HFMA briefing
August 2022

The NHS external audit market

An update on current issues

Introduction

Over recent years we have increasingly heard from our members that they are finding it difficult to appoint an external auditor, with little or no interest being shown in invitations to tender for external audit services. Some members have also reported that their auditor has resigned or has declined to extend the current audit contract.

There are many complex and intertwined factors leading to the issues in the NHS external audit market, with similar issues being reported in local government. HFMA's briefing in February 2021, *The NHS audit market: current issues and possible solutions*[1] explored these issues and covered the tendering process, audit interest, risk, capacity and fees. Issues have also been highlighted for members in a series of blogs including: *Targeting sustainable external audit*[2] and *Year-end audit: targeting a smooth operation*.[3]

The public sector external audit market remains an area of significant concern, with some commenting that it is approaching crisis point. In May 2022, 61 finance directors and chief finance officers in England responded to a short HFMA survey to help establish a picture of the latest position on external audit appointments, and in particular any difficulties in audit procurement.

This short briefing provides a reminder of the key issues in the external audit market and sets out the results of the survey. It also includes an update on national plans, along with local good practice actions that can be taken in the short term.

Key issues in the NHS external audit market

External audit is a statutory requirement and an essential part of the process of accountability for public money, providing an independent review of the financial statements and value for money arrangements (VFM) in place.

There are concerns however, both in the NHS and wider public sector in England, that a lack of those responding to tenders for external audit market contracts is impacting on choice, delivery and cost. With the combination of an unattractive audit market, a lack of auditors with key audit partner status necessary for NHS audits and the inability of government to mandate that an audit firm takes on an audit, there is an increasing risk that a situation will arise where an NHS organisation is unable to appoint an external auditor.

The main issues leading to this lack of interest in delivering public sector audit are explored in detail in HFMA's 2021 briefing, *The NHS audit market: current issues and possible solutions*[1] and are summarised below.

Audit risk

There is now significantly greater regulatory pressure from the Financial Reporting Council (FRC) on audit firms to deliver higher quality audits and to demonstrate much greater professional scepticism. With the increased expectations regarding quality, audit firms face an increase in both reputational risk and the potential for significant fines. They need to consider the risk of local audit to the firm overall, and its opportunity cost compared to delivering other services.

NHS financial constraints, reorganisations and increasingly complex arrangements (such as NHS subsidiaries and collaboratives) create more complex accounting and reporting arrangements which lead to increased audit risk that auditors must consider in accordance with international accounting and auditing standards. The NHS funding regime with the requirement to achieve annual targets along with funding, often made available late in the financial year, that has to be spent in that year increases the risk of financial reporting manipulation. Consequently, this is an area the firms and their regulators are particularly interested in.

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[1] HFMA, *The NHS external audit market: current issues and possible solutions*, February 2021
[2] HFMA, *Targeting sustainable external audit*, March 2021
[3] HFMA, *Year-end audit: targeting a smooth operation*, April 2022

NHS bodies also have a very high public profile given the nature of their operations – so there are heightened reputational risks. The audit scope is also wider including VFM commentary, regularity opinions (for some types of NHS organisations) and enhanced statutory reporting powers in the public sector[4].

The level of audit risk increases the amount of audit testing required, as well as the level and depth of internal quality checks, and therefore impacts on both the fee and relative attractiveness of the engagement.

Auditor capacity

As a profession, there is a capacity challenge for external auditors which goes beyond public sector audit and there are competing demands on staff within the audit firms.

The increased risk and associated amount of audit work required impacts on the already short supply of auditors. The shortage of supply in the public sector is due to a range of factors:

- **Small pool of public sector auditors**: local public audit is a specialised job and firms, as well as individual audit partners, need to be registered to undertake local audits.
- **Requirement to separate external audit and non-audit services**: this has a particular impact on NHS audits as the separation of external audit and non-audit (for example, internal audit, cybersecurity and consultancy) teams means there is lower capacity in the firms where their model was previously to have a team doing both activities.
- **Independence considerations:** there is a limited scope to do non-audit work for NHS bodies given the independence rules, so firms need to make a choice between audit and non-audit services. With increasing procurement on a system basis for non-audit services, this can affect which audits are attractive.
- **Tight and competing audit deadlines:** the window to complete audits of NHS financial statements is tight (particularly compared to the nine months after year end allowed for commercial audits) and the same staff often need to complete local government, not for profit and education audits too, increasing pressure on auditors and squeezing capacity.
- **Inability to forward plan:** compared to the information provided by the local government joint procurement approach, in the NHS there is no central record of when audits will be due for retender, or their current audit fee level, making it more difficult for firms to plan future resource requirements.
- **Value:** not all preparers of accounts think the audit is adding value and therefore from an audit perspective, recruitment and retention issues arise as public sector audit is perceived as more challenging, undervalued and less beneficial to an individual's career progression.

