

**Agenda Item No:** 10

**Report To:** **AUDIT COMMITTEE**

**Date:** **30 June 2015**

**Report Title:** **Future of local public audit – Update (for information)**

**Report Authors:** Paul Naylor, Deputy Chief Executive



**Summary:**

On 31 March the Audit Commission closed and its remaining functions transferred to a number of other bodies. Closure was originally signalled in an announcement by the former Coalition Government in 2010 when it announced its intention to introduce legislation to close the Commission with the eventual transfer of responsibility for local public audit procurement to councils and other audited bodies. This information report provides further background to the Council's responsibilities to procure local public audit services when the current audit contract with Grant Thornton UK expires. A further and more comprehensive report will be presented to the September meeting of the Audit Committee.

**Key Decision:** Not applicable

**Affected Wards:** None specifically

**Recommendations:** **The Committee is asked to note the report for information.**

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## **Future of local public audit – update INFORMATION ITEM**

1. On 31 March the Audit Commission closed and its remaining functions transferred to a number of other bodies. Closure was originally signalled in an announcement by the former Coalition Government in 2010 when it announced its intention to introduce legislation to close the Commission with the eventual transfer of responsibility for local public audit procurement to councils and other audited bodies.
2. The Commission has since outsourced its audit work totally. This led to the Commission appointing Grant Thornton UK as our external auditor for a five-year period as part of a contract covering the south east region. This and the other outsourced contracts secured significant cost reductions for councils, with costs fixed for five years (contracts expire at the end of the 2016/2017 financial audit, so in the autumn of 2017). However, an option to extend for a further two years on similar terms is available to government. If contracts are not extended the council would have to decide on its procurement and award a contract by December 2016. In practice this would mean commencing a procurement by Spring 2016 at the latest.
3. The scope of external audit work under these contracts is limited to cover councils' financial audits (including public inspection rights), grant certification, and providing a value for money opinion. This more limited scope partly accounts for the cost reduction.
4. A decision on whether to extend the contracts or not will be taken by the Secretary of State for Communities and Local Government possibly by the end of this calendar year, and it is hoped will be made following consultation with local government.
5. The Local Audit and Accountability Act 2014, formally enabled final closure of the Commission, and sets out the requirement for councils to create audit panels that would be responsible for recommending a procurement process, and recommending the appointment of an external auditor to their full council for decision.
6. As the Commission was responsible for appointing and monitoring auditors, and setting scale fees etc., government has transferred this responsibility until the end of the current contracts to Public Services Audit Appointments, a subsidiary company of the Local Government Association.
7. Audit panels must be chaired by and have a majority of non-elected independent persons. Audit panels would also be responsible for advising the full council on the 'maintenance of an independent relationship with the appointed auditor', and advising on 'any proposal to enter into an agreement limiting the liability of its auditor'.
8. Originally the government proposed that Audit Committees should possibly perform this role but then be mandated to be constituted with a majority of non-elected representatives. Following considerable opposition to this proposal from local government members and the Local Government Association the proposal was removed, but the requirement for audit panels remained.

9. The Act, supplemented by a subsequent set of regulations ((the Local Audit (Appointing Persons) Regulations 2015)) allows councils to procure audit services in a number of ways:
- a) Individually and hence an individual council would create its own audit panel, or
  - b) Jointly through a consortium approach for a contract to cover two or more councils, reflecting shared approaches to service delivery. In this case councils could create a single joint audit panel, or
  - c) Through a government approved Specified Person who would appoint an auditor on behalf of those authorities that choose this option. A decision to select this option would be one for full council and would not require a recommendation from an audit panel. The Specified Person would take on other responsibilities of an audit panel. It is possible the LGA's company might be approved for this purpose.
10. There is no decision for councils at this time as the timing of the procurement need has not been determined. However a full report on this matter will be presented to the Audit Committee at its September meeting.
11. As further background two papers are attached. The first is a government summary of the bodies to whom the Audit Commission's residual functions have been transferred. The second is a recent Public Finance article written by the final controller of the Audit Commission that sets out a summary from her perspective of the key issues for councils.

