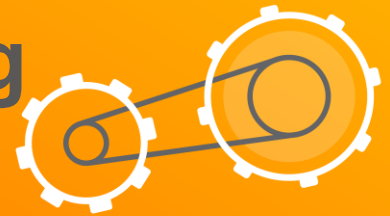




The external audit: best practice in working well together



Introduction

The annual external audit is not only a key statutory requirement for NHS organisations, but should provide important and valuable insight into the financial governance of the organisation. The audit process itself can be a challenging one for all involved with tight timelines and complex issues to resolve.

The recent NHS England and Improvement audit and assurance guidance¹ reminds NHS organisations that it is their responsibility to ensure that a quality audited annual report and accounts is prepared and submitted by the set deadlines. It emphasises that to achieve this will require working with the external auditor.

As the current year-end approaches, it is helpful to reflect on previous years' positive and negative experiences to plan for an audit that runs as smoothly as possible. This briefing aims to support members by summarising the current audit context and sharing top tips from those involved.

¹ NHS England and Improvement, *Audit and Assurance – a guide to governance*, December 2019

Background

All trusts, foundation trusts and CCGs are required to produce a set of financial statements, have them audited, and publish them as part of their annual report and accounts. All NHS bodies are required to prepare their annual report and accounts in accordance with the *Group accounting manual* (GAM)² issued by the Department of Health and Social Care (DHSC). The only exception is that foundation trusts prepare their annual report in accordance with the *Foundation trust annual reporting manual* (FT ARM)³. The annual report and accounts must be prepared and audited in line with the DHSC timetable⁴.

As well as the annual report and accounts, it is management's responsibility to ensure summarisation schedules are prepared and audited in accordance with the timetable. Summarisation schedules are the method of collecting accounts data by DHSC, NHS Improvement and NHS England for accounts consolidation purposes. The content within the summarisation schedules must be consistent with the annual report and accounts, as audited by local auditors.

On completion of the audit, auditors of trusts and CCGs are required to issue an Annual Audit Letter (AAL) that sets out the findings from the audit. It is a GAM requirement that trusts and CCGs publish the AAL, usually alongside their annual report and accounts. For foundation trusts, auditors are not required to issue an AAL but where the auditor does so this should be published.

What is an external audit?

The statutory requirement is for both an audit of the financial statements and value for money arrangements (VFM). *The Code of Audit Practice* (Code)⁵ sets out what local auditors are required to do to fulfil their statutory responsibilities covering the audit of the financial statements; auditors work on value for money arrangements; reporting; and the auditor's additional powers and responsibilities. It is supported by a number of guidance notes⁶ published by the National Audit Office (NAO). Other assurances, such as work on the mental health investment standard and quality report, are outside of the Code requirements. This briefing focuses on the audit of the financial statements and does not consider the other Code requirements or other assurance work undertaken by auditors.

The Code requires compliance with standards issued by a relevant regulatory body which is the Financial Reporting Council (FRC)⁷ for NHS bodies. To meet their duties in respect of the audit of the financial statements, the auditor has to comply with the International Standards of Auditing (ISAs). Auditing standards for audits of financial statements include objectives for the auditor, together with requirements and related application and other explanatory material. Quality reviews are undertaken by the FRC's Audit Quality Review Team (AQRT) and ICAEW's Quality Assurance Department (QAD).

² DHSC, *Group accounting manual 2020/21*, December 2019

³ NHS Improvement, *Foundation trust annual reporting manual*, December 2019

⁴ DHSC, *Annual report and accounts timetable*, December 2019

⁵ National Audit Office, *The Code of Audit Practice*, April 2015 (The new *Code of Audit Practice* will come into force on 1 April 2020 and will apply to audits of local bodies' 2020-21 financial statements onwards)

⁶ NAO, *Auditor guidance notes*, various dates

⁷ FRC, *Current auditing standards*, various dates

The auditor will need to obtain reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Some of the key terms involved include:

