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ICAEW REPRESENTATION

THE AUDIT AND INSPECTION OF LOCAL AUTHORITIES

THE COMMUNITIES AND LOCAL GOVERNMENT COMMITTEE'S INQUIRY INTO THE AUDIT AND INSPECTION OF LOCAL AUTHORITIES

Written evidence submitted on 6 January 2011 by ICAEW to the Communities and Local Government Committee

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INTRODUCTION

1. We are writing to provide evidence in response to the Communities and Local Government Committee's inquiry. ICAEW would be pleased to provide oral evidence on any aspect of its submission.

WHO WE ARE

2. As the largest Recognised Supervisory Body (RSB) in the UK, ICAEW registers all the firms for Companies Act audit work that are currently also carrying out work for the Audit Commission and those firms likely to carry out this work in the future. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued

Executive Summary

4. Devising a new local audit regime to replace the Audit Commission presents an opportunity to review the public audit and accounting regime across the public sector in England, making it more transparent and consistent with other sectors of the economy.

5. The new local audit regime should aim to avoid duplication of activity, provide economies of scale, improve accountability, strengthen financial management within local authorities and improve value for tax-payers' money.

6. The new regime will need to consider whether the Principles of Public Audit remain relevant and if so how they will be reflected in the new arrangements.

7. One option for overseeing the new regime would be to give new responsibilities to the National Audit Office (for example in relation to the Code of Audit Practice, technical support and guidance, assessing audit firms' eligibility to carry out the work).

8. Another option would be to create a small residuary body (for example as part of the DCLG or another suitable public body) to continue some of the key functions of the Commission.

9. An increase in the number of audit firms in the public sector audit market should not be at the expense of audit quality and the safeguarding of public money.

10. The framework for the appointment of auditors should be in line with the principles already established by independent oversight bodies and consistent with other sectors, including protection for local public bodies and audit firms.

11. Standardising the requirement for local authorities to issue annual reports and harmonising financial reporting with the private and central government sectors would improve transparency and accountability for the public and encourage other audit firms to enter the market.

12. Revising and strengthening the role of local authority audit committees would provide an independent basis for the appointment of the audit firm and the monitoring of its performance.

DETAILED EVIDENCE

The Principles of Public Audit

13. The Principles of Public Audit are published by the Public Audit Forum (comprising the National Audit Office, the Northern Ireland Audit Office, the Audit Commission for Local Authorities and the National Health Service in England, the Wales Audit Office and Audit Scotland). The Principles are summarised as:

- the independence of public sector auditors from the organisations being audited;
- the wide scope of public audit, that is covering the audit of financial statements, regularity (or legality), propriety (or probity) and value for money; and
- the ability of public auditors to make the results of their audits available to the public, to democratically elected representatives and other key stakeholders.

The Principles take as their starting point the assumption that the audit of public (taxpayers') money demands safeguards that might not necessarily apply to the same extent in other sectors. In designing the local public audit regime post the Commission, consideration needs to be given to whether the Principles are still relevant and if so how they will be upheld by the new arrangements.

Consistency across the public sector

14. The focus for the new arrangements post the Commission appears to be on the new audit arrangements for local government; however the Commission's current responsibilities also cover the National Health Service in England. Thought needs given as to how audit responsibilities in relation to the NHS in England will be discharged in future.

15. In particular, the Government should recognise that the demise of the Commission presents an opportunity to review the public audit and financial reporting regime across the wider public sector in England. This opportunity to create consistency across local government, health and central government audit should be considered carefully rather than the new regime being treated as a local government issue in isolation.

Successor bodies

16. In addition to its duties around appointing auditors of all local public bodies, the Commission has other specific statutory responsibilities. The Commission drafts the Code of Audit Practice, provides guidance and technical support to auditors, monitors audit quality, sets the grant reporting framework, is responsible for the national fraud initiative and is the public body responsible for providing information under the freedom of information legislation in relation to local public bodies.

17. All of these duties are significant and the Department for Communities and Local Government (DCLG) will need to consider carefully what happens to these responsibilities and who will take them on. This may require the transfer of some Commission costs to whichever body or bodies inherit these responsibilities. It will therefore be necessary for DCLG to consider how these bodies will be funded to enable them to take on these responsibilities.

18. Whatever new arrangements are put in place, DCLG will need to ensure successor bodies should have the following attributes:

- public sector knowledge;
- public sector audit experience;
- technical competence;
- the right infrastructure; and
- adequate resources and capacity.

