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## **LOCAL PUBLIC AUDIT**

### **Next Steps for 2021**

# Contents

Summary of Recommendations .....	2
Introduction.....	4
1. System Leadership.....	4
2. Capacity and skills.....	5
3. Audit fees .....	6
4. Financial sustainability of local authorities .....	7
Concept of going concern and LA CFO duties.....	8
Financial Resilience.....	8
5. Audit expectations gap and wider reforms.....	9
About the Author.....	10

# **Summary of Recommendations**

## **System Leadership**

1. The role of the system leader should include ensuring effective communication between all the relevant and key stakeholders that are needed to make this framework work.
2. The NAO (having already set up the Forum for Local Audit Regulation in England (FLARE)) is in a good position to take on the role of the system leader as it has an overview across both local government and health and can feed back to government departments. If the NAO were to agree to take on this role, it would also need to include local auditors (i.e. the firms carrying out audits of local bodies) in this Forum to ensure that there is dialogue between all parties.
3. MHCLG needs to form a strategic plan to deliver the key recommendations and improvements identified in its response at a faster pace.
4. It is important that all key stakeholders are involved equally in the ongoing dialogue and can participate with equal commitment to resolving the issues highlighted through the Redmond Review.
5. While MHCLG has been leading in the development of this policy objective, other key central government departments (such as the Department of Health (DoH)) should participate fully and commit to the ongoing review and development of the framework.

## **Capacity and skills**

6. The eligibility criteria for local auditors (ie the audit firms) and key audit partners should be reviewed and updated (as a matter of urgency) to allow the capacity in this sector to be increased – paragraphs 70 to 84 in [ICAEW's response to the Redmond Review](#) highlight possible options on how this could be done, including:
  - removing the barriers inadvertently incorporated into the current criteria;
  - repositioning the eligibility criteria (through the Companies Act, the LAAA, and the FRC guidance) to allow entry to a wider pool of auditors (including allowing relevant equivalent overseas experience);
  - allowing more fluidity between private and public sector audit teams within the UK;
  - enabling firms to use relevant and appropriate skills from overseas offices; and
  - developing training programmes to build up the necessary knowledge for new entrants into the market.
7. It is important for key stakeholders (MHCLG, DoH, BEIS, FRC and ICAEW) to review and update the eligibility criteria in a coordinated and structured way.

## **Audit fees**

8. Auditors should have the ability or flexibility (within a defined framework) to set their own fees, considering the complexity of the client, the financial/economic environment, the related risks, the scope of work and therefore the time and resources needed to perform the audit.

9. Local authorities should, where possible, take more control over audit procurement, taking an active role in the process of tendering, negotiating, and appointment of their own auditors. The LAAA allows for individual local authorities to do this.
10. Contract procurement is not a new concept for local authorities – many of them deal with complex transactions daily. If local authorities believe that they do not have the necessary expertise, then ‘audit procurement’ training could be developed and delivered by either MHCLG or another appropriate body.
11. New options to enable local authorities to procure audit should be considered as part of ongoing developments of this framework. However, other options would only be feasible once the ‘capacity and skills’ issues highlighted above are resolved and there is a wider pool of auditors.

### **Financial sustainability of local authorities**

12. While changes to the NAO Code and the work required under the VFM conclusion go part way to addressing this, the need for Section 151 officers to continue to carry out these assessments under legislation, and in discussion with relevant stakeholders (including external auditors), will be even more important going forward. Those authorities that do not have the relevant skills inhouse could consider hiring independent advisors to provide separate assurance reports on the robustness of budget estimates, the adequacy of their reserves and their financial resilience.
13. MHCLG could put into place standard guidelines which could provide local authorities with a framework to commission such engagements to obtain the additional assurance they may need.

### **Audit expectations gap and wider reforms**

14. It is important for the local audit framework going forward for MHCLG to clarify the roles and responsibilities of:
  - a. key stakeholders in the overall framework;
  - b. the roles and responsibilities of auditors (in accordance with legislation, the Code of Audit Practice and international and auditing standards); and
  - c. enhance the responsibilities of those charged with governance within local authorities, by mandating audit committees and include a requirement for independent members to oversee audit within local authorities.
15. It is also important for MHCLG to stay aligned with changes on wider audit reforms to ensure that there is consistency and alignment of audit practices between the sectors (allowing easier movement of auditors).

## **Introduction**

MHCLG published its [detailed response](#) to the [Redmond Review](#) on 17 December.

MHCLG's response is well thought out and has considered the wider picture – that of the overall sustainability of local authority finances, local authority financial reporting and the local audit market.

