

Proposed new system for fee variations

Opted-in local government and police bodies

November 2020

Public Sector Audit Appointments Limited (PSAA) is an independent company limited by guarantee incorporated by the Local Government Association in August 2014.

In July 2016, the Secretary of State specified PSAA as an appointing person for principal local government authorities for audits from 2018/19, under the provisions of the Local Audit and Accountability Act 2014 and the Local Audit (Appointing Person) Regulations 2015.

From 2018/19 PSAA is responsible for appointing an auditor and setting scales of fees for relevant principal authorities that have chosen to opt into its national scheme.

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Summary

- 1 This consultation sets out our proposed new approach for determining fee variations in respect of local audits of opted-in bodies from 2020/21 onwards.
- 2 Fee variations are the mechanism by which Public Sector Audit Appointments (PSAA) approves additional fees for audit work. Additional fees are required when an auditor needs to undertake substantially more work than was envisaged when the fee scale for the audit was set by PSAA. This is an increasingly common occurrence in the current climate. Since PSAA's contracts with audit suppliers were let in 2017, audits have been subject to increased scrutiny and regulatory pressures following a number of controversial financial failures in the private sector. Additional work has been required in the majority of audits to enable a safe audit opinion on the financial statements. The new Code of Audit Practice will apply from 2020/21 and further additional audit work will be needed to deliver the requirement for a commentary on the body's arrangements for value for money.
- 3 The current fee variations process requires the auditor to discuss all proposed variations with the audited body before submitting them to PSAA for determination. Feedback from both auditors and audited bodies frequently refers to the practical challenges and limited value of local discussions about proposed variations which relate to factors which affect most or all audited bodies. Many contributors have asked PSAA to take a national lead on additional fees, where possible removing the need for local negotiations. PSAA is also engaging with MHCLG to facilitate the proposed approach outlined in this consultation.
- 4 PSAA therefore proposes introducing a new approach to fee variations for audits of 2020/21 and subsequent accounts, based on two types of variation:
 - **national variations**, required for changes that relate to the conduct of all or most audits, such as changes to the auditing and accounting codes, standards and regulatory requirements, where a standard cost can be reasonably estimated; and
 - **local variations**, required for issues that relate to local factors arising from the conduct of the particular audit, such as the additional audit work required if accounts reflect complex transactions that are not built into the scale fee, or where working papers are poorly prepared, or for work relating to an auditor's statutory responsibilities such as objections, statutory recommendations or public interest reports.
- 5 Wherever possible PSAA will calculate and determine national variations. Local discussions between the auditor and the audited body will not be necessary. In order to reach fair determinations, PSAA will carry out research into each of the variations which arise in this category. This will include engagement with representatives of both audit suppliers and audited bodies. We will also consult as appropriate with bodies such as the National Audit Office and the Financial Reporting Council. Implementation of new arrangements will necessarily be influenced by how MHCLG chooses to respond to the recent Redmond Review recommendations.
- 6 Local variations will continue to be the subject of local discussions. We think this is appropriate in the context that these relate to matters which are specific and frequently unique to the particular audit. The relevant auditor and the chief finance officer should

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therefore be well aware of the issues and able to bring valuable knowledge and insights to bear.

- 7 The detailed methodology for calculating the value of fee variations uses PSAA's rate card, which prescribes different hourly rates for different levels of audit staff. The Redmond report has recently documented significant challenges in local government auditing, acknowledging that the market is fragile and lacks resilience and highlighting issues in relation to the adequacy and sustainability of audit fees. Against this backdrop we are proposing to increase the relevant hourly rates for fee variations by 25% for 2020/21 audits. The resulting new rates continue to be keenly competitive compared to those payable in other sectors. The cost to local bodies of the rate card increase will vary depending on the scale of any fee variations arising. By way of illustration, if a body experiences fee variations equivalent to say 10% of its scale fee, calculated using current rates, the overall cost of its audit will rise by approximately 2.5% as a result of the rate card change. Current rates will continue to apply for audit years before 2020/21
- 8 We recognise that local bodies are managing hugely challenging budgets and that any increase in the rates for fee variations will be unwelcome. However, in the context of the need to maintain a sustainable audit market going forward, we believe that this is an important and necessary step to take.
- 9 Fee variations often relate to additional audit work which is of a recurring nature. Ideally in these circumstances the scale fee for the relevant body would be updated to reflect the cost of the work concerned in subsequent audits. However, current regulations hamper how quickly this can be done. PSAA is therefore in active discussions with MHCLG with a view to amending the regulations to enable scale fees to be updated more promptly where appropriate.
- 10 We look forward to receiving your comments on our proposals.

