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Your ref: 91

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Dear Sirs

### **Phase 1 – Draft Report: Review of Audit, Inspection and Regulation**

ICAEW is pleased to respond to your request for comments on the consultation to establish by consensus the purpose of audit, inspection and regulation.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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## ICAEW REPRESENTATION

### PHASE 1 – DRAFT REPORT: REVIEW OF AUDIT, INSPECTION AND REGULATION

**Memorandum of comment submitted in March 2014 by ICAEW, in response to the Welsh Government consultation to establish by consensus the purpose of audit, inspection and regulation published in January 2014**

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## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation to establish by consensus the purpose of audit, inspection and regulation published by the Welsh Government on 20 January 2014, a copy of which is available from this [link](#).

## WHO WE ARE

2. As the largest Recognised Supervisory Body (RSB) in the UK, ICAEW registers all the firms that currently carry out work for the Audit Commission (and those firms likely to carry out this work in the future) in respect of Companies Act audits. We also currently provide quality assurance services to the Welsh Audit Office under contract. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council (FRC). We provide leadership and practical support to over 138,000 Chartered Accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

## EXECUTIVE SUMMARY

4. Public Audit Forum consultation in 2002, *The Different Roles of External Audit, Inspection and Regulation: A Guide for Public Service Managers*, sought to address very similar questions to those that that this consultation seeks to resolve. It noted that 'Whilst there are some similarities between the roles of auditors, inspectors and regulators, they are distinct, but complementary, activities.'
5. It is because the roles of auditors, inspectors and regulators are distinct and enshrined in statute, that it is difficult to produce a common definition of AIR, with a unique and universally applicable set of functions and attributes.
6. The key is that audit and inspection are complementary activities, and auditors and inspectors need to work together to minimise overlaps and duplication, and share information, to avoid imposing unnecessary demands on public service bodies.

## RESPONSES TO SPECIFIC QUESTIONS/POINTS

**Q1: In order to define AIR in a way which is useful for practitioners we have sought to distinguish between the purpose of AIR, its core functions and a set of key attributes. Is this approach helpful?**

7. Whether or not this approach is helpful depends on whether you believe that 'Audit, Inspection and Regulation' can be defined as having a single purpose, set of core functions and key attributes. We would take a similar view to that of the Public Audit Forum consultation in 2002, *The Different Roles of External Audit, Inspection and Regulation: A Guide for Public Service Managers*, which sought to address very similar questions to those that that this consultation seeks to resolve. It noted that 'Whilst there are some similarities between the roles of auditors, inspectors and regulators, they are distinct, but complementary, activities.'
8. Recognising that there can be a significant direct and indirect cost of external review which may at times be perceived to represent an unnecessary burden on public services, it would be more meaningful to clearly identify the respective purposes, functions and attributes of Audit, Inspection and Regulation. From this it would become possible to identify areas that overlap, minimise duplication, and areas where information could be shared, to avoid imposing unnecessary demands on public service bodies.

9. It is also necessary to recognise that the discipline of financial audit is very different to that of performance audit, inspection and regulation. Using the definitions contained within the Public Audit Forum consultation:

- financial audit: covers the financial element of auditors' work: the audit of the accounts and the underlying financial systems and processes (including, in specific parts of the public sector, whether public money was spent for the purposes for which it was intended) and the financial aspects of corporate governance, such as internal control and risk management, and probity and propriety
- performance audit: concerned with the performance element of auditors' work: the value for money of services, functions, programmes or specific projects, and the systems and processes put in place by the body to manage its activity and use of resources and to prepare and publish performance information. In local government in England and Wales it also includes auditors' work in relation to best value performance plans
- inspection: process of periodic, targeted scrutiny to provide an independent check, and to report, on whether services are meeting national and local performance standards, legislative and professional requirements, and the needs of service users
- regulation: process by which public sector activity and market forces are directed for the public good. It includes the 'authorisation' or 'registration' of bodies to undertake regulated activities and monitoring of their compliance with statutory requirements and professional standards. It may also include the prescription of compulsory activities and price controls.