19. One option would be for the National Audit Office to take on the majority of the Commission's role (in particular in relation to the Code of Audit Practice, technical support and guidance, monitoring audit firms eligibility and independence, auditor appointments and audit quality). This would be similar to the arrangements which already exist within Wales (by the Wales Audit Office) and Scotland (by Audit Scotland). The NAO contracts some of its work to audit firms already in the local public audit market. This arrangement would avoid duplication; provide economies of scale and would be cost-effective as the NAO already has the necessary public sector audit experience and expertise in place.

20. Where there are specific skill gaps with respect to local audit, the NAO could recruit or receive by transfer key Commission staff with relevant expertise. Another factor which makes this a viable option is that the NAO will be the body responsible for auditing the Whole of Government Accounts (WGA). Local government accounts will be consolidated into the WGA of which the NAO is the external auditor. WGA will be published for the first time for the financial year ending 31 March 2010.

21. Another option would be to create a small residuary body (either as part of the DCLG or another suitable public body) to continue some of the key functions of the Commission. Key aspects of the public audit regime such as audit appointments, independence, audit fees, public interest reports etc. could be discharged by this small central body. This would avoid the possibility of several successor bodies sharing the Commission's different responsibilities, avoiding potential duplication and increased costs.

Audit quality and increased market participation

22. ICAEW is in favour of increasing market participation in the public sector audit market. However, any policy objective to increase market participation should not be at the expense of audit quality and the safeguarding of public money. While potential new entrant firms to the public audit market will already have quality control systems in place for audit work in other sectors, not all audit firms will have the necessary public sector experience and building up such experience will take time.

Power and duties and impact on audit fees

23. The current powers and duties of auditors in the public sector are included in a framework document published by the Commission, which plays a key role in keeping audit fees at a controlled level across the local public audit market. There is no evidence to suggest that under the new regime, giving local bodies the power to appoint their own auditors will necessarily result in a reduction in audit fees paid by individual bodies.

24. If the government is seeking to reduce the overall level of audit fees, it could take the opportunity to consider the current powers and duties of auditors and bring about some consistency in the audit framework between central government, health and local government. It would not, in our view, be sensible to introduce new duties (see paragraph 26) or retain existing powers or duties within local audit (such as public interest reports and inspection of accounts by electors, see paragraphs 28 and 29), which are not mirrored in central government or NHS audit. The more consistency there is between the different parts of the public sector in England, the easier it will be for audit firms to transfer their expertise between the different sectors and achieve economies of scale for the tax-payer.

25. Currently the Commission provides support, in specific circumstances, in terms of guidance, legal advice and indemnity cover for all its appointed auditors. A new framework will need to consider whether such support will remain available to auditors and who will provide it. There will also need to be a minimum amount of support available to auditors new to the market under the new arrangements.

Audit scope, risk and impact on fees

26. It has been suggested that the scope of local public audit could in future require a separate audit opinion for each of the four categories of audit work mentioned in the Principles of Public Audit (see paragraph 13). Not only would this impose on local authority audit a requirement not present in other parts of the public sector in England, but any increase in audit scope will result in audit firms taking on additional risks which would be reflected in the fees charged.

27. The higher the audit risk of a client, the higher the audit firm's potential liabilities in relation to that audit client. In order to mitigate the higher risks and increased potential liabilities, the audit firm is likely to need to increase its insurance cover (as insurance companies will not provide cover at the same level without the benefit of the Commission providing support). This will likely lead to an increase in audit fees, as auditors will need to recover their costs in some way for agreeing to take on an increased scope of audit.

Public interest reports and inspection of accounts

28. Public interest reports are unique to local authority audit in the English public sector. They are produced by the auditor where there are grounds for believing, for example, that an authority has wasted significant amounts of public money through mismanagement or worse. The publication of such reports inevitably brings the auditor into conflict with the audited body. We are concerned that without the protection of the Commission (which currently reinforces the auditor's independence, meets the costs, provides the guidance and support and indemnifies the legal costs that may arise) or a similar residuary body, auditors may be put under pressure not to report in the public interest. There is potential that an auditor's independence could be compromised through the contractual relationship, perhaps with the audited body being unwilling to pay the fees or threatening termination of the contract.

29. Local authorities are again unique in the English public sector for by law allowing local electors to inspect the annual accounts and to raise questions and objections with the auditor. The ability of the auditor to decline to receive such questions and objections is very limited. The result is that much audit time and cost can be expended researching and answering issues raised by electors. Given the greater transparency of spending now available through publication on line of significant local authority expenditure items, a review of whether this unique situation should continue is advisable.