Responding to the consultation

We welcome comments on the proposals contained in this document. Please send feedback using this link:

<https://www.surveymonkey.co.uk/r/MGZPNBJ>

The link is to an online survey, using the questions set out below (there is an option to make additional comments on each question).

The consultation will close on **Tuesday 1 December 2020**.

Consultation response questions

1. Do you agree that fee variation arrangements should be changed to improve the efficiency of the process and to help manage the pressures on senior finance staff and auditors?
2. Do you agree that a system based on two distinct categories - national variations and local variations - would be a logical approach?
3. Do you agree that PSAA should lead on national variations, carrying out research to enable it to assess appropriate additional fees for groups of bodies with similar characteristics, with appropriate consultation?
4. Do you agree that local discussions between the auditor and the audited body should continue to be a requirement in relation to additional audit work arising from factors which are specific to a particular audited body?
5. Do you agree that the fee rates applicable to fee variations should be increased in recognition of the importance of maintaining a sustainable local audit market?
6. Any other comments.

PSAA's new fee variations system

Background

- 11 The Local Audit (Appointing Person) Regulations 2015 require PSAA to consult on and set a scale of audit fees for opted-in authorities before the start of the financial year to which the fees apply¹. In addition, a fee scale cannot be altered after the start of the financial year.
- 12 In some cases substantially more audit work may be required than was envisaged when the fee scale was set. In these circumstances the local audit framework allows PSAA to consider and ultimately determine a fee variation claim from the relevant auditor². The volume and aggregate value of such claims has risen significantly in the past two years as all audits have become subject to increased scrutiny and regulatory pressure following a number of controversial financial failures in the private sector. As a result, additional work has been required in the vast majority of local audits to enable a safe audit opinion on the financial statements. The new Code of Audit Practice will apply from 2020/21 and further additional audit work will be needed to deliver the requirement for a commentary on the body's arrangements for value for money.
- 13 Firms are required to share the details and explain the circumstances of any proposed fee variation with the relevant local body and, in submitting a claim to PSAA, to confirm whether the body has agreed to the proposed variation. This arrangement helps to ensure a rounded, balanced process in which the views of both the auditor and the audited body are heard. This approach has worked well for a number of years, during which fee variations have been the exception rather than the rule. However, it has become more controversial during the recent period in which variations have become much more common. Increasingly, feedback from audit suppliers and audited bodies has questioned whether it is helpful for local discussions to take place in relation to variations which relate to changes which affect most or all bodies.

¹ Regulation 16 includes:

- (1) An appointing person must specify, before the start of the financial year to which the scale of fees relates, the scale or scales of fees for the audit of the accounts of opted in authorities in relation to which the person is the relevant appointing person.
- (2) A scale of fees must relate to a particular financial year, but may be set for more than one financial year at a time.
- (3) An appointing person may vary the scale of fees which it has specified, but must not do so once the financial year to which the scale of fees relates has begun.

² Regulation 17 includes:

- (1) Subject to paragraph (2), the fee for the audit of the accounts of an opted in authority must be set in accordance with the appropriate fee scale specified in accordance with regulation 16.
- (2) If it appears to an appointing person, on the basis of information supplied by the local auditor which it has appointed
 - (a) that the work involved in a particular audit was substantially more or less than that envisaged by the appropriate scale, or
 - (b) any of the provisions mentioned in paragraph (3) apply,the appointing person may charge a fee which is larger or smaller than that referred to in paragraph (1), as appropriate.

A new fee variations system

- 14 Encouraged by feedback from stakeholders, we have therefore considered options for redesigning the fee variations process to improve efficiency and to reduce the burden of local discussions on auditors and senior finance staff. As a result, we are now proposing a new system, commencing from audits of 2020/21 accounts, based on two types of variation:
- a) **national variations** which will reflect national changes in audit requirements: that is, changes that relate to the conduct of all or most audits, such as changes to the auditing and accounting codes, standards and regulatory requirements, where a standard cost can be reasonably estimated; and
 - b) **local variations** which reflect local changes in circumstances: that is, issues arising from the conduct of a particular audit, such as the additional audit work required if accounts reflect complex transactions that are not built into the scale fee, or working papers are poorly prepared, or for work relating to an auditor's statutory responsibilities such as objections, statutory recommendations or public interest reports..

