

Issues paper

September 2010

The future of local audit: issues for consideration

1. Introduction

- 1.1. On 13 August 2010, the Secretary of State for Local Government announced the intention to disband the Audit Commission. The Minister for Local Government, in his letter of 19 August to the Audit Commission's Chairman, asked for a paper setting out the range of options for moving our audit work into the private sector. We have prepared a separate paper on this.
- 1.2. He also asked for our input to the design of the future regime and arrangements for local audit. In this paper we set out the issues that, in our view, need to be considered in developing the new framework for local audit. It is based on an analysis of current statutory provisions and our practical experience of running the existing system.
- 1.3. Each section of the paper includes specific issues (in bold) that CLG may wish to consider in drafting the new legislation – these are summarised in section 2. We recognise that CLG will already have identified and be considering a number of the issues we have raised. However, in drafting the paper we have aimed to be comprehensive, to ensure that all issues are logged and can be fed into the process of designing the new arrangements and the drafting of the legislation.
- 1.4. The sections are:
 - Section 2: Summary of issues for consideration;
 - Section 3: The principles of public audit;
 - Section 4: The Commission's audit functions;
 - Section 5: The functions of the appointed auditor – including public interest reports and dealing with objections;
 - Section 6: Managing the market;
 - Section 7: The appointment of auditors;
 - Section 8: The specification of auditor's work – including the Codes of Audit Practice and certification of claims and returns;
 - Section 9: Monitoring and regulating the performance of auditors;
 - Section 10: The audit of 'small bodies';
 - Section 11: The Commission's work in relation to fraud;
 - Appendix 1: The principles of public audit – further analysis; and
 - Appendix 2: What the Commission currently does.

2. Summary of issues for consideration

Paragraph	Issue
<p>3.5</p> <p>3.17</p> <p>3.18</p>	<p>The principles of public audit</p> <p>Any new audit regime should reflect the established principles of public audit.</p> <p>The most effective way of ensuring the independence of auditors is for them to be appointed wholly independently of the audited body. If Parliament decides otherwise, it should ensure that the appointment process is open and transparent.</p> <p>The independence of auditors must be safeguarded, so that they have:</p> <ul style="list-style-type: none"> a) complete professional discretion in the way they exercise their functions; b) the resources that they need in order to do so; and c) protection against dismissal.
<p>5.7</p>	<p>The functions of appointed auditors</p> <ul style="list-style-type: none"> ▪ Will auditors' general duties remain the same (section 5 of the Act)? ▪ Will auditors' retain their existing rights of access to documents and information (section 6)? ▪ Will there be any change in auditors' reporting responsibilities (sections 8 – 13)? ▪ Will there be any changes in relation to the rights of inspection by members of the public and action by the auditor (sections 14 – 16)? ▪ Will auditors retain their existing special powers in respect of unlawful expenditure (sections 17 – 24)?
<p>5.10</p> <p>5.11</p>	<p><i>Public interest reports</i></p> <p>Safeguards will need to be put in place to ensure that auditors are both able, and have the resources, to carry out special investigations of the sort envisaged by the Secretary of State and to exercise the full range of their wider powers and responsibilities. Equally, if the auditor is given the statutory right to charge the body for any special investigation or work leading to a public report, there will need to be safeguards against the auditor running up unreasonable costs.</p> <p>Part of the role of any new regulator of the local audit regime should, therefore, be to mediate between the auditor and the audited body in relation to costs incurred in the exercise of auditors' special powers and determine the fees payable.</p>