Some of the capacity mitigations available to firms for corporate audit are not available for public sector, such as using overseas staff remotely, either because of restrictions built into public sector framework contracts around data leaving the UK, or because of the specialist nature of the work making it more difficult to utilise staff without relevant industry experience.

Fee levels

The increasing audit regulatory risk, workload and lack of competition for tenders is pushing audit fee levels up in the external audit market – in both the private and public sector. The need for firms to invest in their quality arrangements to respond to changes in expectation, increased work from changes in auditing standards, the impact of new flexible working arrangements on time taken to deliver audits, the ring fencing of audit practices and the increasing expectation on the work performed by specialists are all leading to increased costs. This leads to greater pressure on NHS finance directors tasked with keeping costs down.

NHS audit fees cannot be seen in isolation. Fees relative to the corporate sector have been historically low. As well as commercial audits being generally more profitable, it is also expected that local government audit fees will increase as part of the current joint procurement exercise. Combined with current high levels of inflation, this will increase upward pressure on NHS audit fee levels, particularly if NHS bodies do not want to be priced out of a limited market.

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[4] HFMA, *External audit reports: the role of the audit committee*, February 2022

Audit tendering process

The tender process itself can impact on the level of interest in an audit. There are a number of examples in which it seems that audit committee chairs and senior finance team members have not been sufficiently involved in the procurement process to ensure appropriately tailored tender documentation and process.

Inclusion of non-relevant items in tender documentation, high weighting given to cost rather than quality and inappropriate terms and conditions can all indicate a lack of understanding of and value given to the external audit and may deter bidders, especially in the current market. Likewise, a tight timescale to complete the tender, particularly during peak audit times, or insufficient time between the tender and audit start date does not allow appropriate time for staff planning and orderly handover.

HFMA survey results

In May 2022, the HFMA surveyed finance directors and chief finance officers about their experiences of the external audit market. Some 61 responses were received from across England. Of these, 51% were from NHS foundation trusts, 21% from NHS trusts and 20% from clinical commissioning groups (CCGs). The remaining 8% included integrated care board (ICB) designates and subsidiary companies.

The survey covered: external audit contracts in place; views on the ability to appoint an external auditor; relationships with auditors; the external audit procurement process; CCG part year-accounts; and suggestions on how to resolve issues. The key messages from the survey are set out in **figure 1**.

