Local Audit Reset and Recovery Implementation Guidance (LARRIG) 06

Special considerations for rebuilding assurance for specified balances following backstop-related disclaimed audit opinions

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About Local Audit Reset and Recovery Implementation Guidance

Local Audit Reset and Recovery Implementation Guidance notes (LARRIGs) are prepared and published by the National Audit Office (NAO) on behalf of the Comptroller and Auditor General (C&AG) who has power to issue guidance to auditors under Schedule 6 paragraph 9 of the Local Audit and Accountability Act 2014 (the Act). LARRIGs are prepared and published with the endorsement of the Financial Reporting Council (FRC) and are intended to support the reset and recovery of local audit in England. The guidance in LARRIGs supports auditors in meeting their requirements under the Act and the *Code of Audit Practice* published by the NAO on behalf of the C&AG.

LARRIGs are numbered sequentially and published on the NAO's website. LARRIGs are intended to be in place for a limited period of time and will be withdrawn once no longer necessary.

This LARRIG is relevant to local auditors of local public bodies covered by the Local Audit and Accountability Act 2014 and the *Code of Audit Practice* **except** auditors of local NHS bodies including NHS foundation trusts and smaller authorities as defined by the 2014 Act.

Introduction and context

The guidance within this document is prepared to assist auditors in meeting their responsibilities under the Code of Audit Practice (the Code).

Contents

This guidance is structured as follows:

Status of guidance

1. This LARRIG sets out guidance to auditors of English local authorities in circumstances where the auditor's opinion on the prior year financial statements has been disclaimed because of backstop arrangements included in the Accounts and Audit (Amendment) Regulations 2024. Its purpose is to assist auditors in the process of rebuilding assurance for specific classes of transactions, account balances and disclosures which warrant special consideration beyond the general principles set out in LARRIG 05. It provides principles as well as indicative procedures which, with the application of professional judgement, enable the auditor to make a timely return to being able to determine that, based on sufficient appropriate audit evidence, the financial statements are free from material misstatement.

2. The scope of this guidance is limited to the application of the ISAs (UK) in the exceptional circumstances created by the backlog in completing audits of English local authorities, and where a statutory backstop mechanism has resulted in a significant number of instances where the auditor has disclaimed their opinion on prior year audits. As this guidance is issued by the Comptroller & Auditor-General under paragraph 9 of Schedule 6 of the Local Audit and Accountability Act 2014, it applies only to relevant authorities as defined by the Act. It does not address the auditor's responsibilities for Value for Money arrangements reporting, their wider powers and responsibilities, or circumstances relating to the issuance of the audit certificate. This scope is further limited to audits of annual accounts of financial years ending 31 March 2025 onwards.

3. This guidance is predicated on the assumption that local authorities can present a complete set of financial statements to the auditor in accordance with the applicable financial reporting framework. While this guidance is for auditors, it is also important to emphasise that the timely delivery of audited financial statements is a collective enterprise where both preparers and auditors have important responsibilities. Effective governance and internal controls, allied to accurate and timely financial reporting, are essential conditions to support a return to the timely delivery of audited financial statements where the auditor can reach opinions based on sufficient appropriate audit evidence. A failure on the part of management to present financial statements that represents a true and fair view of the local authority's financial statements may have implications for the overall audit opinion on those statements.

Format of guidance

4. To assist auditors in applying this guidance, four case studies have been included to illustrate the appropriate considerations that auditors may make in the specific

circumstances described in the case studies. While case studies cannot reasonably encompass every possible permutation of circumstances which auditors may encounter, they may help auditors to apply this guidance in the specific facts and circumstances of an individual engagement.

General considerations

5. This guidance also sets out a series of general considerations that may assist auditors in the application of the auditing standards in circumstances that could not have been envisaged during the drafting of those standards.

6. The first consideration is that facts and circumstances differ considerably between different local authorities. Levels of materiality, the underlying control environment, and exposure to various forms of risk will differ between local authorities and between different classes of transactions, account balances and disclosures. This means that the auditor must tailor both risk assessment procedures as well as responses to assessed risks to each individual engagement.

7. A second consideration impinges on the prioritisation decisions that auditors may be required to make. Because the extent of audit procedures required to recover assurance will vary between local authorities whose recent financial statements have been subject to disclaimers of opinion, the auditor needs to apply professional judgement to determine the appropriate level of audit work to achieve this. In doing so, the auditor may consider the timing of when necessary supporting evidence is made available. However, public interest considerations encourage auditors to aim for the timeliest possible return to the position where they can opine on the financial statements based on sufficient appropriate audit evidence. Accordingly, the auditor should plan and perform audits in scope of this guidance with this aim in mind, within the framework provided by the ISAs (UK).

8. A final consideration is that, for many of the local authorities for which disclaimed audit opinions have been issued due to backstop conditions, a reasonable pathway exists through the application of the auditing standards to where the auditor may issue an opinion that is based upon sufficient appropriate audit evidence. The timeframe in which this may be achieved may vary depending on the circumstances of individual engagements. However, there may be several local authorities where limitations of scope, caused by circumstances such as the availability of accounting records, mean that it may not be possible to recover assurance for these entities solely through the application of the auditing standards.