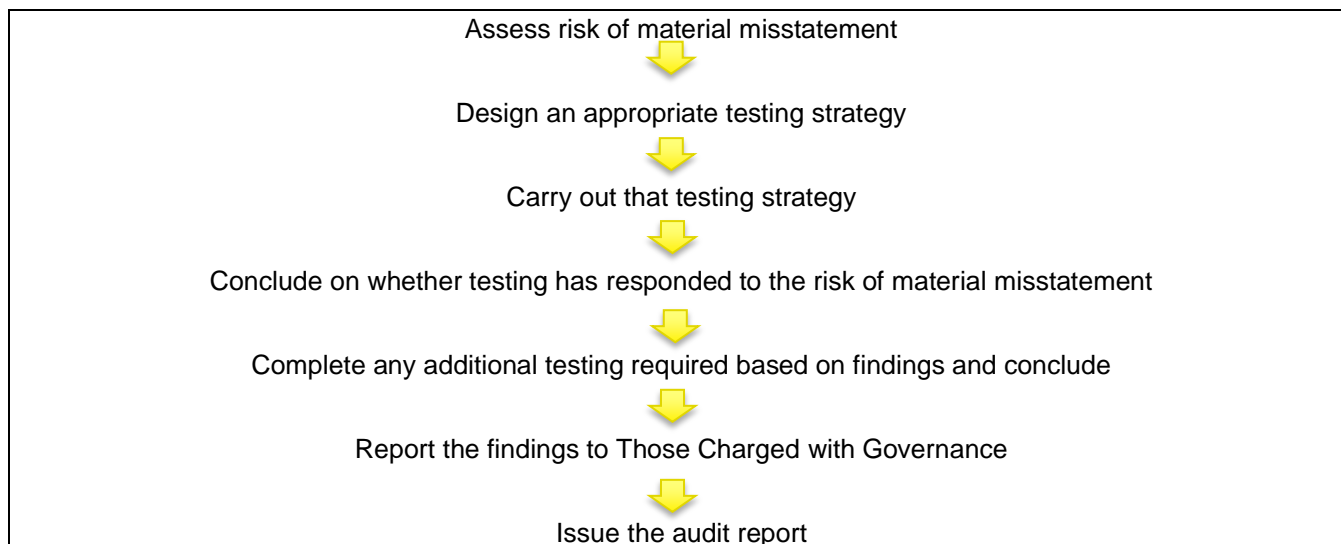
- **Audit risk** (ISA 320): the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. In accordance with ISA 315, the auditor will identify and assess the risks of material misstatement through understanding the entity and its environment.
- **Significant risk**: (ISA 315): an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.
- **Audit evidence**: (ISA 500): information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and, also by the quality of such audit evidence.
- **Materiality**: (ISA 320): the auditor's determination of materiality is a matter of professional judgment - a key element being whether misstatements at that level could influence the decisions of users of the financial statements.

In recent years there have been a number of high profile cases of audit failures and a raft of reviews of the UK audit market (such as Kingman⁸, Brydon⁹, Competition and Markets Authority¹⁰ and the current Redmond review due to report later this year¹¹). Although these are not specifically aimed at NHS auditors they inform the context for audit, reflected in the higher benchmark to meet the required quality standard, and provide some common themes for increased scrutiny.

Areas commonly identified for improvement include: audit scepticism; judgements and estimates; valuations; completeness of transactions; and going concern. In all cases, there is often an insufficient challenge of the facts presented by management and insufficient evidence obtained.

The main element of the audit is the year-end audit visit undertaken on presentation of the draft accounts. However, the audit is an ongoing process throughout the year and in most cases involves regular meetings and an interim audit visit. The key elements of the process are set out in **figure 1**.

Figure 1: An audit in a nutshell



Source: HFMA pre-accounts planning session, Mazars LLP¹²

⁸ DBEIS and FRC, *Financial Reporting Council: review 2018*, December 2018

⁹ DBEIS, *The quality and effectiveness of audit independent review*, December 2019

¹⁰ CMA, *Statutory audit market study*, April 2019

¹¹ Ministry of Housing, Communities and Local Government, *Review of local authority financial reporting and external audit: call for views*, November 2019

¹² HFMA pre-accounts planning conference, *working well with auditors*, January 2020

On conclusion of the audit, the external audit report can be issued and audited accounts submitted. HFMA's briefing¹³ provides further detail on what external audit reports mean, auditors' additional powers and duties and what action NHS organisations have to take when audit reports are modified.