Figure 1: Key messages from the HFMA survey on NHS external audit appointments

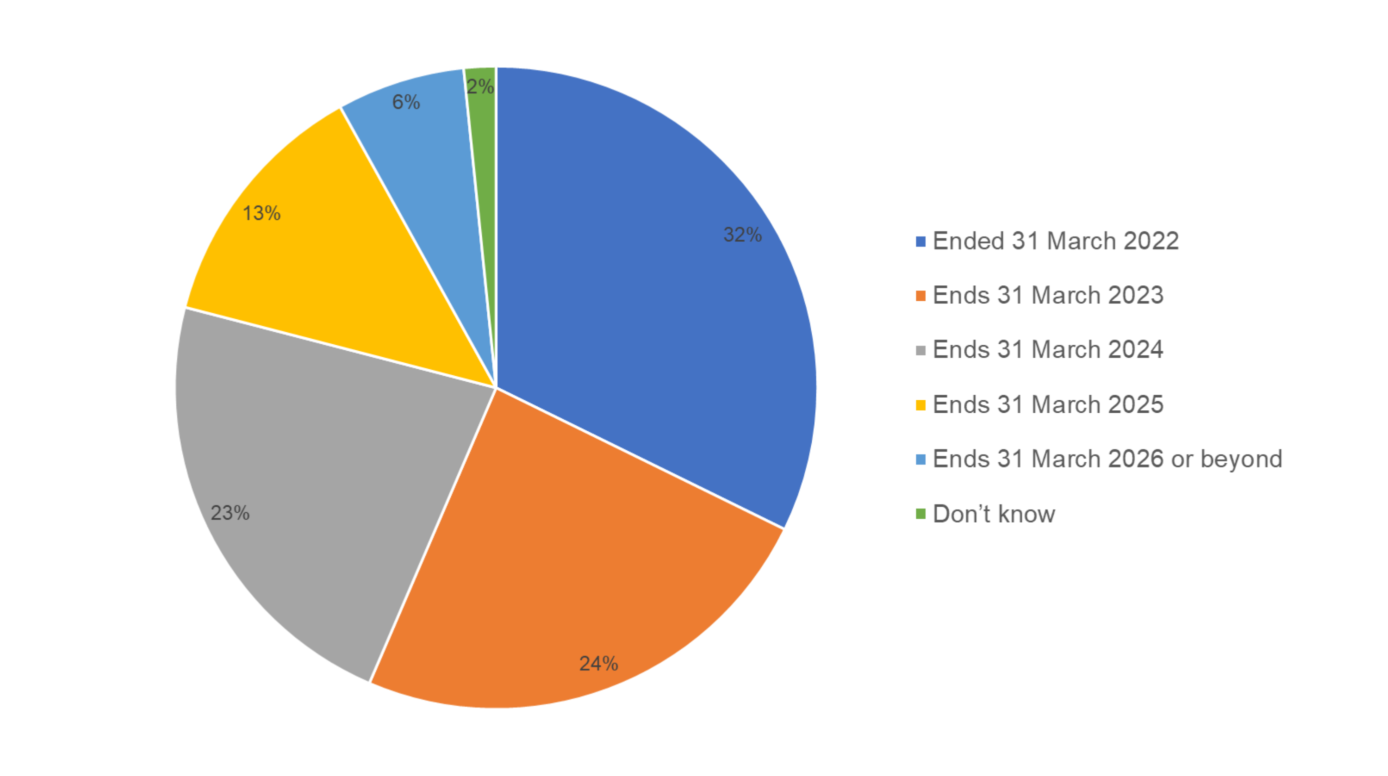
- 68% of respondents had significant or some concerns about their ability to appoint an external auditor in the future.
- For 32% of respondents, their organisation's external audit contract ended on 31 March 2022. Of these, six respondents (11%) stated that no new contract was yet in place, although based on comments four of these are finalising arrangements.
- Contracts are due to end 31 March 2023 for 23% of respondents and by 31 March 2024 for a further 25%.
- 46% of respondents were clear on the external audit arrangements of the CCG 2022/23 part-year accounts.
- 98% of respondents rated the quality of their relationship with their external auditor as excellent or good.
- 92% of respondents felt their relationship with their auditor was about the same as recent years or had improved.

External audit contracts in place

As shown in **figure 2**, for 32% of respondents, their organisation's external audit contract ended on 31 March 2022. Contracts are due to end on 31 March 2023 and 31 March 2024 for a further 23% and 25% of respondents respectively. 19% have contracts in place that end on 31 March 2025 or beyond.

Of those with contracts that ended on 31 March 2022, six respondents (11%) stated that no new contract was yet in place (three CCGs and three trusts/ foundation trusts). Based on the comments provided, two of the trusts were currently carrying out a tender process and one trust was due to issue the invite to tender in summer 2022. Two of the CCGs were finalising discussions with their incumbent auditor and one CCG provided no further details.

Figure 2: When does your external audit contract end?



Views on the ability to appoint an external auditor

Some 29% of respondents had significant concerns about their organisation's ability to appoint an external auditor in the future and a further 39% had some concerns. The remaining 32% had no concerns.

Respondents' comments reflect the problems set out in the key issues section above. Numerous comments from respondents reflected a poor response from their market engagement, with many reporting only receiving one bid. Respondents also noted a concern over the increase in audit fees.