Case Study 1

A local authority has been in receipt of a series of successive disclaimers of opinion on their financial statements arising because of backstop arrangements. Due to issues with the local authority's financial reporting system, the Section 151 Officer has caveated the draft financial statements presented for inspection, noting that they represent a true and fair view apart from several specified audit areas.

In these circumstances, the auditor may enquire of management to understand the basis for the unwillingness to certify the whole financial statements as being true and fair, and to understand whether it will be possible to remediate these underlying issues in reasonable timeframe to facilitate the completion of the audit of the financial statements.

If the issue is not capable of being remediated before the operation of the backstop date, the auditor may consider the implications for the audit of the financial statements. These could include:

- Consideration of potential threats to their independence that could arise if, by continuing to perform the audit, they are in practice assisting management in the preparation of the financial statements through identifying misstatements which should have been reasonably identified before the presentation of the financial statements for audit.
- Consideration of whether these caveats represent a fundamental constraint on the ability of the auditor to achieve the objectives of the ISAs (UK). This will include consideration of whether the issue is pervasive to the financial statements. If the auditor determines that they are not able to achieve these objectives, they may reasonably conclude that they cannot continue to perform the financial statement audit until the underlying issue is remediated, or until backstop conditions necessitates the completion of the financial statement audit.
- Consideration of the impact on the auditor's opinion under backstop conditions. In particular, the auditor may consider whether the caveats represent a management-imposed limitation of scope in accordance with ISA (UK) 705. This will include consideration of the need to communicate this matter to those charged with governance in accordance with ISA (UK) 705, paragraph 12.

In circumstances where management cannot provide draft financial statements which they can certify as being true and fair, the auditing standards might not provide a pathway to where the auditor can issue an opinion on the financial statements based upon sufficient appropriate audit evidence. At the least, the auditor cannot issue an unmodified opinion if the Section 151 Officer cannot certify that the financial statements represent a true and fair view in accordance with the applicable financial reporting framework. It is important to note that these impediments only apply to the audit of the local authority's financial statements, and not to the auditor's other wider responsibilities as part of the audit of a local authority.

Risk assessment procedures

Purpose of risk assessment procedures

9. In establishing the overall audit strategy as required by ISA (UK) 300, the auditor is required to consider the factors that, in their professional judgement, are significant in directing the engagement team's efforts.[1] For audits where the preceding financial year has been subject to a disclaimer of opinion by the auditor, it is highly probable that regaining assurances over opening balances on reserves will be a significant matter. Auditors may conclude that a significant risk of material misstatement is associated with specific balances in the current year audit, because of the way they accumulate over successive years. These may include one or more reserve balances; non-current fixed assets; and deferred capital grants. However, the determination of whether a significant risk of material misstatement exists depends upon the facts and circumstances of each engagement, as well as findings from risk assessment procedures.

10. The auditor is required to plan and perform risk assessment procedures as part of the audit plan.[2] As set out in ISA (UK) 315, the purpose of risk assessment procedures is to identify and assess the risks of material misstatement, whether due to fraud and error, at the financial statement and assertion levels. This is to provide a basis for designing and implementing responses to the assessed risk of material misstatement.[3] They may also serve to confirm whether the auditor's initial assessment on the extent of the risk of material misstatement for reserves balances is appropriate.

11. The auditor may determine either at the determination of the overall audit strategy, or during detailed audit planning, or during the performance of risk assessment procedures, that it will not be possible to achieve the objectives of the ISAs (UK) and issue an opinion on the financial statements that is based on sufficient appropriate audit evidence before any backstop date to which the audit is subject. The auditor may follow the guidance set out in LARRIG 02 when these circumstances arise.

12. The assurance approach for certain classes of account balances, transactions and disclosures within a local authority's financial statements has been to usually rely on assurance from the prior year audit for the opening balances, and to then perform audit procedures over in-year transactions to obtain sufficient appropriate audit evidence that these balances are true and fair and in accordance with the applicable financial reporting framework. This approach is typically employed for reserves balances. However, this

[1] ISA (UK) 300, paragraph 8(c).
[2] ISA (UK) 300, paragraph 9(a).
[3] ISA (UK) 315, paragraph 11.

approach is not always practicable in instances where the prior year audit has received a disclaimer of opinion.

