

Future Arrangements for audit

Purpose of report

For discussion and direction

Summary

This report invites members' views on the key issues in the DCLG consultation paper "Future of local public audit" and asks the Board to authorise the lead members to approve the LG Group response in the light of the discussion and the views expressed by councils and FRAs.

Julie Carney, Deputy Director, Local Government Quality and Performance, DCLG will attend the meeting to talk about the DCLG consultation paper.

Recommendations

1. Members confirm the potential key points of an outline response set out at Appendix B ***attached***.
2. Members provide views on the specific issues raised in paras 1 – 7
3. Lead members be authorised to approve the LG Group response in the light of members' views and the views expressed by councils.

Action

Officers prepare a draft response in the light of views expressed by members and councils and secure Lead Members' approval.

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Future arrangements for Audit

Background

1. On 13 August 2010, Eric Pickles MP, Secretary of State for Communities and Local Government announced plans to disband the Audit Commission and to refocus audit on helping local people hold councils and local public bodies to account for local spending decisions.
2. In summary it was announced that the Audit Commission's responsibilities for overseeing and delivering local audit and inspections will stop; the Commission's research activities will end; audit functions will be moved to the private sector; councils will be free to appoint their own independent external auditors from a more competitive and open market; and there will be a new audit framework for local health bodies.
3. On 30 March DCLG published a consultation paper on the future of public audit, available to view via:
<http://www.communities.gov.uk/publications/localgovernment/localpublicauditconsult>
4. The deadline for responses is 30 June. A full list of the 50 Consultation Questions is **attached** at Appendix A.
5. At the same time the CLG Select Committee initiated an inquiry into the future arrangements for Audit Commission activities. Cllrs Jill Shortland and Robert Light attended to give oral evidence on behalf of the LGA on 7 March.
6. The Audit Commission is currently the main provider carrying out 70% of local public audits through its in-house practice. Government is currently considering a range of options for transferring the Commission's in-house audit practice to the private sector and expects to announce its preferred option ahead of publication of a draft Bill.
7. Julie Carney, Deputy Director, Local Government Quality and Performance, DCLG will attend the meeting to talk about the consultation paper.

Proposed response

8. A full response will be developed in the light of members' views and comments from councils and Fire and Rescue Authorities. Views will be gathered via the Chairman's post-Board newsletter to Council Leaders, via an Alert to Chief

Item 1

Executives and through discussions with various sector groups including the County Councils Network and District Councils Network along with the LGA's Fire Service Management Committee.

9. In the meantime members are invited to

9.1 Confirm the potential key points of an outline response set out at Appendix B attached. (This is based on the LGA's evidence to the Select Committee and on previous discussions at the Improvement Board).

9.2 Provide views on the specific issues raised in paras 11 – 23 below.

10. Some Key Issues on which members' views are invited:

11. Appointment of Auditors: has the right balance been struck between allowing councils to appoint their own auditors and preserving the independence of audit?

12. Councils would be under a duty to appoint an auditor. But in order to preserve the independence of auditors, it is proposed that appointments are made by full council on the advice of an audit committee. Legislation will set out the minimum requirements for an audit committee to ensure independent audit appointments. It is envisaged that the majority of members of the committee will be independent of the council; any councillors on the committee would be non-executive and the chair would be independent of the council.

13. It is also likely that the Government would specify audit committees' responsibilities in relation to the engagement of auditors in legislation. This could range from simply providing advice on the engagement, resignation or removal of auditors to a more detailed mandatory role including, for example, policy on the provision of non audit work, monitoring action on issues identified by the auditor, ensuring an effective relationship between internal and external audit, advising the council on the quality of the audit service, etc.

14. **Comment:** The proposals to widen the composition of audit committees and specify their duties in legislation seem prescriptive and at odds with general proposals around localism and devolution – including recent decisions to abolish Standards Committees. Moreover, during previous discussions at the Improvement Board, members have suggested that the proposal for statutory audit committees is unnecessary since auditors would continue to be registered and monitored to ensure professional standards are maintained.