5.16	<p><i>Objections from local electors</i></p> <p>The provisions for objections to local authority accounts should be reviewed in any new legislation.</p>
5.17	<p><i>Freedom of Information Act</i></p> <p>There may be a case under any new arrangements for auditors themselves to be brought directly within the scope of the FOIA.</p>
6.11 6.12 6.17 6.19	<p>Managing the market</p> <p>The firms' current contracts run to 2016/17. The future of these contracts will need to be considered, in the light of any decisions on transitional arrangements.</p> <p>A panel (or panels) of approved auditors could easily be established by means of a framework agreement, let following an EU-compliant procurement procedure. Such a procedure could be run by OGC with technical and professional advice from the NAO. Framework agreements can only run for four years and any services provided under them conclude within a reasonable period after the end of the four year period. This is less than the normal term of an audit appointment.</p> <p>In a free market, we believe there is a risk that some local authorities may find it hard to attract an auditor with the necessary skills and experience, at a reasonable price. Consideration should be given to the need to appoint an 'auditor of last resort'.</p> <p>Under a free market model, the current benefits of pooling auditors' costs will be lost and councils in remote geographical locations will have to meet the economic cost of the audit. In some cases this may be significantly higher than historical fee levels.</p>
7.2	<p>The appointment of auditors</p> <p><i>The freedom to appoint auditors</i></p> <p><u>The timetable for transition</u></p> <p>The timing of any new duty to appoint auditors needs to be considered carefully, to ensure the smooth transition from the Commission's system to the new arrangements.</p>
7.7 7.8	<p><u>Application of the new duty</u></p> <p>If there is a new statutory duty to appoint an auditor, there will need to be a mechanism for ensuring that all relevant bodies have complied with this duty.</p> <p>The bodies to be covered by the new duty will need to be considered. For example, will there be a requirement for local government pension funds to</p>

7.9 7.10	<p>appoint their own auditor?</p> <p>Will all local government bodies be free to appoint their own auditor, including 'small bodies'?</p> <p>We suggest it might now be appropriate to transfer probation trusts into the Comptroller and Auditor General's regime.</p>
7.11	<p><u>Extraordinary audit</u></p> <p>The power to direct an extraordinary audit is, in our view, no longer needed.</p>
7.13 7.14	<p><i>The appointments process</i></p> <p><u>Code of Practice on Appointment of Auditors</u></p> <p>We suggest that guidance on issues relating to appointment of auditors could be issued through a Code of Practice on Appointment of Auditors. Such a Code should be given statutory force either on the face of the legislation or through subsidiary regulations such as the Accounts and Audit Regulations.</p> <p>The Code might be developed and maintained, and compliance with it might be monitored, by CLG for local government bodies; the Department of Health for the NHS; or the NAO.</p>
7.15 7.16	<p><u>The process for approving the appointment</u></p> <p>We suggest that, in local government, the legislation should reserve decisions on the appointment of auditors to the full Council. The recommendation on the appointment of auditors could be made by the s151 officer and/ or Audit Committee. In this context it may now be timely to make Audit Committees mandatory. Equivalent arrangements will need to be developed for other local government bodies.</p> <p>In the NHS, the appointment of auditors would be a matter for the body's Board, on the advice of the Audit Committee.</p>
7.18	<p><u>The qualifications of auditors</u></p> <p>Criteria for the qualifications of auditors of bodies in each of the different sectors will need to be developed.</p>
7.19 7.20	<p><u>The period of appointment</u></p> <p>Bodies will need guidance on the minimum and maximum period of any appointment.</p> <p>The legislation or supporting guidance will also need to specify the latest date by which an appointment for a financial year must be made.</p>