Relationships with auditors

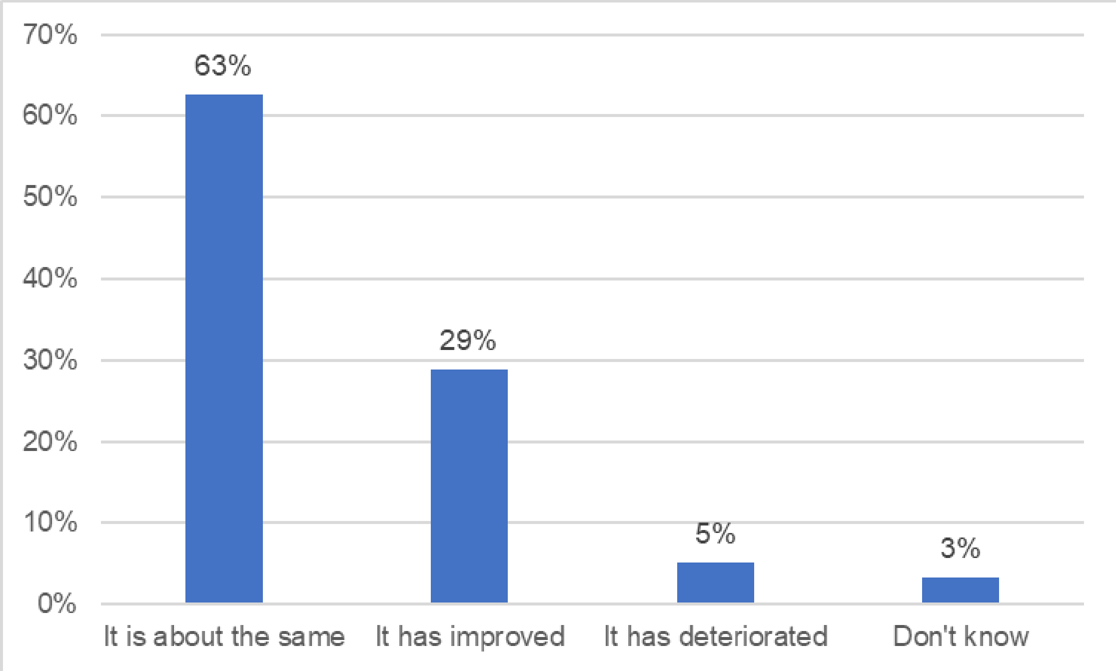
Some 48% of respondents rate the quality of their relationship with their external auditor as excellent and a further 50% as good. Only one respondent rated the quality of the relationship as fair and none as poor. Two respondents did not provide a rating. As set out in **figure 3**, only 5% of respondents felt their audit relationship had deteriorated in recent years.

It is worth noting that this survey was completed before completion of the 2021/22 annual audit. Feedback suggests that this was a particularly difficult year with increasing tension between auditors and finance teams. Reasons cited include issues such as capacity, continuity, sickness and remote working, as well as process issues such as greater audit sampling, late queries and finance teams not motivated to make audit adjustments. This will be explored further in HFMA's year-end survey[5].

Comments from respondents reflected on the importance of building relationships over time and learning lessons from the audit experience. A number of comments also noted an increase in tension due to missed deadlines and a lack of face-to-face interaction.

[5] HFMA, *Year-end accounts: not such a quiet year*, August 2022

Figure 3: How has your relationship with your auditor changed over recent years?



The external audit procurement process

Finance directors and chief finance officers who had recent experience of the external audit procurement process, were asked to share their experiences in the survey. The key issues arising were a lack of interest and increase in audit fees, reflecting a significant market shift in the last two to three years.

Of the 47 respondents who commented, over half (55%) referred to limited interest from firms to bid for their audit contract. Many of those commented that they only received one bid, usually the incumbent auditor, and in two cases no bids were received. 15% commented on a significant increase in the audit cost, with one respondent noting their audit fee had doubled.

CCG part year-accounts

With the Health and Care Act 2022 leading to the establishment of ICBs from 1 July 2022 and demise of CCGs from 30 June 2022, each CCG will be required to have a full audit of a part-year set of accounts.

The audit of the final three-month CCG accounts adds pressure to both the finance team in preparing the accounts and the audit team in finding capacity to resource an additional audit. The majority of audit firms will usually move straight on from auditing NHS accounts to local government accounts and therefore will plan to complete the audit of the three-month CCG accounts at the same time as the audit of the nine month ICB accounts, leaving a large time gap between preparation and audit. The amount of additional work should not be underestimated. CCG balance sheets will remain the same size, but materiality levels based on expenditure will reduce significantly, potentially bringing more balances within materiality thresholds and therefore leading to increases in testing requirements. Each part year audit is likely to take a similar time to a full year audit, with only modest efficiency savings in relation to planning and delivery.

