The Chartered Institute of
Public Finance & Accountancy

CIPFA

Financial Reporting Council - NHS Audit Market Study

A Submission by:
The Chartered Institute of Public Finance and Accountancy

October 2024

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money.

Further information about CIPFA can be obtained at www.cipfa.org

Any questions arising from this submission should be directed to:

Iain Murray
Director of Public Financial Management
CIPFA
77 Mansell Street,
London, E1 8AN
Tel: +44 (0)7880 456190
Email: iain.murray@cipfa.org

Introduction

CIPFA welcomes the opportunity to provide this submission as part of the Financial Reporting Council's NHS Audit Market Study.

For the avoidance of doubt the comments in this submission relate to the audit of NHS providers and Integrated Care Boards (ICBs) in England. While similar or equivalent bodies exist in the devolved administrations of Scotland, Wales, and Northern Ireland these are subject to different audit arrangements specific to each jurisdiction.

1. General

Q1 How well is the NHS audit market functioning? What issues are affecting this market?

1.1 Our understanding is that the NHS audit market in England is functioning but with clear indications to suggest underlying fragility.

1.2 We are aware that some NHS bodies have struggled to secure auditors and that in many cases attempts to tender for external auditors have resulted in either no bidders or only a bid from the incumbent auditor.

1.3 A significant number of NHS audits were not completed by the NHS England deadline in 2023, although this was in large part driven by the transition from Clinical Commissioning Groups to Integrated Care Boards which increased the number of audits in the NHS. More recent performance as set out in the recently published NHS England: annual report and accounts 2023 to 2024 presents an improved performance but still highlights ongoing risks which suggest that the NHS audit market is not in a robust position.

1.4 The key issue affecting the market is the lack of supply. In our view the underlying causes for this can be considered through the following lenses:

- Workforce challenges
- Broader trends and developments
- Regulatory environment

Workforce challenges

1.5 The ability for audit firms to recruit, train and retain sufficient people to conduct NHS audit work remains a challenge. This challenge has been exacerbated in recent years by the impact that the delays in local government audit have had on both the morale of the current workforce but also the attractiveness of local audit to those entering the profession.

1.6 There are currently barriers to entry at two important stages of the profession.

1.7 At the most senior end the need for a firm to be registered for appointment as a local auditor and the need for individuals to be given key audit partner (KAP) status represents a significant barrier to increasing supply with the whole of the local audit market and therefore impacts directly on capacity in the NHS.

1.8 NHS auditors have requirements which go beyond those in the corporate sector and are required to report on the body's arrangements for value for money (we set this out in more detail in paragraph 2.2 below). This work can identify significant weaknesses in respect of governance, financial sustainability, and efficient use of resources. Auditors in the public

sector also have statutory powers which they should consider exercising as part of their role. As such there is a degree of specialisation which warrants specific designation, and we are supportive of the need for KAP status.

1.9 In practice becoming a KAP is heavily reliant on recent and extensive experience of working in local audit. While knowledge of the sector and the operating context of the NHS is essential to ensure high quality audit work, so is technical audit knowledge and experience which can be obtained from work experience in other industries and sectors. We welcome the work underway by the FRC's Professional Body Supervision (PBS) team to set out criteria for approving the specialised training route to obtaining KAP status that is envisaged in the changes to the KAP criteria set out in 2022. This will create routes to KAP status that will allow greater flexibility for people to conduct mixed portfolios of corporate and public sector work.

1.10 This flexibility is also a significant issue for those entering the profession or at the initial stages of their careers. The current requirements of the Company's Act mean that any time spent on local audit (including the NHS) does not count towards the 120 days of statutory audit required to obtain an Audit Qualification. This unnecessarily disadvantages those people who conduct local audit work and restricts the ability of firms to use capacity flexibly across both corporate and local audit work (a particular barrier for smaller firms and new entrants). It also has the potential to diminish the perceived value of time spent conducting local audit work.

Broader trends and developments

1.11 There are other broader changes within the external audit market which have also reduced capacity within the NHS market specifically. Historically many firms had created a single team of sector expertise which they deployed to meet demand in the NHS external audit and internal audit markets. In response to the Competitions and Market Authority review audit firms have sought to create a split between audit and advisory businesses with internal audit teams now forming part of business risk services and sitting in the advisory business. This means that some firms had to reduce their capacity at all levels within external audit teams working in the NHS.

1.12 We are concerned that emerging developments will impact on the ability of audit firms and equally importantly NHS bodies to encourage people to join the public finance profession. The Government recently announced its intention to reduce funding allocated to Level 7 apprenticeships. Should funding be withdrawn from the Level 7 Accountancy apprenticeship, CIPFA envisages that this will cause significant financial challenges and exacerbate existing skills shortages for public sector organisations who are already feeling the impact of years of austerity and under-funding and impact on audit firms to use apprenticeships as a means to train the next generation of auditors and to encourage people from diverse and variety backgrounds to enter the profession.