National variations

- 15 We propose that, with effect from the audit of 2020/21 accounts PSAA will lead on assessing the potential audit work and fee impact of new and updated audit requirements and standards applicable to local audit. These are changes that have the potential to affect the conduct of all or most audits, requiring more or less audit work to be carried out. However, their implications may vary between different types or groupings of local bodies.
- 16 PSAA has already commissioned a programme of work to consider the likely audit work and fee impact of expected changes in audit requirements. Some anticipated changes are unlikely to result in an increase in audit work, but others are potentially significant and may justify fee variations. The latter grouping includes:
- the Code of Audit Practice applicable from 2020/21, which contains new requirements in relation to reporting on value for money arrangements;
 - ISA 220 (Revised): Quality control of an audit of financial statements (applicable from 2020/21 audits);
 - ISA 315 (Revised): Identifying and assessing the risks of material misstatements (applicable from 2022/23 audits);
 - ISA 540 (Revised): Auditing accounting estimates and related disclosures (applicable from 2020/21 audits);
 - ISA 600 (Revised): Specific considerations – audit of group financial statements (applicable from 2020/21 audits); and
 - IFRS 16 Leases (applicable from 2021/22 audits).
- 17 PSAA will undertake research to inform our understanding of each relevant standard or other change in requirements. In doing so we will consult with audit suppliers as well as seeking the views of audited bodies via relevant societies/associations of chief finance officers. Engagement with stakeholders such as the NAO and the FRC will also be

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important to test our thinking and ensure that the resulting additional fees PSAA determines are reasonably consistent with any other relevant assessments. Our intention is to assess the additional work and consequent fee requirements for each relevant change driver, taking account of the differing needs of particular types or groups of authority.

- 18 In some cases, the nature of the change may be more significant for one type of local body than for another and our determinations will therefore need to be stratified accordingly.
- 19 We may find that at the outset a particular change cannot be assessed with the required level of confidence. In these circumstances we may initially specify a range rather than a precise figure for resulting fee variations, reserving final determinations until more information is available.
- 20 In dealing with national variations, PSAA will take particular care to identify ongoing audit work and costs which ultimately need to be consolidated in revised scale fees. This in turn requires careful earmarking of pre-implementation work, for example in relation to prior year disclosures for IFRS 16, as well as any one-off implementation year work which is not a continuing requirement, such as the first year of the new value for money arrangements reporting under the Code of Audit Practice. This work will qualify for a fee variation but is clearly not a recurring requirement.
- 21 A key assumption when determining any national variation will be that both the body and the auditor meet the requirements of the Statement of Responsibilities (see paragraphs 34-35 below).
- 22 We believe our proposed approach to national variations will obviate the need for a significant proportion of local fee variation discussions by relieving audited bodies and audit firms of much of the burden of dealing with system-wide issues at local level. In doing so it responds directly to stakeholders' expressed concerns and offers the prospect of improving both the efficiency of the fee variation process and the consistency of resulting determinations.
- 23 It is important to acknowledge that our proposed approach inevitably involves a degree of estimation. Fee variations will be considered and standardised for groups of bodies with similar characteristics, rather than being determined after assessing the position at the level of each individual body. The system will only realise the benefits outlined if audited bodies and audit suppliers accept that some estimation is implicit in this approach.
- 24 Potential national fee variations will be evaluated at the earliest opportunity, enabling to allow PSAA to build them into scale fees when it is possible to determine the ongoing impact of a change in requirements. Timing of implementation will be influenced by further engagement with MHCLG including how MHCLG chooses to respond to the recent Redmond Review recommendations.

Local variations

- 25 Auditors will continue to advise and enter into local discussions with audited bodies about the nature and circumstances of any potential fee variations arising from the conduct or local circumstances of the particular audit. This will ensure that the audited body is

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informed about likely variations of this type and has an opportunity to seek any further information or explanations from the auditor. Local variations may relate to specific challenges which have emerged during the audit or they may relate to distinctive local developments such as a body implementing new financial systems.

- 26 Local fee variation requests must be made to PSAA by the auditor using a standard process, which PSAA is updating following recent review. The process will identify one-off and recurring implications so that each can be handled appropriately. The auditor should not invoice an audited body until PSAA has authorised it so to do. Further information on the fee variations process is available from the PSAA website.