13. Risk assessment procedures are therefore necessary to identify the likelihood and magnitude of risks of material misstatements in reserves balances in these circumstances. The findings from these procedures will also enable the auditor to design and perform response to identified risks. Auditors are required to obtain more persuasive evidence for risks that occupy a more elevated position on the spectrum on inherent risk.[4]

    a. If a balance is considered to be at the upper end of the spectrum of inherent risk, the auditor may regard it as a significant risk in line with ISA (UK) 330.

    b. Alternatively, if the balance is at the lower end of the spectrum of inherent risk, the auditor may only be required to design and perform responses which are in accordance with ISA (UK) 330, paragraph 18. If an individual reserve balance is not qualitatively or quantitatively material, the auditor may determine that there is no requirement to perform substantive procedures with respect to this balance, depending on inherent risk factors deriving from its quantitative or qualitative significance.[5]

14. In the context of reserves balances, there are inherent risk factors which all local authorities subject to recently disclaimed opinions will share, though the risk profile may differ according to the circumstances of each local authority. There will also be factors specific to each individual local authority's system of internal control. These will be discussed in turn.

15. Appendix 2 of ISA (UK) 315 provides a framework for considering inherent risk factors which arise from obtaining an understanding of the entity and its environment, and the applicable financial reporting framework. With respect to building assurance over reserves, two factors are particularly apparent:

    a. Complexity

    This arises from two sources:

    - Some reserves balances are, by nature, the product of an extensive series of transactions which are accounted for in a variety of different ways. This, in itself, represents an inherent risk factor.[6] Due to a wide range of transactions that are often accounted for and processed in different ways, it is inherently more difficult to identify and capture all the elements that feed into these balances. However, it is important to note that certain

[4] ISA (UK) 330, paragraph 7(b).
[5] ISA (UK) 315, paragraph A8, second bullet.
[6] See also ISA (UK) 315, paragraph A8, first bullet.

reserves balances, such as the Pensions Reserve or the Revaluation Reserve, may not share this inherent complexity due to the nature.

- The applicable financial reporting framework requires the presentation of reserves balances in a prescribed manner, with several distinct account balances required because of statutory requirements. These reserves are characterized as 'usable' and 'unusable' reserves. This creates additional complexity with respect to the classification of specific transactions and how they ultimately impact specific reserve balances.

b. *Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk*

Conditions may be present that create a susceptibility to intentional or unintentional failure by management to present and record transactions in accordance with the applicable financial reporting framework. The extent of certain individual usable reserve balances are key measures for users in terms of assessing a local authority's financial resilience and compliance with statutory requirements. An incentive may therefore exist for management to overstate the value of these balances. The incorrect classification of revenue expenditure as capital expenditure, or the incorrect classification of income and/or expenditure between the General Fund and the Housing Revenue Account, provide examples of how balances may be manipulated in this way.

16. While these inherent risk factors are the most prominent considerations for reserve balances, there are other entity-specific considerations which may impact the overall determination of risk. For example, management incentive to overstate certain usable reserves may be more pressing where a local authority is under considerable financial pressure. In these circumstances, specific procedures that relate to the local authority's system of internal control may be necessary to assess risk and help determine the appropriate audit response.

17. For opening balances for reserves accounts which consist of an extensive range of transaction streams such as the opening balance for the General Fund, it may be appropriate for risk assessment procedures to consider the potential risk of misstatement within each transaction stream, and how those risks could give rise to a risk of material misstatement in the overall opening balance. This will assist the auditor to specify risks with an appropriate level of granularity, as well as design appropriate responses to that specifically respond to the identified risk.

18. As part of the risk assessment procedures, the auditor is required to consider information from other sources.[7] In particular, the auditor should consider the Value for Money work for the current period, as well as for previous reporting periods that have been subject to disclaimers. These will assist the auditor in determining the extent of risks to the financial sustainability to the authority, as well as the processes and controls in place to mitigate those risks. In instances where a different audit firm performed the engagement in previous reporting periods, the current auditor may need to consider Value for Money work with a view to supporting the current year risk assessment procedures when reviewing a predecessor auditor's file.

Specific risk assessment procedures in relation to the local authority's system of internal control

19. It is possible to identify several specific risk assessment procedures which auditors may perform to obtain a better indication of the underlying risk of material misstatement in reserves balances, because of the common transaction streams in local authority financial statements. ISA (UK) 315, paragraph 14 requires that risk assessment procedures include inquiry of management and other appropriate individuals, including any internal audit function; analytical procedures; and observation and inspection. In the context of assessing risk, it may be necessary to extend these procedures to cover periods subject to disclaimed audit opinions. Of course, it will not be possible to use observation as an approach to certain types of risk assessment procedure for past periods, such as reviewing the operation of controls, unless the relevant risk assessment procedure has been observed as part of a previous audit. If this is the case, the auditor will also have to make an assessment as to whether this remains relevant and reliable evidence.

The overall control environment

20. Through inquiry and inspection of relevant documents, the auditor will be able to perform a risk assessment as to whether the overall control environment continued to provide an appropriate foundation of the local authority's system of internal control, or whether any control deficiencies identified during this period undermine the other components of the system of internal control.

The local authority's risk assessment processes

21. The auditor may review and evaluate the Section 25 report made by the Chief Finance Officer as part of its budgetary processes to understand the process of identifying risks to the financial viability to the entity, as well as its process of assessing the sufficiency of its usable reserves to support its operations.[8]

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[7] ISA (UK) 315, paragraph 15.
[8] In this guidance, 'Section 25 report' refers to the report required by Section 25 of the Local Government Act 2003.