FOR INFORMATION

Paul Naylor  
Deputy Chief Executive

June 2015

## **A brave new world for local audit?**

Public Finance Article written by: Marcine Waterman (Final Controller of the Audit Commission)

16 Feb 15

As the Audit Commission finally shuts its doors, there are a host of outstanding questions about practicality, cost and the value of public audit, writes Marcine Waterman

With the closure of the Audit Commission, on March 31, the transition to new arrangements for local public audit starts in earnest. They have been almost five years in the planning. A good deal of work has gone into ensuring that the changes are as seamless as possible. For example, the National Audit Office laid the new Code of Audit Practice before Parliament, ahead of it taking effect on April 1.

The nature of the changes requires stakeholders to adjust to dealing with a wider range of organisations than at present. These include Public Sector Audit Appointments (PSAA) – the independent company established by the Local Government Association to manage our contracts with audit firms – the NAO, the Cabinet Office and the Department for Communities and Local Government. Life will be more complicated for audited bodies, which will have to liaise with government departments, regulators and auditors, about various issues previously dealt with or coordinated by the commission. It is not clear, for example, who will investigate complaints against auditors or their fees after we close.

To give an idea of the new complexity, the ‘future functions at a glance’ table on the commission’s website has almost 40 rows charting the correct point of contact for a range of different circumstances. The Audit Commission will not exist to see how the new arrangements work in practice, although former staff will be watching closely with interested stakeholders. The questions I am curious to see answered fall into three categories: practicality, the cost of audit and maintaining the value of audit.

### **Practicality**

Will stakeholders receive enough clear information about the transitional arrangements leading to the new local appointment of auditors?

PSAA will manage audit contracts until 2017 or 2020. So auditor panels, local procurement of auditors and any sector-led procurement bodies will not be needed for some time after the commission closes. These future arrangements and their timetable remain uncertain. This means that stakeholders will need clear and timely information to help them prepare for procuring their own auditors, and for when the new regulatory framework is fully in place.

Who will collect information about local audit to paint the big picture?

Armchair auditors were meant to come to the fore in response to local government releasing more information onto the web. To date, they have not done so in a way that allows comparisons across the piece. This is not just an issue for independent commentators. Central government relies on information provided by auditors and collected by the commission – for example, to demonstrate that money passed to local bodies has been spent properly. It also helps people trying to hold their council to account for late publication of audited accounts, or for a qualified audit opinion, to know that almost every other authority was able to meet the deadline with a clean audit opinion. The Local Audit and Accountability Act 2014 does not provide for the national collation and reporting of the results of local audits. We believe this information is important to taxpayers and accounting officers and should be available.

PSAA will publish information on the results of auditors' work at local government bodies, including small bodies, until the end of current contracts with audit firms. After that, there has been no clear or specific commitment to produce reports setting out the big picture across local government, or across health, as our Auditing the accounts reports have done. I hope this will be addressed.

How successfully will multiple regulators work together, particularly after our audit contracts finish?

The new arrangements for the regulation of local audit break up the regulatory framework. The NAO, Financial Reporting Council, Recognised Supervisory Bodies, local auditor panels and audit firms will all have parts to play. This creates a number of uncertainties about how local appointment and oversight of auditors will work. Some roles and responsibilities need clarification – for example, about which body will receive and investigate complaints about auditors' conduct. There will be a need for memorandums of understanding between organisations taking over functions from the commission, to support their effective and co-ordinated operation.

How will the arrangements for small bodies work in practice, and will they ensure accountability?

The new arrangements are complex and present practical challenges. The partial exemption of the smallest authorities (those spending less than £25,000 a year) from audit and assurance requirements presents them with a number of practical problems. In particular they will face higher audit fees (particularly those bodies currently charged nothing) because they will have to incur the costs of 'retained auditors'.

For small bodies in general:

- Firms are likely to charge higher prices than currently to bodies in remote locations.
- If, as seems possible, a sector-led body for smaller authorities does not develop, they are likely to lose economies of scale and scope in procuring audits.

In 2013/14, auditors qualified the accounts of 597 small bodies that will become exempt from routine external audit. The risk is that removing independent external auditor scrutiny will reduce the pressure on these bodies to account properly for their financial performance.

### **The cost of audit**

Will the current audit contracts be extended, avoiding procurement costs and locking in inflation-proof low prices for a further three years?