The response covers all the Redmond Review recommendations in detail. This paper concentrates on five key areas that need to be addressed as a matter of urgency within the overall framework:

1. System leadership
2. Capacity and skills
3. Audit fees
4. Financial sustainability of local authorities
5. Audit expectations gap and wider reforms

## **1. System Leadership**

While it was not surprising to see a recommendation in the Redmond Review for a new independent regulator for local audit – it is also not surprising to note that MHCLG has put this recommendation on hold. The government, in 2010, made a policy decision to move away from an Audit Commission style model, in favour of establishing greater consistency of regulation between the public and private sectors. In the Local Audit and Accountability Act 2014 (the LAAA), it created the current regulatory framework, transferring many of the responsibilities of the Audit Commission to the private sector at significant cost to those bodies that took on responsibilities under the framework.

The regulatory framework has not yet been given full opportunity to settle down and there has not been an opportunity to address the current flaws in other, more sensible, cost-effective ways without dismantling the new framework.

MHCLG recognises that a system leader is needed, but also acknowledges that setting up a new body to take on that role is not necessarily the best or most cost-effective way forward when other actions to address the flaws in the system may resolve the wider issues.

MHCLG's detailed response to the Redmond Review is a good example of what is possible, and it recognises the importance and participation of the key stakeholders that are needed to make the local audit regulatory framework operate efficiently and effectively. However, what is still missing and is not quite clear in the response is, which body will take on an overall operational leadership role to:

- pull together the different strands of work (including both local government and health) into a coordinated and coherent strategy;
- develop a programme of work to address key priorities;
- develop an operational plan for delivery; and
- monitor the delivery of the policy recommendations by stakeholders.

This was the key and missing piece in the overall delivery aspects of the regulatory framework and this needs to be urgently addressed.

As part of the future delivery, it is important that all key stakeholders are part of the dialogue in an inclusive way.

## **Recommendations**

1. The role of the system leader should include ensuring effective communication between all the relevant and key stakeholders that are needed to make this framework work.
2. The NAO, (having already set up the Forum for Local Audit Regulation in England (FLARE)) is in a good position to take on the role of the system leader as it has an overview across both local government and health and can feed back to government departments. If the NAO were to agree to take on this role, it would also need to include local auditors (ie the firms carrying out audits of local bodies) in this Forum to ensure that there is dialogue between all parties.
3. MHCLG needs to form a strategic plan to deliver the key recommendations and improvements identified in its response at a faster pace.
4. It is important that all key stakeholders are involved equally in the ongoing dialogue and can participate with equal commitment to resolving the issues highlighted through the Redmond Review.
5. While MHCLG has been leading in the development of this policy objective, other key central government departments (such as the Department of Health (DoH)) should participate fully and commit to the ongoing review and development of the framework.

## **2. Capacity and skills**

A key change needed for the long-term sustainability of the framework is to increase the capacity, skills, and experiences in the local audit market. MHCLG in its response recognises the need to address this issue to enable a wider pool of audit firms to bid for local audit work. While opening up the market was always the intention in the original policy decision and indeed the Recognised Supervisory Bodies (RSBs) approved three new firms as local auditors into the marketplace, subsequent policy decisions did not sufficiently allow for market expansion in the way that was intended leaving the market severely under-resourced and under-skilled.

The dialogue about the necessary skills and experiences needed for public sector audits should be started urgently. Key considerations about whether there is a need for a Key Audit Partner (KAP) for all public sector work could include, for example:

- whether a local government pension scheme is vastly different to a private sector pension scheme? Could the work be carried out by a pension specialist rather than a local government specialist?
- a review of anomalies such as an engagement partner for a Foundation Trust (FT), as a Responsible Individual (RI) under the Companies Act, being able to sign the audit opinion of the FT, but the same RI cannot sign the audit opinion of an NHS Trust – why does this anomaly exist?
- recognition that the audits of Clinical Commissioning Groups (CCGs) are relatively straightforward with the main (and only) complexity being the added requirement for a regularity opinion. This could be compared to other areas where there is a need for a regularity opinion, such as education audits, where there is no requirement for additional eligibility criteria.
- the discrepancy between local bodies and central government audits - Individuals signing central government audit opinions do not have the same eligibility requirements –

many of these financial statements and related audits are much larger than a local authority, yet the eligibility requirements for local bodies is much more stringent.