The local authority's processes to monitor the system of internal control

22. For the financial years subject to a disclaimed opinion, the auditor may review the Annual Governance Statement to understand the governance framework, and internal audit reports to evaluate and assess the functioning of controls.

23. Additionally, the auditor may determine whether the local authority has itself identified any misstatements in its financial statements for the disclaimed period.

The local authority's information system and communication

24. The auditor may undertake procedures to identify whether there have been significant changes to the local authority's information processing activities. The presence of such changes may indicate a heightened risk of material misstatement because of the discontinuity in systems and processes that may arise.

Control activities

25. Where the auditor identifies a significant risk that relates to classes of transactions, account balances and disclosures that relate directly to reserves, the auditor will need to identify specific direct and indirect controls that address the risk. For each identified control, the auditor will need to evaluate whether the control was designed and implemented effectively. Through inquiry and inspection of available records, the auditor may employ professional judgement to determine whether these controls were designed and implemented effectively during disclaimed periods.

Types of risk assessment procedures

26. The exemplar procedures set out below are not intended to be exhaustive. The auditor is not required to perform all of them, and may identify complementary or alternative procedures that, in the context of a specific local authority, better inform their assessment of the risk of material misstatement in opening reserves balances. Some of the examples provided below may be considered substantive procedures in accordance with ISA (UK) 330. The auditor may perform substantive procedures, or tests of controls, concurrently with risk assessment procedures where it is efficient to do so. Additionally, some of the risk assessment procedures below may be relevant to more than one class of account balance or related transactions. Where this is not the case, they have not been repeated under separate headings.

    a. *Usable reserves*

    - The auditor may inspect the financial statements, from the disclaimed period, to ensure movements in relevant reserves are consistent with the requirements of the financial reporting framework, other primary statements and the notes to the financial statements.

- The auditor may also inspect the local authority's reconciliation of its general ledger to its financial statements for the disclaimed period to ensure they are consistent.
- An assessment of overall budgetary controls may assist the auditor in determining the local authority's ability to monitor its own reserves position. The auditor should ensure that any procedures in this area are properly integrated with any work performed on VFM arrangements.
- The auditor may also review budget against outturn for revenue and capital expenditure during the disclaimed period.
- Additional risk assessment procedures may be appropriate for specific usable reserves or underlying transactions based on the auditor's understanding of the financial reporting framework. For the General Fund, the auditor may consider:
    - Inspecting management's reconciliation of the Capital Financing Requirement (CFR) to the balance sheet.
    - Inspecting the Minimum Revenue Provision (MRP) policy approved by Full Council and evaluating if proper 'regard' was given to relevant statutory guidance when setting it.
    - Performing a reasonableness review of MRP charges compared to CFR over a period that includes, but is not limited to, the disclaimed period.
- For the Housing Revenue Account (HRA), the following procedures which may assist the auditor in determining the determining the level of risk around inappropriate or incomplete movements:
    - Extending its inspection of the reconciliation between the general ledger and primary statements for the disclaimed period to include the classification of HRA related ledger codes.
    - A review by the auditor of the design and implementation of controls in operation over classification of HRA income and expenditure from audit procedures performed in the current year, combined with an understanding of any changes since the disclaimed period.
    - Additional risk assessment procedures may be appropriate for specific underlying transactions. For example, the auditor may consider reviewing the reasonableness of movements in rental income in each disclaimed period against approved increases in rent and disclosed changes in housing stock.

b. *Unusable reserves*

- In general, the approach to unusable reserves will be similar to that employed for usable reserves.
- A reconciliation of material movements in the Movement in Reserves Statement to other primary statement and notes for the disclaimed period may help the auditor assess the underlying risk of incorrect classification between different reserve balances.
- Additional risk assessment procedures may be appropriate for specific unusable reserves or underlying transactions based on the auditor's understanding of the financial reporting framework. For example, for the Pension Reserve the auditor may consider if it is equal and opposite, throughout the disclaimed period, to the valuation of the net pension asset or liability disclosed elsewhere on the Balance Sheet.

c. *Property, plant, and equipment*

This class of account balances and related transactions, while not in itself a reserves balance, feeds into several balances within reserves. The following risk assessment procedures may allow the auditor to assess the underlying risks of inappropriate classification of expenditure between capital and revenue items.

- An assessment of the design and implementation of controls in operation over capital additions and the fixed asset register from audit procedures performed in the current year, combined with an understanding of any changes since the disclaimed period.
- A review by the auditor of changes to the composition of the fixed asset register during the disclaimed period, to help identify any potential risks of material misstatement and determine the consistency of additions and disposals with disclosures included in the financial statements issued during that time.
- The auditor may also review the consistency of other information in the narrative report with the financial statements issued during the disclaimed period.