Regulatory environment

1.13 The regulatory risks that audit suppliers are exposed to in the local audit market apply equally to the element specifically related to the NHS. The current arrangements mean that bodies which spend more than £500m a year are categorised as a major local audit and subject to supervision by the Financial Reporting Council's Audit Quality Review Team. This acts as a significant dis-incentive to firms whose corporate audit portfolios may not expose

them to this level of regulatory risk and who may not have the corporate infrastructure or experience in dealing with this level of regulatory scrutiny.

1.14 The level at which major local audit is set has a potentially disproportionate impact in the NHS. This is because the NHS is subject to more frequent and routine reform and restructure in the machinery of government. A recent example would be the impact of the changes in the commissioner landscape with the abolition of smaller clinical commissioning groups (CCGs) and the creation of larger integrated care boards (ICBs). This change has consolidated an equivalent amount of overall spending in fewer bodies, each of which now has an allocation more than the £500 million a year limit and as such is classified as a major local audit. While the amount of public money spent by ICBs has increased, the underlying risks associated with how that money is spent, accounted for, and reported have not. Although large ICB's represent some of the least complicated bodies within the NHS from an accounting and auditing perspective as such they could be an entry point for new suppliers to the market. The fact that all these bodies are major local audits means that new entrants to the market are unlikely to see them as such.

1.15 By revisiting the framework for determining major local audits and potentially designating both the type and size of body it would be possible to mitigate the impact on changes in the structure or funding for local bodies providing both certainty to audit providers about which supervision regime an audit falls under and what that will mean in terms of risks that need to be considered and managed. It would also allow for a more proportionate approach to supervision in this space which considered the inherent risks within an entity as well as its size.

Q2. What, if any, barriers do audit firms face in entering and expanding in the market?

2.1 As noted above in our response to question 1, there are significant barriers to entry because of workforce and regulatory challenges. These also act as barriers to expanding in the market. Firms will understandably be seeking to balance the level of work they can do with the resources available, and the risks and rewards associated with that work.

2.2 Auditors in the NHS have a larger role to play than providing opinions on financial statements. Auditors also provide assurance around the arrangements these organisations have in place for achieving economy, efficiency, and effectiveness in their use of resources. The current system provides external auditors with statutory powers to bring forward matters of concern that should be brought to the attention of the audited body and the public. Auditors have several other statutory powers and duties which require sector knowledge and understanding to discharge:

- to be satisfied that the NHS body has adequate arrangements in place to secure economy, efficiency, and effectiveness in its use of resources and to include a commentary and where necessary recommendations in their auditor’s annual report. Where auditors identify significant weaknesses in arrangements as part of their work, they should raise them promptly with those charged with governance.
- reporting on regularity (ICBs only)
- considering whether to exercise statutory powers such as a report in the public interest, written recommendations to the audited body (ICB and NHS trust only) or a referral to the Secretary of State.

These responsibilities mean that as well as traditional financial statements audit capacity and capabilities, NHS audit suppliers need to ensure that they have access to the skills and knowledge to carry out value for money work and where necessary those needed to discharge the statutory powers and responsibilities placed on them.

2.3 The nature of the NHS market also makes it difficult to expand because there are a finite number of bodies in the NHS and the top-down restructure mentioned above also impacts the size and shape of the market. For example, the creation of Integrated Care Boards meant that the NHS commissioner market went from 106 Clinical Commissioning Groups (CCGs) to 42 ICBs more than halving the number of potential audit clients in this space. On the provider side we are seeing increased group arrangements with bodies coming together to share boards and senior executive teams again potentially reducing the number of opportunities appearing the audit market as they look to jointly procure auditors.

2.4 As well as the size and shape of the market there are other factors in play which impact on the desirability of NHS audit. We set out challenges in respect of capacity constraints in answering question 3 below, in particular the impact of limited capacity and tight delivery timescales.

2.5 In our view a further disincentive to entry and expansion is the underlying financial fragility of local NHS bodies and the command-and-control approach to financial management and financial performance adopted in the NHS.

2.6 In very broad terms the key financial performance indicator for the NHS is to ensure that the Department of Health and Social Care remains within its vote funding. To deliver this overarching aim Integrated Care Systems and by implication the individual bodies within those systems are expected to deliver a pre agreed forecast position at the end of the year. The position is closely monitored throughout the financial year and any deviations, even ones which might result in a more positive financial performance such as a larger surplus or a smaller deficit is seen as undesirable.

2.7 Financial directors in the NHS will frequently refer to the need to “land on the postage stamp.” This need to deliver pre-agreed financial performance creates and environment where there are clear incentives to manipulated financial performance to achieve the desired or required position.

2.8 These factors combine to heighten the fraud risk environment for auditors working in NHS audit and increases the amount of work that NHS auditors need to undertake in respect of key areas of the financial statements which can impact on financial performance.

Q3. To what extent are there constraints on audit firms’ capacity to supply NHS audits? Why?

3.1 As set out in our response to question 1 above we see the major constraints on audit firms' capacity to supply NHS audits are because of shortage in capacity within local audit teams. However, there are other issues which impact on firms.