### Recommendations

6. The eligibility criteria for local auditors (i.e. the audit firms) and key audit partners should be reviewed and updated (as a matter of urgency) to allow the capacity in this sector to be increased – paragraphs 70 to 84 in [ICAEW's response to the Redmond Review](#) highlight possible options on how this could be done, including:
  - removing the barriers inadvertently incorporated into the current criteria;
  - repositioning the eligibility criteria (through the Companies Act, the LAAA, and the FRC guidance) to allow entry to a wider pool of auditors (including allowing relevant equivalent overseas experience);
  - allowing more fluidity between private and public sector audit teams within the UK;
  - enabling firms to use relevant and appropriate skills from overseas offices; and
  - developing training programmes to build up the necessary knowledge for new entrants into the market.
7. It is important for key stakeholders (MHCLG, DoH, BEIS, FRC and ICAEW) to review and update the eligibility criteria in a coordinated and structured way.

## 3. Audit fees

One of the original intentions of the 2010 policy objective was to enable individual local authorities to procure their own auditors. However, during the transition period, the sector claimed that local authorities did not have the necessary skills to negotiate their own audit contracts. This led to the decision to delegate responsibility to Public Sector Audit Appointments Ltd (PSAA) to take on the role of negotiating (bulk) framework contracts (similar to the role previously held by Audit Commission). The health sector, on the other hand, concluded that the individual bodies should procure their own auditors (as per the LAAA).

The efforts to drive down audit fees and tighten the timetable for publication of accounts over the last few years, in a complex sector, has made it difficult for both auditors and local authorities at a time of instability in the economy. The move by MHCLG to address audit fee structures and timing of the publication of audited accounts will be welcomed by both local government bodies and auditors. However, the way in which this is done may need to be reconsidered.

While additional funding of £15m for the financial year 2021/22 to local authorities will, no doubt, be welcome, it will be important to consider the way in which fees are set in the future. Setting fees for five years and binding auditors in for a long period on a set fee-scale is possibly counter-intuitive, when it is unclear what the future risks for the organisations will be.

The way in which audit is procured, the level of audit fees and capacity and skills (see point 2 above) are intrinsically linked. Taking away the responsibility for audit procurement from local authorities takes away their responsibility to build a strong and direct relationship with the auditor. While administratively it may be easier to have a body such as PSAA carry out this role, the lack of direct communication and ability to negotiate and agree audit fees between the local authority and the auditor has led to a misunderstanding about the overall audit environment, the necessary scope of work and therefore the resources and related

audit fees needed at many local authorities. Negotiations regarding additional work necessary for the audit have proven to be difficult (and time-consuming) for auditors as they are required to negotiate both with local authorities and PSAA. These misunderstandings between all parties also serves to increase the audit expectations gap.

The question then arises, whether a mechanism can be agreed upon by which local authorities could, at a minimum under the current contracts, negotiate their own audit fees directly with the auditors in the same way that they procure their other contracts with suppliers. Apart from cutting out the additional layer of bureaucracy, it would provide local authorities with a better understanding of audit procurement (including audit risks/scope/resources and fees). This could lead to a future outcome of local authorities feeling confident enough to procure their own auditors when the current contracts end.

There will be cost/benefit considerations to take into account as running individual procurements for some local authorities could be disproportionate to the benefit. Health bodies have experienced similar issues. In addition, new firms trying to enter the market would have no guarantee of the quantum of work that they might win, which could impact on capacity and skills. Possible solutions could include:

- PSAA changing the way in which it develops its framework contracts. It could allow for suppliers for smaller contract areas, from which local authorities and health bodies could invite bids; or
- Local authorities and health bodies could work together in partnership (in their regions) to develop their own framework contract and invite bids from local firms in the region.

#### **Recommendations**

8. Auditors should have the ability or flexibility (within a defined framework) to set their own fees, considering the complexity of the client, the financial/economic environment, the related risks, the scope of work and therefore the time and resources needed to perform the audit.
9. Local authorities should, where possible, take more control over audit procurement, taking an active role in the process of tendering, negotiating, and appointment of their own auditors. The LAAA allows for individual local authorities to do this.
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11. New options to enable local authorities to procure audit should be considered as part of ongoing developments of this framework. However, other options would only be feasible once the ‘capacity and skills’ issues highlighted above are resolved and there is a wider pool of auditors.

## **4. Financial sustainability of local authorities**

Financial resilience in local government has been an issue for some time. In the Redmond Review, Sir Tony asked respondents whether the going concern opinion was meaningful when assessing local authority resilience.

The last few months, especially with the impact of COVID, have seen local government bodies come under extreme financial pressure. It has led to public interest reports and two local authorities issuing Section 114 Notices recently - it is likely that other local authorities will follow.

## **Concept of going concern and LA CFO duties**

The concept of 'going concern' assumes that an authority, its functions, and services will continue in operational existence for the foreseeable future.

Section 25 of the Local Government Act 2003 requires the local authority's Section 151 Officer (ie the CFO) to comment on the robustness of budget estimates and the adequacy of reserves. Section 114 (1) of the Local Government Finance Act 1988 places a duty on the Section 151 Officer to report certain matters to the authority.

