

Private & Confidential

Tina McKenzie-Boyle
Chairman of the Audit & Governance Committee
Via Email

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Dear Tina

External Audit of Royal Berkshire Fire Authority

Thank you for your letter dated 5 August 2020. Whilst I appreciate that an increase in costs is not welcomed by any organisation there are multiple reasons why at this point it has been necessary to propose increasing external audit fees to the extent that we have. It is the result of an accumulation of factors over a long period of time which has reached a critical point, so I would like to take this opportunity to set out both the context and the need to increase fees to ensure the sustainability of the local government external audit market in the longer term.

Ensuring sustainability in the local government audit sector

The level of work required to deliver you a high-quality audit has grown significantly since we prepared our original tendered for a block of local government audits in early 2017. PSAA are aware that the setting of scale fees has not kept pace with this changing requirement of external audit and their recent communication has reflected this. In addition, you will have seen Sir Tony Redmond recommend, in his recently released Independent Review of Local Audit, that the current fee structure for local audit be revised to ensure that adequate resources are deployed to meet the full extent of local audit requirements. PSAA have asked all audit firms, on an individual audit basis, to prepare an updated scale fee considering the changes that are impacting the audit market.

For Royal Berkshire Fire Authority, there are two main drivers of additional work we are required to perform to deliver a high-quality audit; the change in the risk profile of the organisation, and the additional work our regulators require us to perform. In response to this and the request from PSAA we have looked at what it now costs to deliver an audit. Some elements are specific to Royal Berkshire Fire Authority and some are applicable to all audits, but I can assure you the proposed re-based fee is not the same for all bodies and does reflect different profiles. We have also ensured we have taken a consistent approach where it is warranted and I can confirm we have reviewed, for instance, the fire authorities which we audit, to ensure the approach to re-setting the fees is consistent where the profiles are similar. That said the points you raised in your letter about the relative risk profiles with respect to other public sector bodies, such as local councils, are valid and are reflected in the relative fee proposals to those bodies.

In the context of the wider local government sector we would also make the point that the new proposed fee is about ensuring the sustainability of local audit into the future. The fixed costs associated now with

undertaking any audit in the sector have increased and the previously set fees do not represent a sustainable basis which enables high quality external audit providers to continue to deliver audits.

Change in risk profile

We tendered for an allocation of local government audits in 2017 the tender was based on a risk neutral position for the sector. For a Fire Authority at the time we would have typically expected there to be a single fraud risk recognised (management override of control). Since then, the sector has continued to face financial pressure which increasing the risk of material misstatements to the financial statements.

Due to both an increased fraud risk and a risk of error, for 2019/20 we have recognised the following risks; misstatement due to fraud and error, inappropriate capitalisation of revenue expenditure, pension liability valuation, valuation of land & buildings and Covid-19 disclosures. For each risk we need to;

- Walkthrough the key controls in relation to the risk
- Produce an internal memo setting out our understanding and audit approach to the risk
- Hold a team discussion involving the partner in charge to discuss our understanding and audit approach to the risk
- Set out our approach to those charged with governance in our audit plan
- Where a sample is required, increase our sample sizes by lowering our testing threshold and increasing our sample of random items
- Use a more senior member of staff to complete the work and all this work is required to be reviewed by the partner in charge
- Report our findings to those charged with governance in our audit results report
- Report our findings to the public in our annual audit letter.

The increase in risk has been a gradual process over several years, and we have borne the cost of the additional work up until this point. The scale fee that has been being set by PSAA for Royal Berkshire Fire Authority during that period is actually based on risk and activity levels from 2010. Therefore, we have now reached the point where there is acknowledgement from PSAA that the fundamental basis for setting that fee needs to change to reflect the costs of undertaking an external audit that meets the enhanced quality requirements now pervasive across the whole external audit profession.

Change in regulatory environment – public sector specific

In response to inspection reviews by our regulators¹, we have significantly increased the level of work we perform on the key estimates in your financial statements to ensure we are delivering a high-quality audit. This includes reviewing the work performed by the authority's external experts, which now often requires us to include our own experts on the audit. For example, PPE valuation;

- Valuations of land and buildings – the Authority are responsible for producing a materiality accurate set of financial statements. This includes producing estimates using reasonable supporting assumptions, and complete and accurate source data. Where the Authority do not have the capability within the team to produce the estimate for property valuation BNP Paribas Real Estate UK are engaged to produce the estimate.
- Our work now focuses on reviewing the estimates produced to assess whether they are based on reasonable supporting assumptions, and complete and accurate source data.

¹ - Please see point 4 in the executive summary of the latest PSAA quality report which state '*the main areas of concern highlighted by the reviewers are all ones that have been raised each year for several years on auditing property and pension fund valuations*'

- Where we do not have the capability to review the estimate within our team, we instruct our expert to review the estimate.
- We cannot rely solely on a general assessment of the valuer's competence and objectivity. In the same way we would not rely on a similar assessment of your finance team to assess whether a payables accrual is reasonable.

Similarly, for IAS 19 entries and disclosures we now perform detailed work on the source data your actuary is relying on to complete their estimate and the assumptions they use. Whilst we do appreciate these are estimates as you note, with respect with respect to the Authority, that the additional work on pensions has identified audit adjustments in areas such as the McCloud and asset values in previous years.

Whilst incremental one-offs have been factored into the audit fee through the variations process in the past, the point we are making is there is a base level of work now required, we have now been performing for a number of years and been absorbing the cost of to this point.

In addition, to the specific areas detailed above, we wanted to share with you the additional pressures we are facing to comply with the increase in the regulatory standards, which in turn underpins the value of the audit opinion which we provide:

- At EY we have increased our investment in audit quality in the UK over the last five years to £25million per annum and the number of people dedicated to our audit quality programme by over 25% in the last 12 months alone.
- We have also made significant investments in compliance, technology and talent, to enable us to deliver the sustainable high-quality audits that stakeholders demand.
- Meanwhile, as the CMA highlighted in its recent report, the costs of mandatory audit tendering and switching have largely been absorbed by the audit firms, leading the CMA to conclude that loss-making audits are anti-competitive and intra-firm subsidisation inappropriate.
- We and the other firms in our sector face intense competition for the best people. If we are to continue to provide the highest performing audit teams and protect audit quality, it is vital that we maintain the attractiveness of the audit profession and pay our people appropriately. You make the observation in your letter that this should have been included in the original tender. The issue we face is the seismic change in the market in the intervening 3-4 years and our need to respond to that.
- Market activity has driven greater innovation in the use of technology. The significant investment costs in this global technology continue to rise as we seek to provide enhanced assurance and insight.
- Finally, the significant increase in regulatory scrutiny across the board has increased our costs of compliance as it has, rightly, focused the market on audit quality and as part of this we are committed to achieving zero audit inspection failures.

These factors mean audit pricing will have to rise in the short term. I understand that resources are scarce and the focus for the Authority is on spending those wisely in the current environment. We would note that the assurance the external audit provides to you and your stakeholders is part of that process, ensuring that the millions of pounds entrusted to fire authorities are being appropriately accounted for. We understand you may not agree with our proposals as to how to address this situation, but equally you will understand that we are responding to PSAA, who as the contract holder in this arrangement, have asked us to provide the detail referenced above.

Hopefully this letter has responded satisfactorily to your concerns, but we would of course be happy to talk this through with you in more detail, if that would be helpful.

Yours sincerely



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