Identifying and assessing the risks of material misstatement

27. The auditor shall use the results of risk assessment procedures to identify risks of material misstatement for reserves balances and determine whether they exist at the financial statement level or the assertion level for these balances. In instances where the

disclaimed period extends for more than one year, several factors may mean that the underlying risk of material misstatement is heightened. These may include:

- Loss of institutional knowledge through the departure of key personnel.
- The cumulative loss of experience by a local authority in applying the complex capital financial regime applicable to local government, and the preparation of adequate working papers to support the financial statements.
- The implementation of new IT systems.
- Unfamiliarity and a loss of engagement with the audit process following the comparative absence of audit procedures during the disclaimed period.

These factors are likely to impact several classes of transactions, account balances and disclosures. They are therefore likely to give rise to risks of material misstatement at the financial statement level, rather than the assertion level for reserves balances alone.

28. In the context of reserve balances, the assertions used by the auditor to consider different types of potential misstatements that are most likely to be associated with a risk of material misstatement are:

- Completeness; and
- Accuracy, valuation, and allocation.

The auditor should still apply professional judgement to consider whether other risks of material misstatement are attached to other relevant assertions.

29. The concept of materiality provides the auditor with the appropriate basis for making judgements about misstatements that will be considered material and therefore assist in the identification and assessment of risks of material misstatement. As ISA (UK) 320 states, the determination of materiality by the auditor involves the exercise of professional judgement. Following the issuance of a disclaimer of opinion on a previous set of financial statements, the auditor may consider whether user sensitivity to misstatements will have changed. If user sensitivity has not changed, the auditor may reasonably conclude that the past approach to the determination of materiality remains appropriate.

30. The auditor should also consider the qualitative aspects of materiality for all classes of transactions, account balances, and disclosures. For example, misstatements in particular useable reserve balances that are immaterial by value may have a significant impact upon the financial sustainability of a local authority. There may be other audit areas that are qualitatively material because of the risk that misstatement may have on the user’s understanding of the local authority’s financial position.

31. The determination of performance materiality requires the application of the auditor's understanding of the entity and the consideration of the results of risk assessment procedures.[9] The factors outlined in paragraph 27 above may lead the auditor to anticipate a higher risk of misstatement during the current period in the aftermath of a disclaimer. This may lead the auditor to set performance materiality to a lower level to reflect a heightened risk of undetected misstatements. It may also be reasonable to determine performance materiality on the same basis as used in previous reporting periods if the auditor determines that the risk of undetected misstatements is unchanged. This may be likelier in instances where the local authority has only received one disclaimed opinion because of backstop arrangements.

[9] ISA (UK) 320, paragraphs 11, A13.

Case Study 2

A local authority has received a disclaimer of opinion due to backstop arrangements for their financial statements for the year ending 31 March 2024. Prior to this, the financial statements had not been subject to a modified opinion. There has been no fundamental change in the local authority's activities or its asset base. There are no heightened concerns with respect to the local authority’s financial sustainability. In the past, the auditor has determined materiality with respect to net expenditure.

When determining materiality, the auditor may make the following considerations, as well as the other requirements set out in ISA (UK) 320:

- Has there been any change in user sensitivity to misstatements within the financial statements?
- Has user sensitivity to misstatement in specific balances within the financial statements changed?

Subject to the results of these considerations, the auditor could reasonably conclude that the past approach to materiality in the engagement remains appropriate for the audit of the financial statements for the year ending 31 March 2025.

It is likely that the auditor’s considerations here are insensitive to the number of reporting periods subject to a disclaimer of opinion.

When determining performance materiality, the auditor considers the following, alongside the other relevant requirements in ISA (UK) 320:

- Has there been a recent track record of extensive audit adjustments identified during the audit process?
- Has there been changes at the entity that impinge upon the financial reporting process? These could include changes in key persons responsible for the preparation of the financial statements, or changes in financial reporting systems or business processes.
- Are there any indications of a fall in quality of the financial statements issued for the financial year subject to the backstop-related disclaimer? These may include any misstatements subsequently identified by management after the publication of the financial statements.

If these considerations lead the auditor to conclude that there is a heightened risk of misstatement for the financial statements as a whole, it may be reasonable for the auditor to reduce the level of performance materiality from that selected in past audits to address the heightened probability that the aggregate of uncorrected and undetected misstatements in a class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure.

The determination of performance materiality may also consider the length of time since the auditor has been able to issue an opinion based on sufficient appropriate audit evidence. For example, if a local authority's financial statements have been subject to several years of backstop-related disclaimers, and where there has been little or no substantive audit work performed for each of these audit cycles, the auditor may consider that risks of material misstatement have increased since preparers have not been subject to the full rigour of external audit for an extended period. In this case, it may be appropriate to reduce the level of performance materiality to respond to these risks.