The NHS audit experience

Both the preparation and the audit of the accounts to standard and time can be a challenge, particularly with an increase in complexity of arrangements that NHS bodies are entering into requiring increased accountancy knowledge. Examples of complex areas that add pressure and time include:

- complex subsidiaries
- sale and leaseback of assets
- property disposals
- complex valuation judgements regarding modern equivalent asset/alternative site property valuations
- and specific work regarding management override of control, particularly in relation to achievement of the year end position
- going concern assessments
- accruals and provisions
- agreement of balances

The latest HFMA year-end survey¹⁴ found over one third of respondents felt the audit process was worse than the previous year. The main issues identified were: late sign off of audits; inconsistency in responses from auditors; a lack of audit experience and NHS knowledge; and concerns over timeliness of responses to audit queries. However, there is a mixed picture of experience with some positive examples including: better communication; good organisation for the audit visit and more interim audit work.

As challenge increases for both preparers and auditors, it becomes essential that all involved work together to make the process as smooth as possible.

What works

It is the responsibility of the NHS body's management to have in place an effective system of internal control for day to day accounting, and a well designed and implemented financial reporting and close-down process, including controls over all key estimates and judgements.

Based on feedback from auditors, finance professionals and non-executive directors (NEDs), the most essential ingredient then for a smooth external audit is seeing the audit as a joint effort with ongoing discussion of plans and issues. For example, are there clear expectations and agreed actions where there is a risk to readiness such as poor working papers, complexity of accounting items or auditor resource restraints?

Common themes for a successful experience include: understanding the audit focus; ongoing communication; clear project management; and high quality documentation. What works well for one audit may be different from that of another but the key is to discuss each area to determine what will work best for all involved. The common areas that work well are summarised in **figure 2** and explored further below.

¹³ HFMA, *External audit reports: the role of the audit committee*, April 2019

¹⁴ HFMA, *Year-end survey 2018/19*, September 2019

Figure 2: Good practice for a smooth external audit

Finance teams should....	Auditors should....	Non-executive directors and lay members should....
Planning:		
<p>Engage early with auditors, staff involved (finance and non- finance) and NEDs over both plans and new and complex areas, providing early accounting papers on such items to go through governance. Also ensure NHS wide issues or those arising from prior year or interim work raised are addressed.</p>	<p>Engage early and meet regularly with director of finance (DoF) and finance team to identify potential risk areas and provide clear expectations for audit, set out in a requirements schedule. It may be practical to agree a staggered schedule of working papers due to tight timeframes so finance can prioritise what auditors need first.</p>	<p>Engage early with DoF and auditors via regular discussion, briefings, auditor progress reports and private meetings with auditors as required.</p>
<p>Agree plans for interim and final audit including timetable, accommodation, working paper requirements and a process for amending the plan where necessary whilst keeping the completion date unchanged.</p>	<p>Agree a timetable for completion with dates for interim and final audits including a process for amending the plan where necessary whilst keeping the completion date unchanged.</p>	<p>Understand the process for preparing the accounts and the audit arrangements and challenge where necessary.</p>
<p>Provide training on process and issues to finance, NEDs and those outside finance.</p>	<p>Identify training needs to ensure teams are appropriately trained in both external audit and NHS accounts.</p>	<p>Monitor progress on previous recommendations and ensure actioned.</p>
<p>Prepare and agree a detailed timetable for the preparation and review of the annual report and accounts including all who have a role, both inside and outside of finance. This should include plans to ensure high quality, timely working papers are provided.</p>	<p>Review papers as they are provided and undertake testing in a timely manner. Consider initial testing of any complex areas at interim and discuss potential impact on the final visit.</p>	<p>Undertake early review of officers' papers on areas such as judgements and estimates, accounting policies, disclosure checklist and ensure time and knowledge to challenge with finance teams.</p>
<p>Co-ordinate annual report preparation using one person to lead the overall process including communication with all involved, particularly those outside finance, and overall review.</p>	<p>Plan annual report review, including remuneration report, by understanding arrangements for preparation, particularly for information provided from those outside of the finance team.</p>	<p>Review and comment on the annual report, including remuneration report, before the final committee meeting. The committee should draw on their knowledge of the NHS body to review and ensure they are comfortable with processes adopted by management.</p>
<p>Work with those outside of finance such as legal teams, HR and communications teams to review potential issues and evidence sources and prepare clear papers setting out and agreeing this process.</p>	<p>Provide regular updates for finance and NEDs of both organisational and wider issues.</p>	<p>Understand key changes to organisational arrangements and activity as well as accounting updates and use to robustly review draft accounts.</p>
<p>Undertake quality review of draft annual report and accounts with full working papers for DoF and accounting officer sign off and document this process.</p>	<p>Provide clear timely findings of interim work so that these can be acted on before final visit.</p>	<p>Review and challenge draft accounts as early as possible.</p>