The government has announced it will decide in summer 2015 whether the commission's audit contracts will last until 2017 or be extended to 2020. There is very little room for slippage. I believe that the government should:

- Obtain the views of local bodies on the advantages of locking in inflation-proof contract prices in time for an effective decision.
- Ensure local bodies, auditors and other stakeholders have time to prepare for any impact on the timetable for local procurements.

Will a sector-led body emerge to be an 'appointing person' under the Local Audit and Accountability Act, able to minimise procurement costs and secure lower prices?

The Local Audit and Accountability Act 2014 allows the secretary of state to specify a sector-led body to be an 'appointing person'. There was strong support for this measure during parliamentary scrutiny of the Local Audit and Accountability Bill and among leading bodies in local government. However, this depends on different organisations acting in time. The timing will also need to fit with the government's decision about contract extension. If organisations do not act in a co-ordinated fashion, this puts at risk the possibility of collective procurement and appointment to access economies of scale.

How will the audit market develop after our audit contracts end?

Local appointment of audit will operate in a less managed market. There is a risk that, over time, there will be fewer providers of audit services to local public bodies, not more. This would increase the difficulty of making joint procurements in the absence of sector-led appointment bodies. Without mandatory central procurement of audit, costs will almost certainly rise. Without a central body, firms lose the ability to spread costs and risks over a larger body of work. This suggests that:

- Smaller audits or those in more remote areas will be less attractive to firms without higher prices.
- Local public bodies will have to bear the costs of complying with European Union procurement rules every five years.
- Larger organisations will come to dominate the market over time because they can achieve economies of scale and, with fewer providers, prices will rise.

### **Protecting the value of local public audit**

Will the new arrangements deal effectively with the differences between private and public audit?

The government wishes arrangements for regulating local public audit to mirror those in place for company audits. Public audit has a wider scope, such as examining arrangements to secure value for money, and this has direct implications for auditor qualifications, audit regulation, quality monitoring and the application of ethical standards in local public audit.

In particular, the risk of conflicts of interest calls for effective oversight of how firms apply ethical standards to their non-audit work. Our experience suggests this needs close monitoring. The planned CIPFA guidance on setting up and operating auditor panels will aim to address these risks.

### **How will auditor panels work in practice?**

Will there be confusion about roles and responsibilities between auditor panels and audit committees? As a minimum, each authority should review its constitution and standing guidance to minimise this risk.

Where authorities set up combined auditor panels to make joint procurement more efficient, they will have to consider how to handle issues that involve one body alone. For example, an authority commenting on findings that may lead an auditor to issue a public interest report, may be unwilling to have these discussed by others.

A number of bodies have expressed concerns about the availability of appropriately experienced members for auditor panels.

Will auditor panels support locally procured auditors to be sufficiently robust in addressing financial and governance risks?

Defending the role of external audit is more important than ever in the current environment, which poses risks to good financial management and governance. Local authorities are under financial pressure, leading to a greater chance that some may:

- Cut their finance function inappropriately or downgrade the position of their statutory officers, who have a duty to protect the quality of decision-making with regard to finance and legality.
- Reduce the number of fraud investigators. We reported evidence of this trend in our latest Protecting the public purse report.
- Cut the level of their scrutiny support function, which provides challenge to decision-making – as evidenced in the latest Centre for Public Scrutiny survey.
- Attempt to make transformational service change (such as massive outsourcing or integration) at high speed.

Councils can and will continue to adapt to financial circumstances. Where conventional strategies can no longer be relied on to deliver savings, they will need to develop new approaches to public service delivery that rely less on government funding. Undoubtedly they will face risks as they do so, and local public audit will need to be robust to maintain visible accountability. With the commission closure it will be for the government and others to:

- Find alternative ways to draw on auditors' insights into councils' financial resilience and remain vigilant for signs of financial stress.
- Ensure councils continue to fight fraud vigorously.
- Simplify the new arrangements.
- Keep audit fees as low as the commission has been able to keep them.

No matter where my career takes me next, I will be watching the new audit arrangements with great interest, having spent three years overseeing the current system (and 19 years at the commission before that). Ever the optimist, I've taken the inspiration for the title of this piece from Shakespeare's *The Tempest*. The brave new world of local audit may result in us celebrating, as Miranda does, 'beauteous mankind' – or at least the way public money continues to be robustly accounted for. The other vision of the brave new world, Aldous Huxley's, doesn't bear thinking about.



