in areas not covered by local audit, such as how partnerships are held to account for joint decisions.

Conclusion

Audit committees have a number of key responsibilities and to ensure these are fulfilled effectively, members need to make use of all sources of information available, including reports from management and auditors.

This paper explains the different audit reports and how they relate to each other. Committee members must ensure that they have the time and skills to fully understand audit reports so that they are in a position to scrutinise and challenge actions being taken to address issues the being raised. Although a number of key reports are provided at the year-end, issues being raised at that point should not be a surprise. The audit committee also has an important role in ensuring that issues regarding the body are reported in a transparent way.

In the current financial climate, reflected in an increasing number of qualifications, the audit committee role to oversee strong financial and governance arrangements is as vital as ever.

[13] House of Commons Committee of Public Accounts, *Auditing local government*, March 2019
[14] NHS, *The NHS long term plan*, January 2019