15. Scope of audit: What should the scope of audit be in future?

Item 1

16. The consultation paper outlines four potential options:

Option 1: Reduced scope more in line with companies and with no assessment of value for money. The auditor would:

- Give an opinion on whether the financial statements give a true and fair view of the financial position
- Review and report as appropriate on other information published with the accounts

Option 2: Maintain the current scope of audit with the auditor providing

- An opinion on whether the financial statements give a true and fair view of the financial position
- A conclusion as to whether the body has arrangements in place to secure vfm based on locally defined priorities and having regard to financial resilience and regulatory propriety
- Reviewing and reporting as appropriate on other information published with the accounts

Option 3: Increase the scope and volume of audit work. The auditor would still provide an opinion on the financial statements but would also provide conclusions on

- Regularity and propriety – compliance with relevant laws, etc
- Financial resilience – about *future* sustainability of the body
- Value for money – about the *achievement* of economy, efficiency and effectiveness.

Option 4: under this option all public bodies would be required to produce and publish an annual report about their arrangements for securing vfm, and whether they have achieved economy, efficiency and effectiveness; regularity and propriety; and financial resilience. The annual report would be published – enhancing transparency. The auditor would

- Give an opinion on the financial statements
- Review the annual report
- Provide reasonable assurance on the annual report.

17. **Comment:** Option 3 which includes an assessment of “financial resilience” and value for money will be more burdensome and appears to reintroduce elements of CAA. Option 4 has some similarities with our self regulation proposals in that there is some basis on self assessment – but producing an annual report would be a new requirement.

18. The LG Group’s approach to date has been that the scope of audit should in future be more tightly focussed around the accuracy of the financial statements

Item 1

and issues of probity. This would point towards Option 1. Authorities would be free to “buy in” additional audit activity if they chose to do so.

19. **Arrangements for smaller public bodies:** Under current legislation the statutory audit requirements for smaller bodies are the same as those for larger ones - though since 2002 the Commission has ensured bodies with an income of £1m or less are subject to a “limited assurance” audit framework. The consultation paper proposes:
 - 19.1 that the income and expenditure of a body should determine what level of audit or scrutiny is required and that bodies with an income of between £1,000 and £6.5m would be subject to an independent “examination” (similar to that followed in the charities sector) rather than a full audit.
 - 19.2 that the appointment process should also be proportionate and either:
 - 19.2.1 the appropriate county or unitary authority appoint the independent examiner, or;
 - 19.2.2 the appointment be made by the small body itself, but with the involvement of an audit committee – for example working jointly with other smaller bodies to create a joint committee or joining with a larger local public body and utilising their audit committee.
20. **Public Interest Reports:** It is proposed that the duty on an auditor to consider whether to make a report in the public interest should be retained. Public interest reports – the consultation paper says – are a key part of the current audit system and provide a vehicle through which the public are made aware of issues of significant interest to them. Of the 131 public interest reports issued since 2002 only 13 have related to principal local authorities. The costs of public interest reports would fall on the audited body.
21. **Auditor Liability:** The Audit Commission currently indemnifies auditors for costs they incur if they are engaged in litigation. The consultation paper suggests that in future it would be possible for auditors and audited bodies to deal with auditor liability as part of their contractual negotiations – within the context of a legislative framework. Without a liability agreement audit firms, the consultation paper says, may increase their fees to match the increased risk.
22. **A competitive market:** During discussions at the LG Group Improvement Board some members have stressed that the new arrangements must deliver a competitive market for audit and that this is more likely to be achieved:
 - 22.1 Where the Audit Commission’s in-house audit practice can be successfully transferred to the private sector in a way that enables it to retain current expertise and act as a competitor to the major audit firms

17 May 2011

Item 1

22.2 Where the future arrangements for audit are not so burdensome and restrictive that they dissuade smaller firms from entering the market.

23. **Links to sector self regulation and improvement:** sharing intelligence in order to manage the risk of underperformance is a key part of sector self regulation proposals. It would be helpful if auditors were under an explicit expectation to share intelligence, where appropriate, with the LG Group so that sector support could be offered on proactive basis.

Timetable and Membership of the Commission

24. Although the original intention was to have new arrangements in place for auditing England's local public bodies by 2012/13, this is subject to parliamentary timetables. The current consultation exercise will be followed by consultation on draft legislation which means that the parliamentary processes might not begin until 2012.
25. As a consequence the new audit arrangements would probably not commence until 2013/14 financial year at the earliest. This is later than originally intended and may have implications for current commissioners.