Some 13 chief finance officers responded to the question on whether they were clear on arrangements for the external audit of the CCG 2022/23 part-year accounts. 54% were clear on the arrangements; 31% were partly clear; and 15% were not clear. Since the survey was completed in May 2022, NHS England has held updates for chief finance officers including the opportunity to ask questions.

Suggestions to resolve audit market issues

When asked for suggestions on how to resolve the issues in this area (both short and longer term), respondents comments focused on the following key areas:

- **Cost:** audit fees will need to increase in order to have a viable market.
- **Understanding regulation:** clear communication and appreciation of the level of work required by auditors to meet their regulatory requirements would help to reduce tension.
- **National framework:** a number of respondents felt a national framework, such as that overseen by the Audit Commission or Audit Reporting and Governance Authority (ARGA), should be in place to oversee the audit appointment process, fees and quality.
- **New entrants:** to help address the audit capacity issues, measures or support mechanisms could be put in place to support medium size audit firms step into the market – working with them to identify and overcome barriers to entry and build capacity would help.
- **Conflicts of interest:** respondents felt clarification was needed on potential conflicts of interest when auditing an ICB and providing consultancy within the ICS providers.
- **Streamlining accounts:** to make the NHS accounts clearer and simpler for all stakeholders including auditors.
- **Procurement arrangements:** advice from one finance director recently involved in audit procurement included:
    - give the auditors plenty of time to respond
    - send out an informal notification in good time that an exercise will be done
    - ensure someone with a good understanding of the audit is involved to make the specification sufficiently detailed and relevant to allow respondents to understand their key criteria in appointing the auditor
    - give them an understanding of the tricky areas of your own business so that there is honesty on both sides.
- **ICS tendering:** there could be advantages in all ICS bodies tendering for external audit services at the same time. There would potentially be a more attractive bundle of work and would result in the exclusion of only one firm from consultancy in the area. However, it may also be difficult for one firm to resource the larger audit in the area and existing conflicts of interest in an area will need to be resolved.

National developments

The NHS audit market cannot be viewed in isolation. The same auditors often complete NHS, local government, housing, education and charity audits; and the issues faced span much of the public and third sector.

The audit timeframes are interlinked. In 2020/21, just 9% of local government audits were completed by the deadline of 30 September 2021[6] and a large proportion of these remain ongoing (40% of opinions for 2020/21 local government bodies had not been issued at the end of July 2022). This has implications for the interim and end of year NHS audits. The NHS audit timing, including CCG part-year accounts likewise has an impact on the audit of local government and other public sector audits.

In local government, Public Sector Audit Appointments Limited (PSAA) is responsible for appointing an auditor and setting scale fees for those authorities that have chosen to opt into the national scheme. However, while this approach ensures opted-in bodies have an auditor (so avoids local procurement), it does not resolve the issues in delivery of audit as demonstrated by the large proportion of audits not completed by the audit deadline noted above. The PSAA is currently undertaking its procurement exercise for 99% of the eligible bodies that opted into its appointment scheme for the next five-year appointing period which begins 1 April 2023.[7]

In December 2021, the Department of Levelling Up, Housing and Communities (DLUHC) published its package of measures to support the improved timeliness of local government audits. This included a number of measures such as moving the audit deadline to 30 November

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[6] ICAEW, *Local authority audit hits breaking point as 91% miss deadline*, October 2021
[7] PSAA, *Appointing period 2023/24 – 2027/28*, website extract July 2022

for 2021/22 and to 30 September for the following six years and a proposal for the ARGA (the new body due to be established to replace the FRC) to take on a systems leader role for local audit. In February 2022, the House of Commons' Public Accounts Committee (PAC) stated it 'welcomes the measures that DLUHC set out to address audit delays but noted that these will take time to implement'. It also raised concerns that DLUHC had yet to set out a detailed plan or timetable to address the crisis, and that its response to the recommendations in the PAC report on local auditor reporting 'lacked detail'.[8]

In May 2022, DLUHC published its response the *Local audit framework: technical consultation*[9] and set out a series of measures to strengthen the local audit framework. These included confirmation that ARGA will become the system leader for both local government and health audits. The response provides details about how the government intends ARGA to operate as the local audit system leader including:

- ARGA will have a specific objective 'to ensure the local audit system operates effectively'
- responsibility for setting the *Code of audit practice* will transfer over from the National Audit Office
- a board member will be recruited with specific responsibility for the local audit unit
- ARGA will be tasked with producing an annual report on its activities as system leader and the findings from local audits
- the system leader will be funded directly by the DLUHC.