**Q2: Do you agree with our definition of the purpose of AIR? Do you have any suggestions on how the definition could be improved?**

10. The consultation defines the purpose of AIR as:

- Protecting the interests of citizens by holding the use of public resources to account and by rigorously telling the story of how citizens experience services; and
- Contributing to the wider improvement framework, within organisations, the Welsh Government and wider public sector.

11. Whilst the purpose defined in the consultation, goes some way to defining the purpose of performance audit, inspection and regulation, it doesn't adequately capture the purpose of financial audit. Financial audit ultimately gives an opinion on whether the financial statements give a true and fair view and have been prepared in accordance with relevant accounting standards and practices. As such financial audit doesn't rigorously tell the story of how citizens experience services or contribute to the wider improvement framework, at least not in the way that the consultation document seems to imply.

12. Whilst the scope of an audit in the public sector is wider than in the private sector, the value for money conclusion given focuses on the arrangements that a body has put in place, rather than the outcomes that have been achieved, something that is more a focus of Inspection and Regulation.

**Q3: We have identified 6 core functions for AIR. Does our list capture the full scope of AIR or are some functions missing? Would you give particular weight or priority to any of the functions?**

13. The problem with trying to identify core functions which span audit, inspection and regulation, and are equally applicable to each, is that they each serve a different and separate function and only when brought together and the results of each viewed as a whole do they provide an overview of how a local area is performing.

- 14.** The core functions of audit, inspection and regulation are each separately defined in statute. Whilst some of the six core functions for AIR listed in the consultation are applicable to each element of AIR, they are not universally applicable to all. For example, financial audit doesn't provide assurance as to the quality and cost effectiveness of service provision, or identify, act upon and report early signs of 'failure' or inform policy and practice.
- 15.** In whether AIR can identify, act upon and report early signs of 'failure', it is necessary to consider the differing roles of auditors, inspectors and regulators. Regulators may require certain actions to be taken, while auditors and inspectors generally cannot do so directly. Thus, some regulators can impose financial penalties or prevent regulated bodies from continuing in operation by removing their registration or authorisation where standards are deemed to be unacceptably low.

**Q4: Our list of core functions includes contributing to improvement and reporting early signs of failure. Should these be key functions of AIR? If yes, why? And if no, why not?**

- 16.** Whilst improving and maintaining the quality and performance of public services, and their underlying management systems and processes, is fundamental to the work of the national audit agencies, each aspect of AIR do so in different ways and with a different focus. For example, financial auditors will as a matter of course identify and report weaknesses in, or make recommendations to improve, accounting and reporting practices, financial systems and processes, internal controls and other financial aspects of corporate governance. In some cases these may be reported to the management of the audited body 'in private', in others - where the issue raised is more significant – they may do so in public.
- 17.** Reporting early signs of failure, may be a key function of inspection and regulation, however, it isn't a primary function of audit, further demonstrating the difficulties in trying to define AIR by a set of common characteristics. The main reason for this is that with the exception of considering whether an entity is a going concern, which considers management's assessment of the coming 12 months, financial audit is always backward looking.

**Q5: We have also identified seven key attributes. Do they capture how AIR should be conducted? Should any additional attributes be added? Would you give particular weight or priority to any of the attributes?**

- 18.** As with the other comments above, it is difficult to capture universal key attributes for AIR. For example, the consultation document states that 'Proportionality must apply at two levels. Firstly, in deciding whether it is appropriate to use AIR, and secondly, in deciding its nature, scope and duration.' However, you cannot decide whether it is appropriate to use financial or performance audit. It is either statutorily required, or it isn't.
- 19.** A financial audit cannot demonstrate and report on the impact of its activities on services scrutinised, as it isn't scrutinising services and is unlikely to be able to demonstrate it delivers benefits commensurate with its cost, as financial audit is a statutory requirement, the benefits of which may not be consistently measurable.
- 20.** The independence of auditors, inspectors and regulators in the public sector from the bodies under review is crucial in ensuring that public bodies are accountable for their performance in terms of both stewardship of public money and the delivery of high quality services. Such independence, together with their perceived operational independence (whether formal or not) from government, ensures that these agencies can 'speak as they find' and 'without fear or favour' in a wholly objective way.

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