The duty of the Section 151 Officer to report is triggered if they believe that a decision involves (or would involve):

- unlawful expenditure,
- the local authority has taken or is about to take a course of action which if pursued to its conclusion would be unlawful and is likely to cause a loss or deficiency; or
- the local authority is about to enter an item of account which is unlawful.

Likewise, the Section 151 Officer must inform the authority where they believe that the authority's expenditure is likely to exceed available resources (the section 114 notice). A Section 114 notice means that no new expenditure is permitted, except for safeguarding vulnerable people and statutory services.

## **Financial Resilience**

The issuing of these notices is a stark reminder to government of how fragile local government finances currently are. The long-term sustainability of key programs is now more important than ever in an era where austerity has been a key government policy and public sector spending has continued to be cut. The current turbulent financial climate creates financial dilemmas for many local authorities in how they will make decisions for future years. While related news that government will provide further funding to local government for COVID related activities is welcome, this funding is unlikely to stretch far enough to cover the future shortfalls in budgets.

Prospective financial information to cover longer time periods is necessary for accountability and decision-making purposes and has implications for the financial resilience of local authorities. The going concern concept should therefore not be dismissed when assessing a local authority's financial resilience.

It will be important for local authorities in the coming months and years to monitor their budget assumptions and financial resilience closely. In the past, pre the LAAA, local authorities relied on auditors to provide them with support in this area. With changes in auditing and ethical standards over recent years, it is no longer feasible for auditors to be closely involved in areas which are essentially considered to be management duties.

### **Recommendations**

12. While changes to the NAO Code and the work required under the VFM conclusion go part way to addressing this, the need for Section 151 officers to continue to carry out these assessments under legislation, and in discussion with relevant stakeholders (including external auditors), will be even more important going forward. Those

authorities that do not have the relevant skills inhouse could consider hiring independent advisors to provide separate assurance reports on the robustness of budget estimates, the adequacy of their reserves and their financial resilience.

13. MHCLG could put into place standard guidelines which could provide local authorities with a framework to commission such engagements to obtain the additional assurance they may need.

## 5. Audit expectations gap and wider reforms

Criticism has been directed at both local auditors (about competences and audit quality), and at local authority staff (about the quality of their working papers). There continues to be a fundamental misunderstanding about the role of auditors, particularly under the LAAA. A webinar through which Sir Tony presented his recommendations late last year, highlighted that there was still an expectations gap in relation to local authorities understanding of the role of auditors.

The purpose, scope and value of audit has been the subject of on-going debate and discussion through the Brydon, Kingman, and CMA reviews of audit. **It is important for the future sustainability of local audit to ensure that local audit reforms are aligned with the wider audit debate and the accountancy profession continues to work on audit reforms in a coordinated way** - MHCLG recognises this in its response.

When discussing the expectations gap, it is also important to consider the role of those charged with governance and the part that they play in the overall framework of financial reporting, governance, and external audit. It is worth reviewing the discrepancy between Health and Local Government Audit Committees. Health Audit Committees are mandatory and require independent representation, which brings in both the necessary skills and expertise to hold auditors to account and to challenge management. Local Government committees are not mandatory and do not have any requirements for independent representation.

The Brydon report [\*Assess, Assure and Inform: Improving Audit Quality and Effectiveness\*](#), (published 18 December 2019) recognised that all the stakeholders in the audit process bear a level of responsibility. It recognised the roles of the CEO and CFO and it proposed measures for greater clarity in relation to the role of audit committees.

### Recommendations

14. It is important for the local audit framework going forward for MHCLG to clarify the roles and responsibilities of:
  - a. key stakeholders in the overall framework;
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15. It is also important for MHCLG to stay aligned with changes on wider audit reforms to ensure that there is consistency and alignment of audit practices between the sectors (allowing easier movement of auditors).

## About the Author



Sumita Shah is a freelance consultant. Her 35+ year career includes being a practicing public sector auditor with the UK Audit Commission, before joining ICAEW in 2001 where, for many years, she developed and led a significant proportion of its public sector activities.

Post the 2010 policy announcement to abolish the Audit Commission, Sumita has been actively involved in responding to the development of the new local audit regulatory framework.

While at ICAEW, in response to Government legislation, she developed, co-ordinated, project-managed and implemented ICAEW's role as a recognised supervisory body for local public audit enabling accountancy firms to be licensed and registered & monitored. She also authored, on behalf of ICAEW several public sector audit papers, including *Audit v other forms of assurance: A Special Report*, *Procurement: Tendering for Local Audit* special report, its *Local Public Audit: expectations gap paper* and *its response to the Redmond Review*.