3.2 The NHS operates to a very tight and strict timetable which is driven by the need to lay the Department of Health and Social Care, NHS England, and Consolidated Provider Account before Parliament. The clarity of expectations around deadlines coupled with effective

monitoring centrally has many benefits, not least that it focuses the efforts of auditors and accounts preparers to deliver collaboratively within these timescales. It does though condense a significant amount of work into a narrow timeframe and presents an inherent resourcing challenge for firms.

3.3 Over time the amount of work that auditors are having to carry out in a number of areas has also increased as a result of changes to auditing standards (in particular the revisions to ISA 315 and ISA 240) and in response to areas of focus from inspection and regulation of local public audit. This means that the narrow window available to audit financial statements has become even more constrained.

3.4 Audit firms largely use the same teams to deliver NHS and local government audit work. The ongoing delays to local government audits in England mean that firms are under continued pressure to use their limited capacity to address this backlog. While this does not impact on the main final accounts window in May and June which is largely reserved for the delivery of NHS audit, it has impacted on the ability of firms to spend time on planning and interim visits during other times in the year with the result that more work is having to be delivered in the year end/final accounts window.

3.5 We know that NHS England and DHSC have an ambition to return to laying the main national consolidated accounts before Parliament in advance of summer recess. While we are always in favour of timely and accurate financial reporting, attempts to reduce the audit window for NHS bodies would put increased pressure on what is already limited capacity within the audit market. This would likely act as a disincentive to firms considering expanding their share of the market and may act as an incentive for them to in fact look to reduce their market share.

Demand for audit

Q4. How effective is the process for selecting and appointing NHS auditors?

4.1 Currently each NHS body in England procures and appoint its own auditor. Initially this system worked effectively and there was healthy competition in the external audit market for NHS bodies. However, evidence in recent years suggests that competition within the NHS audit market is not working as initially intended. Over time we have seen the emergence of several issues which are of concern:

- Commoditisation of audit and procurement focused on cost as opposed to quality when scoring tenders.
- A reduction in and lack of competition within the market with some providers leaving the market and others choosing to consolidate rather than expand their share of the market.
- Inability to find auditors – we are aware of some NHS bodies who have either failed to attract interest when appointing auditors and had to reappoint their incumbent auditor or in extreme cases have failed to appoint auditors.

4.2 With these emerging trends in the NHS market there is a risk that NHS bodies will be unable to demonstrate that they are achieving value for money through their procurement process for audit and even more concerning may fail to appoint auditors. The absence of an auditor of last resort in the current arrangements appears an increasingly significant gap against this backdrop.

Q5. What do NHS bodies expect from their audits and are their expectations being met?

5.1 Our understanding is that NHS bodies will look for the same as other bodies from their audits in that they want high quality audits which are delivered in line with the NHS England timetable and wherever possible add value to the body. As well as the work on the financial statements NHS auditors provide a conclusion on the body's arrangements to secure economy, efficiency, and effectiveness in its use of resources, often referred to as the value for money conclusion. The value for money conclusion can be an area where NHS auditors can add value and share their insights into the effectiveness of a body's operations. With the tight timescales mentioned above there is a risk that the full value to NHS bodies from this work is not always realised. The tight timetable in the NHS is understandable but it does run the risk that the focus becomes on completing the process in line with the timetable rather than considering what value is being obtained from it.

5.2 As noted above we are aware there have been some trends in the market, in particular the commoditisation of audit which would suggest that NHS bodies do not always understand and value external audit. Anecdotally we have heard of procurement for external audit being both rushed and, in some cases, built on template documentation used for the procurement of internal audit. This would suggest more can be done to improve the profile and importance of external audit within the sector.

Regulatory framework

Q6. What distinguishes NHS audits and to what extent do the current audit (and reporting) frameworks serve the needs of NHS bodies?

6.1 Our view is that the overall scope of NHS audits and the surrounding framework are effectively designed and any failure to meet expectations of individual bodies are because of the broader constraints and challenges within the market.

6.2 The key things that distinguish NHS audits are the responsibilities set out above in paragraph 2.2. These are important as they capture the key difference between the NHS audit as local public audit and the role that it plays in the stewardship of public funds.

Future of NHS audit

Q7. What, if any, changes are required to ensure a well-functioning NHS audit market?

7.1 We think that the following changes would over time ensure the continue and improved functioning of the NHS audit market.

7.2 Changes to the Key Audit Partner requirements to allow those with sufficient experience of auditing other sectors to obtain KAP status through appropriate training and qualification as well as through relevant work experience.

7.3 Working with Government to make the necessary changes to legislation so that time spent working in local public audit can be included in the 120 days of statutory audit needed for an audit qualification.

7.4 Ensuring that any future changes to the NHS timetable take in to account the impact on local NHS audit providers and does not act as a disincentive to either enter or remain in the audit market.

7.5 Considering whether wider reforms to the local public audit system might present the NHS to revisit procurement processes and in particular the opportunity to secure an auditor of last resort.

7.6 While not directly within the gift of the FRC or NHSE we think that there is potential for planned changes to funding for level 7 apprenticeships will have a profound impact on access to the public finance profession and act as a barrier to increasing capacity and diversity within both the audit and NHS finance workforces.