<p>7.21</p> <p>7.24</p>	<p><u>The terms and conditions of appointment</u></p> <p>There may be a need to develop some standard terms and conditions of appointment, which set out the expectations of appointed auditors.</p> <p>Consideration will need to be given to how the costs of litigation arising from the exercise of auditors' powers will be funded under the new arrangements.</p>
<p>7.25</p> <p>7.27</p>	<p><u>Independence issues</u></p> <p>Bodies will need guidance on the type of independence issues that may arise and that they need to consider in the appointments process.</p> <p>Bodies will also need guidance on the safeguards to be applied when deciding whether to subsequently award non-audit work to their auditor.</p>
<p>7.28</p>	<p><u>Termination or resignation</u></p> <p>The legislation or supporting guidance should mirror the safeguards included in companies' legislation on the termination of auditors' appointments and resignation by auditors.</p>
<p>7.29</p>	<p><u>Publication of the auditor's contact details</u></p> <p>We think there should be a duty on audited bodies to publish the identity and contact details of the appointed auditor.</p>
<p>8.10</p> <p>8.11</p> <p>8.12</p>	<p>Specification of auditors' work</p> <p><i>Codes of Audit Practice</i></p> <p>We think there is a continuing need for a statutory Code of Audit Practice and that the requirement for the Code to be approved on a periodic basis (five years) should be retained.</p> <p>The new Code could be developed by: CLG for local government bodies; the Department of Health, for NHS bodies; or the NAO.</p> <p>Because they include internal references to the Commission, the current Codes would need to be revised before the new arrangements come into effect.</p>
<p>8.13</p> <p>8.16</p>	<p><i>Technical specification</i></p> <p>We believe the Codes should continue to be high-level documents, so there needs to be some mechanism to replicate the detailed guidance and advice that underpins the Codes.</p> <p>There will continue to be a need for a body to:</p> <ul style="list-style-type: none"> • specify the approaches to be followed, to ensure consistency

8.17	<p>across the sectors;</p> <ul style="list-style-type: none"> • provide guidance and advice to auditors on their application; and • respond to technical queries. <p>The body taking on these functions needs to be authoritative and independent. It could be CLG for local government bodies; the Department of Health for the NHS; the Home Office for police; the NAO; or the profession (the ICAEW or CIPFA).</p>
8.22	<p><i>Certification of claims and returns</i></p> <p>There will need to be discussions, involving the NAO, HM Treasury and key departments, such as DWP, on any future arrangements for the certification of claims and returns.</p>
8.24	<p>Consideration needs to be given to the transitional arrangements for the completion of the last round of certification work under the Commission's current arrangements. Arrangements will need to be put in place to resolve any queries on auditor qualifications and chase stragglers.</p>
	<p><i>Technical support for auditors</i></p>
8.28	<p>We believe there will be a continuing need to provide technical support to auditors.</p>
8.29	<p>We suggest that a Technical Issues Group should be established, with a representative from each firm in the market, to discuss and where possible agree lines to take on emerging issues. This group could be established under the auspices of the NAO.</p>
8.30	<p>In the NHS, the Department of Health may wish to take on this role.</p>
	<p>Monitoring and regulating the performance of auditors</p>
9.6	<p>There will be a continuing need for the quality of audit work to be monitored and reported on, both to provide assurance to audited bodies, the taxpayer, government departments and other stakeholders, and to provide market intelligence to those procuring audits.</p>
9.7	<p>We suggest that the AIU should now take on the role of reviewing and reporting on the quality of local audits in its own right. The AIU has three years' experience of reviewing public sector audits, so might be willing to take on this responsibility and to extend the scope of its reviews to cover auditors' certification and value for money work. Clearly, any extension to the AIU's remit will need to be funded.</p>
9.8	<p>The way to give formal effect to this would be to include specified local public bodies in England in 'The scope of independent inspection' which is determined annually by the Financial Reporting Council's Professional Oversight Board.</p>
9.10	<p>Some alternative mechanism to provide the NAO with information on the</p>

