

Response to Consultation on the Future of Local Public Audit

Report of the Treasurer

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1 Purpose of Report

This report responds to the consultation paper issued by the Government on the future of public audit.

2 Recommendations

The Committee is asked to:

- a) Consider its views on the general thrust and implications of the Consultation Paper as well as specific responses to questions; and
- b) Agree that officers reflect these views in a report to the Fire Authority on 15 June 2011 in order that it may respond formally to the Department for Communities and Local Government.

3 Background

The Department for Communities and Local Government (CLG) issued a consultation paper on the "Future of local public audit", asking for responses by 30 June 2011. The paper was e-mailed to Members of the Committee at the beginning of May.

With the coming abolition of the Audit Commission the Government is looking at ways to "refocus audit on helping local people hold their councils and other local public bodies to account for local spending decisions".

The Government's vision for the future of local audit is based on the following four design principles, further details of which are given in section 4 of this report:

1. Localism;
2. Transparency;
3. Lower audit fees; and
4. High standards of auditing.

The consultation sets out proposals to meet these principles, and asks a number of questions to help develop the framework before publishing legislation in draft in the autumn. The key issues dealt with in the consultation paper are:

- All local public bodies with a turnover of over £6.5m will appoint their own independent (external) auditor.
- This appointment would be made by the full Authority, taking into account the advice of an independently chaired audit committee, and with an opportunity for the electorate to make an input.
- The National Audit Office would prepare audit codes of practice and prescribe the way in which auditors are to carry out their functions.
- Registration of audit firms and auditors, as well as monitoring and enforcement of audit standards, would be undertaken by the accountancy professional bodies under the supervision of the Financial Reporting Council and its operating bodies.
- It is expected that local authorities will wish to co-operate to ensure there is wide competition for external audit contracts, and will want to work together to procure an external auditor.
- Proposals include changes to the structure of audit committees, with the chair being independent of the local authority. The vice chair would also be independent to allow for possible absence of the chair. The elected members would be non executive and non cabinet members, and the majority of the members of the committee would be independent of the authority (in support of the increased transparency agenda).
- The audit committee would have responsibility for the engagement of the external auditor and also the monitoring of its independence and quality of work. The committee would advise the full Authority on the appropriate criteria for engaging an auditor and how these could be weighted. The committee would also be involved in the evaluation of bids.
- Other proposals are made regarding failure to appoint an external auditor, rotation of audit firms, resignation / removal of auditors and auditor liability.

- The future of public interest reports / disclosures is also covered.

This report sets out those questions relevant to the Fire Authority, and relates them to the effective delivery of the government's four principles. Some comment is made, but the main intention is to seek the meeting's views in order to pass them on to the Fire Authority.

4 General Design Principles

In proposing a new framework for local public audit, the Government has expressed its vision in the following set of design principles:

- **Localism and decentralisation** – freeing up local public bodies, subject to appropriate safeguards, to appoint their own independent external auditors from a more competitive and open market, while ensuring a proportionate approach for smaller bodies
- **Transparency** – ensuring that the results of audit work are easily accessible to the public, helping local people to hold councils and other local public bodies to account for local spending decisions
- **Lower audit fees** – achieving a reduction in the overall cost of audit
- **High standards of auditing** – ensuring that there is effective and transparent regulation of public audit, and conformity to the principles of public audit

The Paper then asks the following question:

Q1 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?

5 Regulation of Public Audit

Codes of audit practice

The Audit Commission currently has a statutory duty to prepare, keep under review and publish statutory Codes of audit practice. A replacement body must, therefore, be found and the Paper proposes the National Audit Office, rather than either the professions or the Financial Reporting Council. The Paper then asks:

Q3 Do you think that the National Audit Office would be best placed to produce the Code of audit practice and the supporting guidance?

There seems no reason to think that this would not fulfil the current principles as adequately as the previous arrangements, although it is not guaranteed that there would be any savings in costs or that they would be passed on to local authorities.