# The future of the Audit Commission's functions

## Future of Local Audit

In August 2010, the Department for Communities and Local Government (DCLG) announced plans to put in place new arrangements for auditing England's local public bodies.

## Local Audit and Accountability Act 2014

The Act received Royal Assent on 30 January 2014. The Act makes it possible for the Audit Commission to close, in line with Government expectations, on 31 March 2015, 30 years after it was established.

Several of the Commission's functions will continue after its closure.

**Management of audit contracts.** An independent company created by the Local Government Association (Public Sector Audit Appointments Limited) will be responsible for overseeing the Commission's current external audit contracts with audit firms from 1 April 2015 until December 2017 or up to 2020. It will manage the contracts and exercise statutory powers to appoint auditors, set and determine fees, and to make arrangements for housing benefit subsidy certification.

The professional conduct of auditors will continue to be regulated by the professional accountancy bodies<sup>[1]</sup>. From 2017 or up to 2020, Recognised Supervisory Bodies will determine the eligibility of local public auditors and register them and, in turn, they will be recognised and supervised by the Financial Reporting Council. The Financial Reporting Council's Audit Quality Review team will monitor the local public audits carried out by auditors through new regulatory arrangements.

**Grant certification.** The role of making arrangements for housing benefit subsidy certification will transfer to Public Sector Audit Appointments Limited from 1 April 2015. It is intended that this role will continue until housing benefit is rolled into Universal Credit, or until the audit contracts end – whichever happens first. The independent company will not have a role in relation to the certification of other grant claims.

**Code of Audit Practice.** The National Audit Office will produce and maintain the Code of Audit Practice and provide supporting guidance to auditors from 1 April 2015.

**Whistleblowing.** The Comptroller and Auditor General will be a prescribed person to whom whistleblowing disclosures can be made in respect of local public bodies under the Public Interest Disclosure Act 1998 from 1 April 2015. Appointed auditors retain their status as a prescribed person under the Act.

**National Fraud Initiative.** The Audit Commission powers to conduct the National Fraud Initiative will pass to Cabinet Office on the 1st of April 2015, and the NFI will run under Cabinet Office powers from that date onwards. The NFI matches data provided by some 1,300 participating organisations from across the public and private sectors against data provided by other participants, and key data sets provided by government departments and other national agencies, to prevent and detect fraud.

**Counter fraud.** To preserve the legacy of the Audit Commission's counter-fraud work we will publish relevant counter-fraud tools and outputs online with open access before the Commission closes at the end of March 2015.

**Provision of information about audit.** The National Audit Office will publish information previously provided by the Audit Commission. The NAO will become the owner of *Council Accounts: A Guide to Your Rights*, often referred to as the guide to the electorate's rights with regard to the audit of their local authority. Public Sector Audit Appointments Limited will continue to publish Auditing the Accounts and quarterly and annual reports on auditor compliance and audit quality.

**Analytical tools.** Three of the Audit Commission's analytical tools that are primarily maintained to support audit contracts will transfer to Public Sector Audit Appointments Limited and will continue until the end of the current audit contracts: the two Value for Money Profiles Tools (for councils and for fire authorities), and the Audit Fees Comparator Tool. The Financial Ratios Tool is also likely to continue, although arrangements are yet to be finalised.

**National value for money studies.** Building on its existing work, including in the Health sector, the National Audit Office now also carries out studies which consider the value for money of services delivered by the local government sector.

**Best value inspections.** The power to carry out Best Value inspections (not exercised by the Audit Commission since 2010) transferred to the Secretary of State for Communities and Local Government on 4 April 2014.

**Audit Commission historic reports and information.** The National Archives preserves copies of the Audit Commission's website and these are available at [http://webarchive.nationalarchives.gov.uk/\\*/http://audit-commission.gov.uk/pages/default.aspx](http://webarchive.nationalarchives.gov.uk/*/http://audit-commission.gov.uk/pages/default.aspx). For copies of the Commission's past reports you may view these on the National Archives website.

Not all of the professional bodies will be Recognised Supervisory Bodies for the purposes of local public audit.

See the [Future functions at a glance page](#) for contact details after 1 April 2015