A shadow system leader arrangement at the FRC will start from September 2022 until ARGA is legally established. A director of local audit has been appointed and is due to take up the post in September 2022. Further detail is yet to be provided on how this shadow arrangement will operate and what the impact will be on the NHS.

Local good practice

National changes to improve the situation will take time to have an impact. The significant reduction in audits as the NHS moves from 106 CCGs to 42 ICBs presents an opportunity to relieve the pressure, but this will not be realised until the 2023/24 audit year. ICBs will bring other issues such as increased potential for registered audit firms to have conflicts of interest arising due to audit firm's relationships with other bodies within the system.

The move to ICBs also provides an opportunity for audit firms and the sector together to explore options to create a vision for what the future of the market looks like and agree a strategy.

A reminder of the immediate practical actions that can be taken to make the audit appointment process as smooth as possible within the current framework is helpful. These are explored in detail in HFMA's 2021 briefing[1] and focus on:

- understanding the competing pressures faced by all parties involved
- establishing clear arrangements for effective working relationships throughout the audit
- ensuring senior finance executives and audit committee members are involved in the tender specification and ensuring that tenders are issued in a timely manner (with discussions starting ideally two years in advance of the start of the audit year)
- valuing the work of the auditor and ensuring finance directors are involved throughout the year, but particularly during the audit
- considering accounting and audit implications as part of the risk assessment when establishing new or complex arrangements.

Based on feedback from auditors, finance professionals and non-executive directors (NEDs), delivering a quality audit to time, as well as ensuring the experience is as painless as possible for all involved, requires ongoing planning, continuous communication and understanding of the pressures faced by all. The HFMA's briefings, *The external audit: best practice in working well together*[10] and *Year-end working papers: a good practice guide*[11] aim to provide further support by sharing good practice examples.

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[8] ICAEW, *PAC: Government not addressing local audit crisis with 'sufficient urgency'*, February 2022
[9] DLUHC, *Local audit framework: technical consultation*, May 2022
[10] HFMA, *The external audit: best practice in working well together*, February 2022
[11] HFMA, *Year-end working papers: a good practice guide*, February 2022

Conclusion

Current issues in the external audit market continue to mount. In particular, regulatory pressure on audit firms and increased level of work is impacting on already tight audit capacity and audit fees. Initial feedback from a number of our members on the 2021/22 statutory audits is that it has been a particularly difficult year, with finance teams and auditors at stretching point. Some auditors have reported concerns about the quality of NHS accounts and working papers. We will be conducting a year-end survey to collect feedback and inform discussions about what needs to be done.

Some audit firms have made it clear that the national desire to move timelines forward to enable the Departmental accounts to be signed off before the summer recess may lead to partial withdrawal from the audit market.

There are opportunities to alleviate pressure on the market with the reduction in number of NHS audits due to the changes brought about by the Health and Care Act, as well as plans being put in place for ARGA to become the system leader covering both local government and health. However, these will take time to pay dividends.

Ultimately, if public sector audit continues to be undervalued, less profitable than alternative sectors, time pressured and high risk, then there is the real danger that firms will choose to withdraw from the NHS market.

About the HFMA

The Healthcare Financial Management Association (HFMA) is the professional body for finance staff in healthcare. For over 70 years, it has provided independent and objective advice to its members and the wider healthcare community. It is a charitable organisation that promotes best practice and innovation in financial management and governance across the UK health economy through its local and national networks.

The association also analyses and responds to national policy and aims to exert influence in shaping the wider healthcare agenda. It has particular interest in promoting the highest professional standards in financial management and governance and is keen to work with other organisations to promote approaches that really are 'fit for purpose' and effective.

The HFMA offers a range of qualifications in healthcare business and finance at undergraduate and postgraduate level and can provide a route to an MBA in healthcare finance. The qualifications are delivered through HFMA's Academy which was launched in 2017 and has already established strong learner and alumni networks.

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