Registration of auditors

The Audit Commission Act 1998 stipulates that for an individual or a firm to be appointed as an auditor, the person/s conducting the audit must be a member of one of the specified professional bodies and has such qualifications as may be approved by the Secretary of State (none have been so approved). The Audit Commission regulates the quality of the work of auditors by setting minimum qualifications, which a public sector auditor must have, in conjunction with standards set by the professional bodies for membership.

Regulating the qualifications and quality of audits must be addressed and the Paper proposes that, as under the Companies Act 2006 (“the Companies Act”), an overall regulator (the Financial Reporting Council) would have responsibility for authorising professional accountancy bodies to act as recognised “supervisory bodies” for local public audit. Any such body would need to comply with the statutory requirements set out in the proposed primary legislation. It would have the roles of registration, monitoring, and discipline in relation to local public audit. The Paper, therefore, asks:

- Q4 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?**
- Q5 Who should be responsible for maintaining and reviewing the register of statutory local public auditors?**
- Q6 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?**
- Q7 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?**

If the Financial Reporting Council can demonstrate that it has both the resources and the expertise to undertake the role, and wishes to do so, then there is no reason to argue against it taking on the role as overall regulator.

It is difficult to know how to ensure opening entry to the market does not result in inexperienced auditors, who may end up charging more for “learning on the job” , or, if fees are restricted, failing to deliver an adequate audit.

Monitoring and enforcement

The Audit Commission currently monitors the quality of auditors’ performance. The Paper is, therefore, proposing that this role is taken over by the “supervisory bodies”, referred to above, who would cover local public audits in future.

The Paper has a concern that, under the Companies' Act, certain major companies are so important as to be designated "public interest entities". The overall regulator is directly involved in monitoring the quality of their audits. If this task fell on the Financial Reporting Council, for some of the local public audits it would increase its costs and this would ultimately be reflected in increased fees. The Paper, therefore, asks:

Q8 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?

Q9 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?

Q10 What should the role of the regulator be in relation to any local bodies treated in a manner similar to public interest entities?

To be logical the same criteria and processes applied to the companies sector should apply to the public sector. If this means that some of the functions of the Audit Commission cannot be reduced in the new arrangements, then this will offset some of the hoped-for savings in the cost of audits under the new arrangements.

6 Commissioning Local Public Audit Services

Currently the Audit Commission appoints all auditors of local public bodies after consulting the body. A new method of commissioning is, therefore, required. The Paper proposes that the full council (authority) of bodies with turnover greater than £6.5m will appoint directly, on advice from an audit committee. This is intended to balance local influence against the independence of the auditor. Legislation will also provide for joint procurement and joint audit committees to facilitate effective procurement. The paper asks:

Q11 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?

The increase in local flexibility is to be welcomed but there is a concern as to whether there will be a genuine choice of alternative auditors. Joint audit committees are likely to be more workable the more their focus is limited to the functions specified in the Consultation Paper.

The Consultation Paper then considers the structure and nature of the audit committee it envisages.

“We envisage that in the new system, an audit committee could be structured in the following way:

- The chair should be independent of the local public body. The vice-chair would also be independent, to allow for the possible absence of the chair.
- The elected members on the audit committee should be non-executive, non-cabinet members, sourced from the audited body and at least one should have recent and relevant financial experience (it is recommended that a third of members have recent and relevant financial experience where possible).
- There would be a majority of members of the committee who were independent of the local public body.

When choosing an independent member of the committee, a person can only be considered for the position if he or she:

- has not been a member or an officer of the local authority/public body within five years before the date of the appointment
- is not a member nor an officer of that or any other relevant authority
- is neither a relative nor a close friend of a member or an officer of the body/authority
- has applied for the appointment
- has been approved by a majority of the members of the council
- the position has been advertised in at least one newspaper distributed in the local area and in other similar publications or websites that the body/local authority considered appropriate”

The Consultation Paper then asks:

Q12 Do you think we have identified the correct criteria to ensure the quality of independent members? If not, what criteria would you suggest?