Responses to the assessed risk of material misstatement

32. ISA (UK) 330 requires the auditor to design and perform further audit procedures whose nature, timing, and extent are based on and responsive to the assessed risks of material misstatement at either the financial statement level, or the assertion level.[10] In the context of this guidance, the auditor is required to design and perform procedures which are proportionate to the risks of material misstatement that might be attached specific assertions in relation to opening reserve balances. The auditor is also required to obtain more persuasive evidence as their assessment of risk increases.[11]

33. In relation to the spectrum of risk for individual reserve balances that the auditor might identify through risk assessment procedures, there is a spectrum of potential response:

    a. The auditor may regard individual reserve balances that are both qualitatively and quantitatively immaterial as non-significant account areas, with the consequence that they do not perform any substantive procedures with respect to those balances.

    b. For material opening reserves balances that the auditor has not identified as a significant balance, the auditor is required to perform substantive procedures that can be tailored to the auditor's consideration of the assertion where there is a reasonable possibility of the misstatement being material.[12]

    c. For opening reserve balances that the auditor has identified as a significant balance, the auditor is required to perform substantive procedures which are designed to detect any potential material misstatements.

    d. Where a significant risk has been identified in relation to a significant opening reserves balance, the auditor is required to substantive procedures that are specifically responsive to the identified risk.[13]

34. A series of potential substantive procedures are set out below, which the auditor may use and tailor in response to these risks:

    a. The auditor may obtain audit evidence with respect to the total valuation of reserve opening balances via a proof-in-total approach. The auditor may use audit evidence relating to the valuation of assets and liabilities at year end. Since the auditor should also be able to obtain assurance on in-year movements in reserve balances through procedures performed in relation to the income and expenditure transactions and

[10] ISA (UK) 330, paragraphs 5-6.
[11] ISA (UK) 330, paragraph 7(b).
[12] ISA (UK) 330, paragraphs 18, A42 – A47.
[13] ISA (UK) 330, paragraph 21.

statutory adjustments taking place during the reporting period, the auditor should therefore be able to obtain audit evidence over opening reserve balances in total.

b. The auditor may also consider the results of audit procedures performed in relation to other balances to generate audit evidence on whether classification of balances and transactions as reserves is fairly stated. These procedures may also be able to provide assurance as to whether balances have been correctly classified to the appropriate balance within reserves.

- For the revaluation reserve, the auditor's audit procedures performed in relation to fixed assets may also provide assurance in relation to this balance.
- Since the pension reserve balance should, in most cases, be equal and opposite to the valuation of the net pension asset or liability recognised elsewhere on the balance sheet, the auditor may obtain sufficient appropriate evidence by confirming that this is the case if the appropriate audit procedures have been performed on the net pension asset or liability.

c. Depending on the assessed risk of material misstatement for specific types of reserve balances, the auditor may also develop further audit procedures to obtain sufficient appropriate audit evidence that these individual balances are correct. An example of such a procedure is provided below:

- For both the capital adjustment account and the capital grants unapplied reserve account, the auditor may need to perform substantive procedures on movements in these balances since the last set of accounts to receive an unmodified opinion to obtain sufficient appropriate audit evidence over opening balances.

d. The auditor will also need to consider whether these procedures have obtained sufficient appropriate audit evidence that the residual risks of material misstatement are reduced to a significantly low level to determine that the opening balances of remaining reserves, such as the General Fund and HRA, are fairly stated.

e. The auditor may perform substantive procedures in relation to transactions in prior periods subject to disclaimers if they consider the assessed risk of material misstatement in certain opening reserve balances such as the General Fund Reserve and the HRA warrants this approach. Since the auditor's responsibilities for the opening balances are to ensure that they are materially correct in relation to the current reporting period, the auditor should use the same approach to materiality as has been adopted for the current reporting period.[14] ISA (UK) 320 does not permit

[14] ISA (UK) 510, paragraph 6. This paragraph makes it clear that the auditor is required to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements.

auditors to set a separate higher materiality for opening reserves balances than for the financial statements as a whole.

35. The auditor is required by ISA 330, paragraph 18, to perform substantive procedures for all material classes of transactions, account balances, and disclosures. For reserve balances that are deemed material but not significant, the auditor may design substantive procedures which address those assertions for which a risk of material misstatement may be reasonably possible.[15]

[15] Further guidance on the appropriate design of procedures is provided by ISA 330, paragraphs A43–A47.

Case Study 3

A local authority has received a backstop-related disclaimer on its financial statements for the years ending 31 March 2023 and 31 March 2024. There have been no fundamental changes in the activities in which the local authority is engaged. The draft financial statements indicate that reserves balances are sufficient for the short to medium term, but there are moderate concerns about its long-term financial sustainability due to cost pressures in adult social care. The auditor's risk assessment procedures have identified the following:

- There are no indications that the local authority's control environment has substantially changed over the course of the two years subject to disclaimers.
- The local authority has a reasonable track record in the production of high-quality financial statements with only a limited number of misstatements identified in past audits.
- A review of movements in reserves balances and statutory adjustments during the disclaimed period indicate that these are consistent with the primary statements and supporting notes, and the auditor's understanding of the requirements of the financial reporting framework.
- An assessment of the Section 25 report on the adequacy of reserves indicates that the local authority has adequate reserves for the short to medium term.
- A review of capital controls in operation at the local authority suggest that they have been generally functioning satisfactorily.