On site visits:		
Be organised, open and clear including use of weekly catch up meetings.	Be organised, open and clear including use of weekly catch up meetings.	Be aware of the audit timetable and ask to be kept up to date in a timely manner of issues arising.
Be available and provide a schedule of who is responsible for each key area and when they are available.	Be available and provide a schedule of when auditors will be on site.	Raise comments early on draft accounts and annual report – don't hold these back for the final committee meeting.
Keep minimal account versions actioning agreed changes ideally together with changes highlighted for review.	Be clear on any additional testing identified and agreed amendments you are expecting to see on completion.	Understand misstatements, corrections and NEDs' role in considering adjustments identified by audit.

Communication

Ongoing, clear and honest communication is the number one pre-requisite to a smooth audit. This covers both informal and formal communications between all involved – auditors, staff (inside and outside finance), NEDs and experts.

Early discussion of any new, significant, complex or unusual items is essential, supported by a paper from finance and a timely audit response. This avoids technically complex discussions within the final audit timeframe and avoids a climate of distrust which will arise if the auditor identifies an issue that the NHS body has not previously raised. **Figure 3** sets out top topics for early discussion with auditors.

Auditors should be clear on expectations, discussing working paper requirement schedules, audit timings and implications of issues arising. Discussions on how the audit will best work for all are key and can consider items such as the opportunity to use technology, how best to raise queries and liaison with staff outside of finance. Audit progress updates for NEDs are helpful, as well as the opportunity to hold private discussions with the auditor as necessary.

For on-site visits, many find it useful to hold a weekly catch up meeting to cover: progress, audit queries and sticking points; impact of errors identified; extended testing; amendments; and reporting consequences. This will help any concerns on how the audit is going - from both finance and the auditor's perspectives - to be raised and addressed quickly. After the audit is completed a debrief meeting should be held to consider what worked well and not so well to feed into planning for the next audit. As the auditor will need to move on quickly to other audits, it is important to do this before the lessons from the audit experience are lost.

Figure 3: Top topics for early conversations with auditors

Have early and ongoing conversations with auditors and clearly document evidence for....

- application of new accounting standards
- accounting policies, particularly those that are new or changed
- judgements and estimates
- approach to journals
- valuations
- changes in activity including any joint arrangements
- going concern assessment
- risk sharing agreements
- agreement of balances disputes
- any other large or complex transactions

Project management

Good project management helps to strengthen a collaborative approach, clarify expectations and ensure ongoing monitoring of progress. It should be used to remind everyone of the times when the audit needs to be prioritised and how this can work in practice. All areas of the audit must be covered including the financial statements; value for money; annual report and remuneration report; as well as whole of government accounts. Examples of areas to be covered include:

- liaison meetings throughout the year
- audit committee attendance and requirements
- when and how working papers will be provided i.e. is there the option for electronic upload
- what information is needed from outside finance and how this will be obtained and supported
- the annual report can often be fragmented or forgotten as part of the sign off timetable so it is important to agree who, what, when and how for each of its sections – it is helpful to have an overall lead (both for finance and audit) to coordinate its preparation and review
- arrangements for the on-site audit visits including:
 - accommodation – ideally with minimal changes and physically close to finance
 - who will be available and when (finance team and auditors) and communication plan
 - timing and attendees for catch up meetings
 - who will be responding to audit queries and a realistic time for responses
 - IT issues such as read only access to ledger and wi-fi access
- internal quality review arrangements
- sign-off process.

Documentation and evidence

High quality working papers with relevant and meaningful evidence are needed to demonstrate that the transactions and account balances are supported allowing: the director of finance to have confidence in the accounts; the accountable officer to have the confidence to sign the annual report and accounts; NEDs to confidently approve annual report and accounts; and the external auditor to be able to gain sufficient, appropriate audit evidence to support their audit.

The annual report and accounts is the responsibility of the organisation and the accounting officer's statement is very similar to the audit opinion including confirmation on items such as: compliance with reporting requirements; inclusion of appropriate accounting policies; reasonableness of judgements and estimates; preparation is on a going concern basis; and that the annual report and accounts taken as a whole is fair, balanced and understandable. The accounting officer will need to satisfy themselves they have sufficient assurance to make this statement and NEDs will need to be satisfied by evidence where challenges are made. Clear documentation is a key component for this.

For auditors, ISA 500 is clear on the requirements of appropriate and sufficient audit evidence. This will include the need to evidence the accuracy and completeness of information provided by management, as well as whether it is sufficiently precise for the auditor's purposes. When using the work of a management's expert, the auditor will also be required to evaluate the competence, capabilities and objectivity of that expert; obtain an understanding of the work of that expert; and evaluate the appropriateness of that expert's work as audit evidence.

Audit is more than discussion – understanding the assumptions underpinning key decisions should be a starting point for the auditor not the main audit procedure. Evidence must be sufficient and appropriate, recognising the importance of quality over quantity. This will need to be subject to robust review, challenge and corroboration by the auditor. If the NHS organisation can present third party evidence to support their working papers then this is ideal. Where judgements and estimates have been made then the thought process and any supporting evidence should be documented.

Working papers should be produced in a timely manner, be electronic and include a summary schedule of all working papers provided with appropriate cross referencing to detail. For each account balance an individual working paper should be provided which agrees from the accounts to the trial balance, includes narrative and evidence and the person responsible for preparation. It should also include an analytical review to ensure consistency with in-year reporting and activity that provides the reason for variance from expectations. It is also helpful if working papers are written with the assumption that the reader does not know the NHS or the organisation.

Specific areas where working papers can often be strengthened include:

- **Agreement of balances:** good explanations and evidence need to be maintained for mismatches throughout the year
- **Judgements and estimates:** documentation of thought process and evidence of underlying data is essential
- **Year-end receivables (debtors) and payables (creditors):** a full breakdown of the final year end debtors, rather than in year transactions is needed to test the final balance
- **Reviews completed outside finance:** discussions such as with HR on staffing and employment related issues or with legal on potential impact of legal cases should be documented
- **Overall final review for internal quality assurance:** keeping documentation of the process provides helpful assurance over what has been reviewed

Understanding the audit focus

As set out in figure 1 above the audit testing strategy is risk based and, in accordance with ISA 315, assesses the risks of material misstatement in the financial statements through understanding the entity and its environment including the entity's internal control. There are some areas that will always be seen as a higher risk, many of those flagged in audit quality reports mentioned above. These include:

New and significant items

Auditors will always need to review new, significant or unusual transactions. It is important to understand key changes to the financial statements to be able to appropriately support these. For example, in 2019/20 and 2020/21, the new accounting standard on leases will be on auditors' agendas. The HFMA briefings on financial reporting¹⁵ and year-end reminders for finance teams¹⁶ and non-executive directors¹⁷ identify the key changes for the year which may affect NHS bodies' annual reports and accounts.