9.11	<p>progress of audits relevant to its own responsibilities will need to be put in place under the new arrangements.</p> <p>We suggest that a body should also be responsible for specifying standards of performance and monitoring the performance of appointed auditors against them, and for producing an annual report summarising the results. These could be roles for the NAO.</p>
10.12	<p>The audit of ‘small bodies’</p> <p>It is unlikely that, in an unmanaged market, the efficiencies of scale that are essential to the viability of the limited assurance regime could be sustained. There is a real risk that the skills and experience of current audit suppliers would be lost, as it is unlikely that they would wish to be appointed to individual councils other than on a very selective basis.</p>
10.17	<p>For bodies with expenditure below £1,000, (some 1,200 bodies), the audit is carried out free of charge. For those bodies with expenditure above £1,000, but below £5,000 (a further 1,900 bodies), the fee is only £50. Unless special arrangements are made, if fees are to be set at an economic level, these bodies will experience a significant increase in audit costs. Indeed, there is a risk that, for some bodies, audit fees will be disproportionate to total expenditure.</p>
10.19	<p>We think it would be timely to review the wider governance and accountability arrangements for small local bodies. One option would be for them to be subject to internal audit by the relevant District council, which already acts as the precepting authority, on a cyclical basis. Internal drainage boards could be supervised by the Environment Agency. However, such changes in independence may not be welcomed and would appear to run counter to the policy of localism.</p>
10.20	<p>Another option would be to introduce a system of ‘independent examination’, similar to that which applies to smaller charities.</p>
10.21	<p>Technical support to small bodies and their auditors could be provided by the sectors themselves (NALC/ SLCC for local councils; the ADA for internal drainage boards), subject to resources being made available; CLG; the NAO; or the profession (CIPFA or the ICAEW).</p>
10.22	<p>Consideration should be given to expanding the role of the Local Government Ombudsman to include financial and governance issues at local councils.</p>
11.2	<p>The Commission’s work in relation to fraud</p> <p><i>Annual fraud survey</i></p> <p>We believe the annual fraud survey of local government should be continued. It could be undertaken by the National Fraud Authority or by CLG.</p>

	<i>National Fraud Initiative</i>
11.9	We believe that the NFI and the Commission's data matching powers should be retained in some form.
11.10	We suggest that the Commission's data matching powers should be transferred to either: the NAO or the National Fraud Authority.

3. The principles of public audit

- 3.1. Those responsible for spending public money are accountable for its use. The accountabilities attached to public money are special, reflecting the fact that it is raised by compulsory levy and service users do not normally have a choice of service provider.
- 3.2. Citizens, as taxpayers and users of services, must have confidence that public money is safeguarded, handled with absolute integrity, properly accounted for, and spent wisely, and that public business is conducted in accordance with proper standards.
- 3.3. Effective external audit helps create such confidence: it is an essential element in the process of holding local public bodies to account for their use of public money and makes an important contribution to the stewardship of public resources and the proper conduct of public business.
- 3.4. The principles that underpin the arrangements for public audit were codified in 1998 by the Public Audit Forum¹, but have deep historical roots. They are that:
 - a) auditors are independent of the audited body;
 - b) auditors may report widely to the public and other key stakeholders; and
 - c) the scope of auditors' work covers not only the audit of financial statements, but also 'regularity' (legality), propriety (probity) and use of resources (value for money).
- 3.5. **Any new audit regime should reflect the established principles of public audit.** These are summarised below. A fuller analysis of the principles of public audit is set out in Appendix 1.

Independence

- 3.6. The methods of appointment of the auditors of public services should ensure that appointed auditors:
 - a) are, and are seen to be, independent of the audited body;
 - b) can carry out their role freely; and
 - c) can report without fear or favour, because they are not at risk of losing the appointment if they act or report in a way that is unwelcome to the audited body.
- 3.7. The current system, in which the Commission appoints auditors on behalf of the local and national taxpayer, ensures that those responsible, and accountable, for the stewardship and use of public money are not involved in appointing those responsible for scrutinising how it is spent.
- 3.8. This is particularly important where public bodies have tax raising powers and the auditor can report publicly on issues relating to corporate governance and value for money, and has powers to challenge the legality of transactions.

¹ The Public Audit Forum comprises the five public audit agencies in the UK: the National Audit Office; the Audit Commission; Audit Scotland; the Northern Ireland Audit Office; and the Wales Audit Office.