Independent appointment of auditors

30. There are a number of aspects to the independent appointment of auditors in the public sector, which ICAEW has concerns about.

Eligibility criteria

31. The eligibility criteria for firms wishing to conduct public audit need to ensure that only competent auditors with the appropriate knowledge, skills and experience are appointed. However, there needs to be a mechanism in place to enable new firms wishing to enter the market the opportunity to gain the appropriate knowledge, skills and experience.

Power of electorate to veto appointment

32. ICAEW is not in favour of the power of the electorate to veto the appointment of auditors, which would be unique to local authority audit across the public sector in England. In our view, this could be counter-productive and expensive to the whole appointment process and could result in an authority wasting valuable time and resources going through a re-tender process. In our view, the audit appointment should be made by the full council on recommendation from the audit committee.

Mandatory rotation of auditors

33. The Commission, under the current regime, appoints auditors (to local and health bodies) for a fixed period and upon re-appointment may appoint the same firm with a change of lead partner. This is in line with the Auditing Practices Board's ethical standards. There have been discussions on the benefits of mandatory rotation of local authority auditors with the suggestion that (to further reinforce independence) the audit appointment should be limited to two, three or five year appointments with a change of audit firm after a fixed period.

34. In our view, the looked for benefits of mandatory rotation need to be weighed against the disbenefits. Mandatory rotation of the whole audit firm has been tried in other jurisdictions but has not been a success. We are only aware of one G20 economy which requires mandatory firm rotation on a continuing basis. The key problems of mandatory rotation are:

- rotation of auditor firms for short periods may decrease audit quality, because although the appearance of independence is very important, knowledge of the organisation is critical to quality;
- it erases the cumulative knowledge of an audit firm and thereby reduces audit effectiveness and efficiency and increases costs to organisations; and
- it can be used as an excuse to undermine audit quality by allowing issues to be hidden after a rotation.

35. The risk of over-familiarity is a valid concern, as is the threat of complacency if a competitive tendering process is not on the horizon. However, the value of experience and transfer of knowledge must also be acknowledged. If a good audit committee is in place, it will keep the choice of auditor, and the performance and objectivity of the incumbent, under constant review and should be willing, when it sees fit, to conduct a fresh tender. In the private sector, ICAEW has stated that there should be mandatory rotation of audit partner at least every seven years for public interest entities, as required by the Statutory Audit Directive. We believe that this achieves an appropriate balance in the regulatory framework between the necessity of renewal and the benefits of continuity.

36. The Statutory Audit Directive requirement mirrors the Code of Ethics issued by the International Ethics Standards Board for Accountants (IESBA) under the oversight of the independent Public Interest Oversight Board (PIOB). The Code mandates the rotation of key audit partners on public interest audits at least every seven years to protect against over-familiarity and requires potential threats due to over-familiarity to be considered for all other audits. We are not aware of a jurisdiction in which a partner rotation period of less than five years has been deemed appropriate.

37. ICAEW's view, therefore, is that we should be consistent with the framework promulgated by independent international oversight bodies and should not introduce a different framework solely for local public audit. It would be inconsistent if mandatory rotation was brought into local government in England, but there was nothing similar in health, central government or indeed the private sector.

38. In considering all of the above, both parties should have the right to terminate the relationship if it is felt to be unsatisfactory with appropriate safeguards.

Monitoring audit quality and licensing of audit firms

39. Currently the Commission reviews the quality of audits of local public bodies by contracting with the Audit Inspection Unit (AIU) of the Financial Reporting Council. A similar arrangement could be envisaged post the Commission, however in the private sector the remit of the AIU is restricted to public interest entities (basically companies with a market listing). A review of whether the AIU should be responsible for monitoring the quality of all local public audits would be appropriate.

40. Giving a new responsibility to Recognised Supervisory Bodies (RSBs) to register audit firms for public audit should be considered. Currently, the Audit Registration Committees of the RSBs only register auditors and responsible individuals for the purpose of Companies Act audits. There is no equivalent provision for public sector audits. Thus, the RSBs do not recognise public sector audit work under the registration and therefore do not license auditors separately for public sector audit work. There would need to be a legislative provision for the Audit Registration Committees of the RSBs to take on this additional role. However, it would seem inconsistent for there to be a requirement for audit firms to be registered for the audit of local public bodies without there being an equivalent requirement for the audit of National Health Service bodies, central government bodies and agencies.