Conclusions and next steps

26. A full response will be developed in the light of members' views and comments from the sector and submitted to Lead Members for approval.

Financial Implications

27. There are no additional financial implications arising from this report

Appendix A

DCLG Consultation “Future of local public audit” - list of consultation questions

1. Have we identified the correct design principles? If not what other principles should be considered? Do the proposals in this document meet these design principles?
2. Do you agree that the audit probation trusts should fall within the Comptroller and Auditor General’s regime?
3. Do you think that the National Audit Office would be best placed to produce the Code of audit practice and the supporting guidance?
4. Do you agree that we should replicate the system for approving and controlling statutory auditors under the Companies Act 2006 for statutory local public auditors?
5. Who should be responsible for maintaining and reviewing the register of statutory local public auditors?
6. How can we ensure that the right balance is struck between requiring audit firms eligible for statutory local public audit to have the right level of experience, while allowing new firms to enter the market?
7. What additional criteria are required to ensure that auditors have the necessary experience to be able to undertake a robust audit of a local public body, without restricting the market?
8. What should constitute a public interest entity (i.e. a body for which audits are directly monitored by the overall regulator) for the purposes of local audit regulation? How should these be defined?
9. There is an argument that by their very nature all local public bodies could be categorised as ‘public interest entities.’ Does the overall regulator need to undertake any additional regulation or monitoring of these bodies? If so, should these bodies be categorised by the key services they perform, or by their income or expenditure? If the latter, what should the threshold be?
10. What should the role of the regulator be in relation to any local bodies treated in a manner similar to public interest entities?

17 May 2011

Item 1

11. Do you think the arrangements we set out are sufficiently flexible to allow councils to cooperate and jointly appoint auditors? If not, how would you make the appointment process more flexible, whilst ensuring independence?
12. Do you think we have identified the correct criteria to ensure the quality of independent members? If not, what criteria would you suggest?
13. How do we balance the requirements for independence with the need for skills and experience of independent members? Is it necessary for independent members to have financial expertise?
14. Do you think that sourcing suitable independent members will be difficult? Will remuneration be necessary and, if so, at what level?
15. Do you think that our proposals for audit committees provide the necessary safeguards to ensure the independence of the auditor appointment? If so, which of the options described in paragraph 3.9 seems most appropriate and proportionate? If not, how would you ensure independence while also ensuring a decentralised approach?
16. Which option do you consider would strike the best balance between a localist approach and a robust role for the audit committee in ensuring independence of the auditor?
17. Are these appropriate roles and responsibilities for the Audit Committee? To what extent should the role be specified in legislation?
18. Should the process for the appointment of an auditor be set out in a statutory code of practice or guidance? If the latter, who should produce and maintain this?
19. Is this a proportionate approach to public involvement in the selection and work of auditors?
20. How can this process be adapted for bodies without elected members?
21. Which option do you consider provides a sufficient safeguard to ensure that local public bodies appoint an auditor? How would you ensure that the audited body fulfils its duty?
22. Should local public bodies be under a duty to inform a body when they have appointed an auditor, or only if they have failed to appoint an auditor by the required date?
23. If notification of auditor appointment is required, which body should be notified of the auditor appointment/failure to appoint an auditor?

17 May 2011

Item 1

24. Should any firm's term of appointment be limited to a maximum of two consecutive five-year periods?
25. Do the ethical standards provide sufficient safeguards for the rotation of the engagement lead and the audit team for local public bodies? If not, what additional safeguards are required?
26. Do the proposals regarding the reappointment of an audit firm strike the right balance between allowing the auditor and audited body to build a relationship based on trust whilst ensuring the correct degree of independence?
27. Do you think this proposed process provides sufficient safeguard to ensure that auditors are not removed, or resign, without serious consideration, and to maintain independence and audit quality? If not, what additional safeguards should be in place?
28. Do you think the new framework should put in place similar provision as that in place in the Companies sector, to prevent auditors from seeking to limit their liability in an unreasonable way?
29. Which option would provide the best balance between costs for local public bodies, a robust assessment of value for money for the local taxpayer and provides sufficient assurance and transparency to the electorate? Are there other options?
30. Do you think local public bodies should be required to set out their performance and plans in an annual report? If so, why?
31. Would an annual report be a useful basis for reporting on financial resilience, regularity and propriety, as well as value for money, provided by local public bodies?
32. Should the assurance provided by the auditor on the annual report be 'limited' or 'reasonable'?
33. What guidance would be required for local public bodies to produce an annual report? Who should produce and maintain the guidance?
34. Do these safeguards also allow the auditor to carry out a public interest report without his independence or the quality of the public interest report being compromised?
35. Do you agree that auditors appointed to a local public body should also be able to provide additional audit-related or other services to that body?