Public reporting

- 3.9. The principle of public reporting links directly to the principle of independence, as it allows auditors to discharge their accountability to the citizen, on whose behalf they are appointed and act.
- 3.10. Public reporting acts as a powerful discipline on public sector bodies as the possibility of a public report can be used to make audited bodies act responsibly.

The wider scope of public audit

- 3.11. The wider scope of public audit reflects the special accountabilities attached to public money.
- 3.12. Public servants are not only accountable for what they do, but also how they do it. The public, quite rightly, expects public business to be conducted in accordance with due process and to conform to high standards of propriety.
- 3.13. The absence of market disciplines, arguably, means that there are not the same pressures on public sector bodies and their managers to make best use of scarce resources.
- 3.14. So audit in the public sector extends beyond the audit of the financial statements, to include reviews of corporate governance, including legality and propriety, and reviews of arrangements to secure value for money.
- 3.15. Auditors of local government bodies also have specific responsibilities to members of the public.

Issues for consideration

- 3.16. These are the fundamental principles that underpin public audit in the UK. We believe they are enduring and need to be reflected in any new arrangements.
- 3.17. **The most effective way of ensuring the independence of auditors is for them to be appointed wholly independently of the audited body. If Parliament decides otherwise, it should ensure that the appointment process is open and transparent.**
- 3.18. **The independence of auditors must be safeguarded, so that they have:**
 - a) **complete professional discretion in the way they exercise their functions;**
 - b) **the resources that they need in order to do so; and**
 - c) **protection against dismissal.**

4. The Commission's audit functions

- 4.1. The Audit Commission's audit regime, as set out in the Audit Commission Act 1998 (the Act), reflects the fundamental principles of public audit. It covers approximately 11,000 bodies, which together are responsible for spending some £200 billion of public money.
- 4.2. Of these, 878 are 'principal bodies', comprising:
 - a) 357 local authorities;
 - b) 268 NHS bodies;
 - c) 38 police authorities; and
 - d) 215 other bodies, including fire and rescue authorities; national park authorities; conservation boards; larger internal drainage boards and joint committees; and probation trusts.
- 4.3. The rest (9,800) are 'small' bodies, with income or expenditure ranging from £1 million down to £100 or less, comprising:
 - a) 9,400 parish and town councils (local councils);
 - b) 150 internal drainage boards; and
 - c) 250 other bodies (for example, charter trustees and port health authorities).
- 4.4. Under Part II of the Act, the Commission has four statutory functions in relation to audit:
 - a) appointing auditors to local government and NHS bodies (section 3 of the Act);
 - b) preparing and keeping under review Codes of Audit Practice which prescribe how auditors should discharge their statutory duties (section 4 of the Act);
 - c) prescribing scales of fees for audits (section 7 of the Act); and
 - d) making arrangements for the certification of grant claims and returns (section 28 of the Act).
- 4.5. The Commission also appoints auditors to NHS charities under section 43A of the Charities Act 1993.
- 4.6. To enable it to discharge these statutory powers and duties, the Commission currently carries out a number of regulatory activities. They are:
 - a) managing the market for the supply of audit services (see section 6, below);
 - b) appointing auditors to local government and NHS bodies and specifying the terms of their appointment, including scales of fees (see section 7);
 - c) specifying technical aspects of auditors' work and promoting a consistent approach by auditors, through the provision of technical support (see section 8); and

- d) monitoring the performance of auditors (see section 9).
- 4.7. In regulating the regime, the Commission aims to:
- a) secure and maintain high-quality, value for money external audits; and
 - b) promote a consistent approach by the Commission's and the firms' auditors across the country.
- 4.8. The audit of small bodies poses special and particular challenges for the Commission and auditors. The Commission therefore applies a quite different regulatory approach in relation to these small bodies, so that it is proportionate to the amounts of public money involved (see section 10 – the audit of ‘small bodies’).
- 4.9. The Commission also carries out specific activities in relation to fraud in local government (see section 11).
- 4.10. A summary of what the Commission does in relation to each of its main regulatory activities is set out in Appendix 2.
- 4.11. The oversight and regulation of the local audit regime is the Commission’s core function. Yet it accounts for only a small part of the Commission’s total expenditure.
- 4.12. Our directorate of Audit Policy and Regulation comprises 36 staff and the total cost of regulating the regime amounts to £3.1 million. This represented only 1.4 per cent of the Commission’s total costs and 1.8 per cent of the costs of audit in 2009/10.