Audited bodies' responsibilities

41. There are a number of aspects in relation to the possible new framework that need to be thought through carefully before decisions about the new audit framework are made.

Current accounting and reporting framework

42. Local government is in the process of implementing International Financial Reporting Standards (IFRS), which should help to bring local government accounting more in line with financial reporting in other sectors. However, there is further opportunity brought about by the proposal to abolish the Commission for DCLG to review the overall accounting and reporting framework within local government and simplify it. In particular, it could take the opportunity to review the complex capital accounting regime and various trading accounts that exist within the framework which are unique to local government within the UK. Such accounting does not exisit within other sectors.

43. If local government accounting were brought more into line with central government accounting and indeed more in line with a set of company financial statements it would help to bring about consistency in financial reporting, not just within local government but also with other sectors. It would no doubt help the consolidation process that will be required for the Whole of Government Accounts reporting initiative. Reducing reporting complexities in the sector could also help increase the audit market participation as less specialisation would be required.

Annual reports

44. In our view, there should first be a duty upon audited bodies themselves to report on their own arrangements on the services they provide. One way of achieving this would be through the publication of an annual report. Auditors could then provide an opinion on whether the information contained within the annual report was consistent with the financial statements. This would be in line with auditors responsibilities for Companies Act audits. We acknowledge that this may not be well received by the sector and would require some changes within local government accounting and reporting frameworks. Other sectors, including central government, the corporate and banking sectors and companies already publish annual reports, therefore this would be bringing local government into line with other sectors. This would also meet and be consistent with a wider government policy on transparency and accountability and could indeed result in a reduction in audit costs if auditors are only reporting on management's assertions.

Corporate governance framework

45. Currently having audit committees within an authority's structure is voluntary rather than mandatory. This is inconsistent with other sectors. Having an audit committee with independently appointed members is, in our view, key to the success of the government's intention of independent appointment of auditors. The audit committee, with its independent membership, could provide some protection to the audit firm from the threat of termination of contract by management.

Grants certification

46. Local authorities currently receive more than £46 billion worth of grants and funding from government departments. The Commission currently makes arrangements for the certification of the claims and returns that local authorities are required to submit to government departments to indicate that the monies that they have received have been spent in accordance with the terms and conditions of the grant schemes. Under the current arrangements, the appointed auditor provides the assurance on these claims and returns to government departments based on certification instructions (which are agreed in advance with government departments by the Commission). Each separate assurance report on each grant claim that an auditor provides at each local authority is subject to separate fees.

47. Under a new framework, government departments would need to play more of a role in engaging with the auditor and the grant recipient. This, in practice, may be more difficult, because of the number of grants and number of bodies that receive such funding. However, there are already similar arrangements in place when funds are allocated to private sector organisations. ICAEW has a framework document (published in March 2010) which outlines the key issues in this area. This could, in our view, be easily transferred to grants received by public sector organisations. However, it would mean that grant-paying bodies would need to review their own arrangements, take on more responsibility for identifying their requirements and be prepared to have discussions with auditors (or the auditors' accountancy bodies) to ensure that there is no expectations gap.

Audit of small bodies

48. The audit requirements for smaller bodies (such as parish councils) are currently the same as for larger bodies. Although, for a number of years, the Commission has operated a 'light touch' audit for smaller bodies with the smallest bodies not paying any fees for their annual audit.

49. We note the government's intention to consider how it treats parish and town councils and other bodies and to ensure that a more proportionate approach is adopted, similar to that which applies to small companies and charities.

50. We are in favour of a more proportionate approach being considered and adopted and our suggestion would be for government to set a turnover threshold for a full audit similar to that of small companies (currently £6.5million). We are also in favour of an approach similar to that adopted by the Charity Commission i.e. the independent examination of bodies at the lower end of the scale.

51. We are, however, not in favour of a regime whereby each small body will be required to appoint its own auditor. The smaller parish councils do not necessarily have the skills or expertise to appoint their own auditor and it would not be appropriate to place this additional burden on them, which would inevitably be at a cost.

52. For the smaller end of the scale, our view is that the precepting authority (to whom the parish is accountable) should take the responsibility for carrying out some checks of how the precept is spent. The precepting authority could use its own internal auditors or perhaps even its external auditors for this purpose (recognising that they were would be cost involved in using its external auditors).

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