Q13 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?

Q14 Do you think that sourcing suitable independent members will be difficult? Will remuneration be necessary and, if so, at what level?

An obvious comment is that there would be a need to remunerate people with sufficient knowledge, who would be prepared to take on these responsibilities. Sharing with other authorities would make the task easier and reduce costs to an individual authority. This authority has no non-executive members and no cabinet.

7 Role of the Audit Committee

If the Audit Committee receives legally defined duties as a result of this Consultation then a number of options are available:

Option 1

Limit mandatory duties to advising the Authority on the appointment, resignation or removal of the auditor, and leaving it to local discretion over a wider role for the committee.

Option 2

A more detailed mandatory role would be specified, covering issues already within the remit of our committee. The paper then asks:

Q15 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?

Q16 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?

Q17 Are these appropriate roles and responsibilities for the Audit Committee? To what extent should the role be specified in legislation?

Q18 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?

A comment would be that only option 2 would leave an audit committee fulfilling the ongoing functions that the audit committee currently undertakes. However, the more complex and widespread the committee's duties become the bigger challenge it will be to appoint and to fund their operation.

The Paper also proposes that the public becomes involved in appointing the auditor by commenting on the list of potential auditors and also by being able to make representations to the audit committee on the issues relating to the auditor. The Paper asks:

Q19 Is this a proportionate approach to public involvement in the selection and work of auditors?

This is an additional freedom for the public but, based on past experience of public interest in accounting matters, in practice is unlikely to be a significant issue.

Because the Audit Commission is currently the contractor but in future this role will fall directly on the audited bodies, detailed arrangements need to be put in place to deal with:

- i Failure to appoint an auditor
- ii Rotation of audit firms and staff
- iii Resignation or removal of auditors

A number of detailed proposals are made, all of which seem pragmatic, although there is a potential additional cost, if there are contractual problems.

Also in the section of the Paper dealing with commissioning audits is the issue of **auditor liability**. At present auditors owe a duty of care to local authorities not third parties. Public authorities can sue auditors for breach of care. In addition the Audit Commission indemnifies auditors pursuing litigation concerning special powers.

The consultation paper recognises that there will be a need to enable liability limitation agreements to be reached between public authorities and their auditors. Without this fees might increase. The Paper asks:

Q28 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?

There should be no increase in fees to public bodies, but there would be an apparent loss in some cases of the ability to sue auditors for breach of care.

8 Scope of Audit and the Work of Auditors

The Audit Commission is charged with undertaking the following:

- Giving an opinion on whether the accounting statements give a true and fair view of the audited body's financial position and of its income and expenditure;
- Providing a conclusion as to whether the body has proper arrangements for securing value for money, having regard to specified criteria (such as financial resilience and to regularity and propriety) and in accordance with guidance issued by the Commission;
- Reviewing and reporting on, as appropriate, other information published with the financial statements, including the statement on internal control / annual governance statement and the remuneration report; and
- Reviewing and reporting on the Whole of Government Accounts return.

The Consultation Paper puts forward four **options**:

- 1 Remove the need to report on value for money;
- 2 Maintain the current scope of audit;
- 3 Retain the opinions on financial statements but provide conclusions on regularity and probity, financial resilience, value for money, in order to provide assurances on the way local public bodies spend money; and
- 4 Require the assurances in option 3 to be captured by the authority in an annual report, which would be reviewed by the auditor, who would also provide reasonable assurances on it.

The consultation paper then asks:

Q29 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 provide sufficient assurance and transparency to the electorate? Are there other options?

Q30 Do you think local public bodies should be required to set out their performance and plans in an annual report? If so, why?

Q31 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?

Q32 Should the assurance provided by the auditor on the annual report be 'limited' or 'reasonable'?