The auditor uses professional judgement to determine whether it is necessary to perform testing on accounting entries in historic periods based on their underlying assessment of risk. Higher risks to financial sustainability allied to a weak control environment may create an opportunity to misrepresent the level of usable reserves at the local authority through management override. However, the auditor may also determine that longer term risks occupy a less prominent position on the spectrum of inherent risk than shorter term risks. Where the auditor assesses that the risks are low and that the controls are satisfactory, it may be reasonable to determine that either limited or no historic testing is necessary.

If the auditor determines that short-term risks to financial sustainability and an unsatisfactory control environment do not result in heightened risks of material misstatement, the auditor may determine that the following procedures are appropriate:

- The application of a proof-in-total approach to determine the overall valuation of reserves.
- Other procedures on other specific reserve balances as deemed appropriate by the auditor, based upon their assessment of the risk of material misstatement and whether the balance is material, and paying particular attention to risks of incorrect classification between different reserves balances.

The auditor may also review audit evidence from other procedures to identify whether there are indications of prior period errors which would have an impact on reserve balances.

Case Study 4

A large and complex local authority with relatively complex group arrangements has been subject to four years of disclaimed opinions due to backstop arrangements. No significant audit work has been performed during these years. The local authority is also unable to produce accounts on a timely basis and management have informed the auditor that it does not have the capacity to respond to audit queries, since it is currently preparing for local government re-organisation. The auditor's risk assessment procedures have identified the following:

- The local authority has experienced changes in key personnel involved in the financial reporting process, including the Section 151 Officer, and there has been a significant erosion of corporate memory with respect to the reporting periods subject to disclaimed opinions.
- While the local authority's General Fund position remains marginally positive, the local authority has identified the need for significant savings, even in comparison with its peers.
- The auditor's work on VFM arrangements identified significant weaknesses in several areas. The matters identified included a history of failing to meet savings targets, unsustainable and unplanned use of reserves to bridge resulting funding gaps, and an optimism bias resulting in management's financial planning being based on unrealistic assumptions. In addition, management accounts are poorly presented and difficult to understand.
- A review of the financial statements issued during reporting periods subject to a disclaimer has identified significant internal inconsistencies as well as inconsistency with management accounting.

In these circumstances, the auditor would take into consideration the following when determining the location of risks of material misstatement on the spectrum of inherent risk: the underlying complexity of the local authority; the number of periods subject to disclaimed opinions due to backstop arrangements; indications of a weak control environment; lack of capacity within the financial reporting function; and potential incentives to overstate the General Fund position.

In these circumstances, it may be reasonable for the auditor to determine that there is a significant risk of material misstatement in the opening balance for the General Fund. The auditor's risk assessment procedures may also identify that the significant risk is primarily associated with one or more specific transaction streams that feed into the General Fund position. In these circumstances, the auditor may reasonably conclude that testing of transactions from these streams from disclaimed periods provides the only pathway to obtain sufficient appropriate audit evidence that the opening balance for the General Fund is fairly stated.

The auditor may also consider whether the inability of the local authority to respond to audit queries constitutes an inability to obtain sufficient appropriate audit evidence. This may constitute a management-imposed limitation of scope, which is likely to be pervasive to the financial statements as a whole. The auditor could then reasonably conclude that the objectives of the financial statement audit, as set out in the ISAs (UK), cannot be met. In this event, the auditor should consider the implications for their work, as well as the need to communicate on these matters with those charged with governance.

Special considerations for other specified matters

36. There are other audit areas that merit special considerations following one or more reporting periods where the auditor has disclaimed their opinion because of backstop considerations. These areas may also give rise to risks of material misstatement. These are considered below.

Property, plant, and equipment

37. While these classes of assets are not directly reflected in reserves, transactions relating to these balances often have an important impact on the determination of reserves. Facts and circumstances may differ significantly between local authorities, and so the most efficient and appropriate audit approach will also vary between different engagements.

38. Based on their risk assessment procedures, auditors will need to consider what procedures are required in relation to the completeness assertion for these classes of assets. These may include testing transactions such as additions, disposals, reclassifications, and depreciation during disclaimed periods.

39. For the valuation assertion, the number of disclaimed periods may impact the audit approach. Some revaluations are performed on a rolling programme over up to five years. In these circumstances, and where there is only one disclaimed period, the auditor may conclude that the most efficient approach is to test revaluations from that disclaimed period alongside the work performed in the current year.

40. As the number of disclaimed periods increases within the context of an individual engagement, the extent of audit procedures required to rebuild assurances over revaluations will also increase. The most efficient and effective approach to rebuild assurances will depend on the facts and circumstances of the individual engagement. It may be appropriate for auditors to refrain from performing audit procedures on past transactions, and to wait until assets are revalued under the ongoing programme of asset valuations performed by Management. Where auditors consider it necessary to rebuild assurance prospectively, they should consider discussing its approach with management. In these circumstances, the proportion of the asset base that management revalue each year may limit how rapidly assurances can be rebuilt.