5. The functions of appointed auditors

- 5.1. The statutory roles and responsibilities of appointed auditors are quite distinct from those of the Commission. The Act confers all the duties and powers of the appointed auditor on the firm or individual officer of the Commission.
- 5.2. Auditors appointed under section 3 of the Act, whether a firm or an officer of the Commission, are public office holders. They have a separate legal identity and their actions and decisions can be challenged in the Courts.
- 5.3. Auditors are statutorily independent and exercise their duties and powers in their own right. The Commission cannot:
 - a) interfere with an appointed auditor's exercise of his or her professional skill and judgement in performing his or her statutory functions;
 - b) substitute its own judgements for those of an appointed auditor in the exercise of those functions; or
 - c) direct an appointed auditor to act or to review his or her decisions, as only the Courts have the powers to do so.
- 5.4. The responsibilities and powers of auditors are set out in Part II of the Act. They are to:
 - a) comply with the Commission's Code of Audit Practice (section 5(2));
 - b) give an opinion on the financial statements of the audited body (section 5(1)(a));
 - c) satisfy themselves that the accounts comply with statutory requirements and have been compiled in accordance with proper practices (section 5(1)(b)–(d));
 - d) satisfy themselves that the audited body has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources (section 5(1)(e)); and
 - e) certify completion of the audit (section 9).
- 5.5. In addition, auditors have other specific statutory powers and duties:
 - a) for all audited bodies, to consider issuing a public interest report concerning any matter that comes to the auditor's attention during the course of the audit, which they judge should be considered by the audited body or brought to public attention (section 8);
 - b) for local government bodies:
 - to decide whether the audited body should consider formally, and respond to in public, matters raised in an audit report (section 11);
 - to give electors the opportunity to raise questions about the accounts, and consider and decide upon objections received from electors in relation to the accounts (sections 15 and 16);

- where unlawful expenditure has been or is about to be incurred by an audited body, to apply to the Courts for a declaration that an item of account is unlawful, to issue an advisory notice, or apply for judicial review (sections 17, 19A and 24); and
- c) for NHS bodies, to refer a matter to the Secretary of State if they have reason to believe that an audited body has made, or is about to make, decisions involving potentially unlawful expenditure or has taken, or is about to take, potentially unlawful action likely to cause a loss or deficiency (section 19).
- 5.6. Auditors also certify grant claims and returns, acting as agents for the Commission, under arrangements made under section 28 of the Act.
- 5.7. The new legislation will give an opportunity to reconsider the scope of the audit and other aspects of the current audit regime, but there are specific issues to be considered in relation to auditors' duties:

Issues for consideration:

- **Will auditors' general duties remain the same (section 5 of the Act)?**
- **Will auditors' retain their existing rights of access to documents and information (section 6)?**
- **Will there be any change in auditors' reporting responsibilities (sections 8 – 13)?**
- **Will there be any changes in relation to the rights of inspection by members of the public and action by the auditor (sections 14 – 16)?**
- **Will auditors retain their existing special powers in respect of unlawful expenditure (sections 17 – 24)?**