Q33 What guidance would be required for local public bodies to produce an annual report? Who should produce and maintain the guidance?

Option 1 would reduce audit work; 2 would maintain the status quo, although the guidance provided by the Audit Commission may need to be replaced; 3 would probably increase work; and option 4 would increase costs for both authorities and audit, at least compared with option 1.

The preferred option depends on a view over the best way for the Government and the public to see and judge the value provided by local authorities. An annual report will not be particularly effective in reaching the public directly, if past experience is a guide, and there will be a need to maintain and prepare meaningful comparative data.

An option might be to adopt Option 1 and for the Government to explore other ways of ensuring that authorities demonstrate value for money in a way that did not require formal auditing.

At present "Public Interest Reporting" requires the auditor to report in the public interest on any significant matter coming to notice in the course of an audit. The auditor can also make recommendations and issue advisory notices, if there is proposed, or there has been, unlawful expenditure.

The Consultation Paper proposes to keep these powers in place but to protect the independence of the auditor through rules on resignation or removal. It then asks:

Q34 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?

The obvious response is that appropriate rules ought to be capable of being drawn up. The current audit powers do appear to be a useful safeguard for public propriety.

The paper also deals with the provision of non-audit services. This is often cost effective but can compromise audit independence. The Audit Commission currently permits such work, subject to a number of rules, including strict limits on its value. The Paper recognises this and proposes that such work can be permitted but subject to a number of safeguards, which it acknowledges, could affect competition by limiting eligible auditors. The paper, therefore, asks:

Q35 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?

Q36 Have we identified the correct balance between safeguarding auditor independence and increasing competition? If not, what safeguards do you think would be appropriate?

The paper provides no evidence as to how frequently the Audit Commission currently permits its auditors to undertake such work. A response could be that it is important to encourage a genuinely open market for auditors and that they should not be permitted to undertake non-audit work. Such work could then be sourced through the usual procurement processes. Alternatively, the current Audit Commission Rules appear appropriate but would need to be monitored.

The Audit Commission and appointed auditors are prescribed persons under the Public Interest Disclosure Act 1998. They have a key role in enabling employees to raise internal concerns safely and acceptably. The Paper recognises this role and proposes to replicate it through the new proposed audit committees, where it is suggested that an independent member is designated as a point of contact. The Paper then asks:

Q37 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?

This solution seems appropriate in the envisaged new circumstances.

The Consultation Paper also deals with the question of Transparency. At present members of the public currently have rights to question the auditor of an audited body about its accounts and raise objections, if the audited body is not a health body, in respect of unlawful items of account or matters, on which the auditor can make a report in the public interest. The auditor may also apply for a declaration to the Court. Objectors have the right to appeal to the Courts about an auditor's decision.

The Paper proposes to remove the rights to object to the accounts; the audit and the auditor would be open and transparent and would consider any relevant representations. It is also proposed to bring the auditor's work on a public audit within the scope of the Freedom of Information Act, although this may push up fees. The Paper asks:

Q38 Do you agree that we should modernise the right to object to the accounts? If not, why?

Q39 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?

Q40 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?

Q41 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)?

The changes do appear sensible as the right to object is currently little-used and cumbersome. There is a danger of limiting the attractiveness of becoming an auditor and increasing costs, if the auditor must respond to freedom of information requests.

9 Financial Implications

There are no immediate financial implications in this report.

10 Legal Comment

There are no legal implications other than those outlined in the report.

11 Equality Impact Assessment

Officers have considered the Services Brigade Order on Equality Impact Assessments (Human Resources 5 Part 2) and have decided that there are no discriminatory practices or differential impacts upon specific groups arising from this report. An equality impact assessment has not, therefore, been completed.

12 Appendices

There are no appendices attached to this report

13 Background Papers

The Department for Communities and Local Government (CLG) consultation paper on the “Future of local public audit”