Revenue recognition

Under ISA 240 there is a presumed risk of fraud in revenue recognition. The audit will therefore have a specific focus on revenue transactions such as contract variations, disputes and unrecoverable debt.

Management override of controls

Under ISA 240 there is a presumed risk of management over-ride of controls and there are standard procedures required by the ISA. Auditors will need to be able to articulate specifically where the risk manifests itself in the financial statements and their planned response. The audit is therefore likely to have a specific focus on areas such as journals, one-off unusual transactions, accruals, prepayments and other accounting estimates.

¹⁵ HFMA, *Financial reporting – watching brief 2019/20 and beyond*, December 2019

¹⁶ HFMA, *2019/20 year end reminders: issues raised at the pre accounts planning conferences*, February 2020

¹⁷ HFMA, *Year-end reminders for non-executive directors and lay members*, February 2020

Judgements and estimates

Auditors will apply professional scepticism to judgements and estimates. An accounting paper is helpful to demonstrate the thought process that management has adopted for both NEDs and auditors to review and challenge - and these can often be provided early in the year. Examples of things to consider and document are: the justification for taking a particular approach, including references to the standard, particularly if that has changed from prior periods; consistency with other assumptions; realism of assumptions; what alternative assumptions have been considered and why these have not been selected; and what underlying data has been used.

Asset valuations

This is an area where material figures are involved and a small percentage error on a large balance can lead to a non-trivial difference. Auditors will pay particular attention to depreciation and how the public dividend capital (PDC) calculation has been derived. Alongside the significant levels of judgement and estimate involved, the level of reliance by management of work of an external expert means this is a key area of focus for audit. As such, the auditor will look at changes in assumptions; asset lives; whether management understand and have challenged the experts' assumptions; and underlying data. Further information on valuation issues are included in the HFMA briefing on property, plant and equipment¹⁸.

Going concern

There are continuing financial pressures within the provider and commissioning sector and it is important that the NHS body's management and the auditor are aware of the requirements for assessing going concern in the public sector context. While public sector bodies, including NHS trusts and CCGs, are generally considered to be a going concern for the purposes of preparing financial statements, the NHS body's management need to consider the requirements of International Accounting Standard (IAS) 1, the FReM and the GAM in determining whether additional disclosures are required. There is no presumption of going concern status for NHS foundation trusts. Directors must decide each year whether or not it is appropriate for the NHS foundation trust to prepare its accounts on the going concern basis, taking into account best estimates of future activity and cash flows.

Whilst it is unlikely that an NHS body will be determined not to be a going concern, this does not exempt the management of NHS bodies from the requirement to undertake a going concern review. ISA570 requires auditors to challenge management's going concern assessment with rigour, and the recent revision to the standard strengthens the work required by auditors including understanding uncertain events, uncertain income streams and over-reliance on third party funding. Particularly in light of financial challenges faced by many NHS organisations, auditors will focus on management's assessment and underlying evidence, cashflow, deficits and borrowing. The NAO guidance to local auditors in AGN 05 provides further detail on requirements¹⁹ and HFMA's briefing on going concern also provides further detail on assessment and reporting requirements²⁰.

Conclusion

Looking ahead, the current context for audit is set to continue with challenges including tight timeframes, resource constraints and an increasing focus on audit quality. To deliver 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 both sides. Based on members' experiences, the key to a successful audit is a collaborative approach with early discussions of any issues arising. This briefing has shared tips from all those involved that they have found to help the audit of the financial statements go as smoothly as possible.

¹⁸ HFMA, *Property, plant and equipment: accounting and valuation issues*, December 2019

¹⁹ NAO Auditor guidance note 5, December 2019

²⁰ HFMA, *Going concern - Assessment and reporting requirements in difficult times*, October 2019

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About the HFMA

The Healthcare Financial Management Association (HFMA) is the professional body for finance staff in healthcare. For nearly 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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