Fee variations for ongoing requirements

- 27 As we have outlined, fee variations which are of a recurring nature, whether national or local, should be consolidated into scale fees at the earliest opportunity. Unfortunately, however, current regulations inhibit seamless early consolidation. This is best explained by way of an illustration. A variation relating to 2020/21 may be determined in say, September 2021, and be identified as recurring. By that stage the 2021/22 year has clearly started, and current regulations prohibit alteration of a scale fee after the start of the financial year. The variation will therefore have to be repeated in respect of 2021/22 and the earliest opportunity for consolidation will be 2022/23. PSAA is currently in discussions with MHCLG concerning the possibility of amendments to the regulations to enable earlier updating of scale fees.
- 28 In the meantime, we are currently finalising a detailed review of fee variations approved for 2018/19 to identify those which relate to ongoing audit requirements. Our next main fee consultation will propose the consolidation of these variations into 2021/22 scale fees.

Fee variation rates

- 29 The fee rates applicable specifically to fee variations are set by PSAA in the form of a rate card which prescribes hourly rates for different types of audit staff, for example partners, managers, and other staff. The rates represent an important part of the mechanism for determining both national and local variations. The rate card has been subject to successive fee reductions in recent years, linked to changes in scale fees. Over the same period, rates for audit work in other sectors have risen. This is an increasing concern to audit suppliers given the higher volumes of variations as a result of increased audit work now required.
- 30 The Redmond report has recently documented significant challenges in local government auditing, acknowledging that the market is fragile and lacks resilience and highlighting issues in relation to the adequacy and sustainability of audit fees. Against this backdrop we are proposing to increase the relevant hourly rates for fee variations by 25%. The resulting new rates, set out in the table below, continue to be keenly competitive compared to those payable in other sectors. Going forward we plan to review the rate card annually alongside scale fees.

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Fee variation rates

| Description | Hourly rates | | | |
|--------------------------------|----------------------|--------------------|-------------------|----------------|
| | Partner/ Director | Senior Mgr/ Mgr | Senior Auditor | Other staff |
| PSAA current rates | £132 | £73 | £47 | £36 |
| Proposed rates from 2020/21 | £165 | £91 | £59 | £45 |

- 31 The cost to local bodies of the rate card increase will vary depending on the scale of any fee variations arising. By way of illustration, if a body experiences fee variations equivalent to say 10% of its scale fee calculated using current rates, the overall cost of its audit will rise by approximately 2.5% as a result of the rate card change.
- 32 We recognise that local bodies are managing hugely challenging budgets and that any increase of this type will be unwelcome. However, in the context of the need to maintain a sustainable audit market going forward, we believe this is an important and necessary step to take.
- 33 In determining fee variations PSAA will continue to challenge the auditor's request for the variation in a variety of ways including:
- reviewing the justification and supporting documentation;
 - considering the complexity and size of the variation including the time inputs of staff;
 - comparing with similar variations for other bodies;
 - confirming that the work is consistent with the auditor's responsibilities and PSAA's other records;
 - confirming that the authority has agreed the fee variation (and if it has not, consulting with the body to understand concerns); and
 - ensuring that the auditor has reported the variation to the relevant body in the required manner.

Statement of responsibilities

- 34 The [statement of responsibilities of auditors and audited bodies](#) sets out the expectations on which scale fees are based. The statement effectively represents the terms of engagement between appointed auditors and audited bodies and summarises their respective responsibilities. Scale fees are based on the expectation that audited bodies can provide the auditor with complete and materially accurate financial statements and supporting working papers within agreed timeframes. Where an authority is unable to fulfil these requirements, local fee variations may be required.
- 35 The same expectations will apply to the expected work covered by national fee variations. If an audited body does not meet its responsibilities, creating a need for further additional audit work, an additional local fee variation could also apply.
- 36 The statement of responsibilities also applies to auditors. Additional audit costs that arise due to auditors not meeting the expectations are ineligible for a fee variation.

Next steps

We welcome comments from audited bodies and stakeholders on the proposals outlined in this document. The closing date for comments is **Tuesday 1 December 2020**. Consultation feedback should be made using the survey at:

<https://www.surveymonkey.co.uk/r/MGZPNBJ>

- 37 Please send any questions on this consultation to: workandfeesconsultation@psaa.co.uk.
- 38 We will take account of the feedback to this consultation in setting out its fee scale proposals for 2021/22 early in 2021.
- 39 If you have complaints about the way this consultation has been conducted, these should be sent by email to generalenquiries@psaa.co.uk.