Item 1

36. Have we identified the correct balance between safeguarding auditor independence and increasing competition? If not, what safeguards do you think would be appropriate?
37. Do you agree that it would be sensible for the auditor and the audit committee of the local public body to be designated prescribed persons under the Public Interest Disclosure Act? If not, who do you think would be best placed to undertake this role?
38. Do you agree that we should modernise the right to object to the accounts? If not, why?
39. Is the process set out above the most effective way for modernising the procedures for objections to accounts? If not, what system would you introduce?
40. Do you think it is sensible for auditors to be brought within the remit of the Freedom of Information Act to the extent of their functions as public office holders? If not, why?
41. What will be the impact on (i) the auditor/audited body relationship, and (ii) audit fees by bringing auditors within the remit of the Freedom of Information Act (to the extent of their functions as public office holders only)?
42. Which option provides the most proportionate approach for smaller bodies? What could happen to the fees for smaller bodies under our proposals?
43. Do you think the county or unitary authority should have the role of commissioner for the independent examiners for smaller bodies in their areas? Should this be the section 151 officer, or the full council having regard to advice provided by the audit committee? What additional costs could this mean for county or unitary authorities?
44. What guidance would be required to enable county/unitary authorities to:
- a.) Appoint independent examiners for the smaller bodies in their areas?
 - b.) Outline the annual return requirements for independent examiners?
- Who should produce and maintain this guidance?
45. Would option 2 ensure that smaller bodies appoint an external examiner, whilst maintaining independence in the appointment?
46. Are there other options given the need to ensure independence in the appointment process? How would this work where the smaller body, e.g. a port health authority, straddles more than one county/unitary authority?
47. Is the four-level approach for the scope of the examination too complex? If so, how would you simplify it? Should the threshold for smaller bodies be not more

17 May 2011

Item 1

than £6.5m or £500,000? Are there other ways of dealing with small bodies, e.g. a narrower scope of audit?

48. Does this provide a proportionate, but appropriate method for addressing issues that give cause for concern in the independent examination of smaller bodies?
How would this work where the county council is not the precepting authority?
49. Is the process set out above the most appropriate way to deal with issues raised in relation to accounts for smaller bodies? If not, what system would you propose?
50. Does this provide a proportionate but appropriate system of regulation for smaller bodies? If not, how should the audit for this market be regulated?

Appendix B

Outline of key points of LG Group response

- Future arrangements for the Audit Commission's activities need to be set within the context of the Coalition Government's approach to transparency and stronger local, rather than national, accountability.
- External audit makes an important contribution to the stewardship of public resources and the corporate governance of public services, but the current arrangements can be improved.
- Local people and communities should be the primary audience for audit and a simpler and more easily understandable framework for published accounts is required.
- We welcome the proposal that councils should appoint their auditors.
- The new arrangements must deliver a competitive market. This is more likely where the Commission's in-house function can be successfully transferred to the private sector and where future arrangements do not dissuade smaller audit firms from entering the market
- We fully acknowledge the need for appropriate safeguards to preserve the independence of audit and ensure public trust in the process and outcomes is not jeopardised. But at the same time we are concerned that the new approach to audit does not become over regulated and prescribed through Government guidance
- Audit Committees - This proposal is both excessive and unnecessary. It is reminiscent of the standards committees which the government recently recognised were overly bureaucratic and runs contrary to the Government's agenda around devolution and localism. Moreover there will still be a regulatory framework including the registration of auditors and monitoring of the quality of audits.
- Procurement: There needs to be sufficient flexibility in the arrangements for procuring audit to enable a number of organisations to work together to jointly procure audit across a local area.
- Scope of Audit: The scope of audit should in future be more tightly focussed around the accuracy of the financial statements and issues of probity (that the authority's financial activities are materially free from fraud and corruption).