41. Where the auditor is unable to fully rebuild assurances on this balance, the impact on the audit opinion for the current and future audit opinions will need to be considered. The auditor may also consider the public interest perspectives set out in paragraph 7 of this guidance when applying professional judgement in determining the opinion in these circumstances,

Responses to identified risks of fraudulent financial reporting in previous reporting periods subject to disclaimers of opinion

42. The auditor may determine that there is risk that undetected fraudulent financial reporting in previous reporting periods for which the auditor has issued a disclaimer relating to backstop conditions results in a significant risk of material misstatement for specific opening balances within the current year financial statements. This could arise from management's ability to misclassify transactions between different classes of transactions and balances through override of controls. For example, this could include overstatement of the General Fund Balance, or misclassification between the General Fund and the Housing Revenue Account.

43. The auditor's response to this risk may depend on the extent of audit procedures performed during reporting periods subject to a disclaimer. For example, the auditor may determine that the risk is at a similar level to that found in a continuing engagement. If all the necessary substantive testing was performed during the year or years subject to a disclaimer, the auditor will need to perform appropriate procedures to facilitate the inclusion of this work as audit evidence in the current year file. The auditor may need to design alternative approaches which are responsive to the assessed risk in instances where the predecessor auditor was a different firm.

44. The extent of the auditor's response to any identified risk should also have regard to the specific facts and circumstances of the engagement. For example, local authorities that have a heightened incentive to manipulate their financial statements to improve perceptions of their financial sustainability may be regarded as being subject to a higher risk of fraudulent financial reporting.

45. The auditor's response to any identified risks should be responsive to the specifics of the identified risk. For example, if understatement of the Minimum Revenue Provision is an identified risk, the auditor's response should include testing the accuracy of the reported amount in accordance with the approach adopted by the local authority's stated MRP policy, and that it does not represent a departure without good cause from statutory guidance on the matter.

46. The auditor's response to any identified risks should include testing subsequent correcting journal entries relating to account areas which directly relate to those risks. Such areas may include:

    - The appropriate classification of revenue expenditure and capital expenditure.
    - The allocation of income and expenditure between the General Fund and the Housing Revenue Account.
    - Determination of the Minimum Revenue Provision.

Pensions-related balances

47. Local Government Pension Schemes are subject to triennial revaluations with interim desktop revaluations performed by the scheme actuary. The last triennial valuations were for the position on 31 March 2022. Due to timing reasons, the impact of this would have been first reflected in financial statements for the year ending 31 March 2023.

48. In instances where the opinion on the financial statements for the years ending 31 March 2023 and 31 March 2024 have been disclaimed, the auditor may have no assurance over the source data used for the triennial valuation, or for the subsequent roll-forward valuation. It may be impractical and inefficient for the auditor to obtain these assurances for the year ending 31 March 2025, especially if a different firm acts as the pension fund auditor. In these instances, the auditor is unlikely to be able to rebuild assurance on pension balances until the next triennial valuation, which will impact financial statements for the year ending 31 March 2026. While this should not prevent the auditor from being able to obtain assurances over other reserve balances, the impact on the audit opinion for the current and future reporting periods will need to be considered. As set out in paragraph 41, the auditor may also consider the public interest perspectives set out in paragraph 7 of this guidance when applying professional judgement in determining the opinion in these circumstances.

49. In instances where only the opinion for the financial statements in the year ending 31 March 2024 has been disclaimed, the auditor may be able to obtain assurance over the roll-forward procedures for that year. This should allow the auditor to obtain sufficient appropriate audit evidence over all pension-related balances for the year ending 31 March 2025, provided that they have assurances from the pension fund auditor on the source data from the previous triennial valuation

Departure from LARRIG Guidance and Raising Technical Issues or Queries

50. Where auditors judge that they need to depart from the guidance in a particular engagement, this should be drawn to the attention of the NAO and the FRC who will consult with the appropriate organisations within the local audit system to resolve the issue.

51. Auditors in firms should raise queries within the firm, in the first instance, so that the relevant technical support service can consider whether to refer queries to the NAO.

52. All queries related to LARRIGs should be submitted to the NAO's 's Local Audit Code and Guidance (LACG) team by e-mailing LACG.queries@nao.org.uk. Auditors are reminded that only nominated contacts can email LACG Queries. Please email lacg@nao.org.uk to request additional contacts to be added, including details of role and supporting explanation.

53. The NAO also engages with the firms through its Local Auditors Advisory Group (LAAG) and supporting technical networks to consider any emerging regime-wide technical issues on a timely basis. Auditors should follow their in-house arrangements for bringing significant emerging issues relating to the reset and recovery of the local audit system to the attention of their supplier's representative on LAAG or the relevant technical network.