Public interest reports

- 5.8. The Secretary of State confirmed in his announcement that 'auditors will retain a duty for reporting issues in the public interest. They will be able to undertake special investigations where they, the local government sector or any continuing inspectorates such as Ofsted in the case of children's services, or Care Quality Commission on adult social care, raise concerns about a council. Following any such investigations auditors will report locally and be able to make recommendations to the council, the sector, inspectorates, and if necessary to Government'.
- 5.9. However, we believe there is a significant risk that other proposed changes may render these existing reporting powers inoperable in practice. Local authorities have, in the past, made great efforts to prevent the auditor issuing a public interest report. Only the fact that the Commission has stood behind auditors (and met their costs incurred in investigating a particular issue) has enabled them to do

so. In future, where the auditor has a direct contractual relationship with the body and wishes to retain the appointment, we think there is a risk that, other than in the most extreme cases, the auditor may be unwilling to jeopardise the relationship with the body by reporting in public in this way. Moreover, given that the body itself will now be meeting the auditor's costs directly, there is a risk that auditors' ability to discharge their wider functions will be constrained by the level of the fee they are able to negotiate. These considerations are also likely to apply to the exercise of the wider range of auditors' special powers and responsibilities.

5.10. In these circumstances, **safeguards will need to be put in place to ensure that auditors are both able, and have the resources, to carry out special investigations of the sort envisaged by the Secretary of State and to exercise the full range of their wider powers and responsibilities. Equally, if the auditor is given the statutory right to charge the body for any special investigation or work leading to a public report, there will need to be safeguards against the auditor running up unreasonable costs.**

5.11. **Part of the role of any new regulator of the local audit regime should, therefore, be to mediate between the auditor and the audited body in relation to costs incurred in the exercise of auditors' special powers and determine the fees payable.**

Objections from local electors

5.12. In local government, one of the auditor's special responsibilities is that of considering objections to the accounts from local electors. Currently, these rights impose a potentially expensive burden upon auditors, local authorities, and council taxpayers alike. The new legislation provides an opportunity to review these rights.

5.13. The Act permits electors to ask the auditor questions and to raise objections in respect of unlawful items of account or matters on which the auditor can make a report in the public interest. Where the objection concerns illegality, objectors have the right to appeal to the Courts about an auditor's decision.

5.14. The right to object to the auditor was first enacted more than 150 years ago, at a time when the auditor was the only individual to whom an elector could raise issues of concern. Now, electors can raise concerns through a wide variety of appropriate avenues for redress, including the Local Government Ombudsman (in relation to maladministration) and the Information Commissioner (on matters concerning the rights that individuals have under the Freedom of Information and Data Protection Acts).

5.15. The right to object to the accounts is a mechanism by which 'armchair auditors' can have an impact. However, in recent years the right has been exercised in a way that amounts to a 'tax on your neighbour'. Auditors have only limited discretion to refuse to investigate legitimate objections, but the costs of investigating objections, which are recovered from the relevant local authority and, therefore, funded by council taxpayers, can be totally disproportionate to the sums involved in the complaint, or to the normal audit costs of the authority.

5.16. **The provisions for objections to local authority accounts should be reviewed in any new legislation.**

Freedom of Information Act

- 5.17. Aspects of the work of appointed auditors are currently brought within the scope of the Freedom of Information Act (FOIA) by the fact that the Commission, as regulator of the regime, comes within its scope. Auditors are public office holders and have commensurate responsibilities and accountabilities for the exercise of public functions. However, auditors are currently not covered by the FOIA. **There may be a case under any new arrangements for auditors themselves to be brought directly within the scope of the FOIA.**

6. Managing the market

Background

- 6.1. There are two distinct markets for the supply of audit services to local government and local NHS bodies. The first market covers the 878 'principal bodies', such as local authorities and primary care trusts, of which 610 are local government bodies and 268 are NHS bodies. The second market covers the 9,800 'small bodies', such as parish councils, with income or expenditure ranging from £1 million down to £100 or less (see section 10).
- 6.2. The market for local government audits is highly specialised. This reflects the complex legal, governance and financial control framework in which audited bodies operate and the nature of the audit itself, which includes considerations of legality and reporting in public, and dealing with local electors. It is quite different from audit in the private sector.
- 6.3. In the NHS, the forms of governance and financial reporting are closer to those that exist in the private sector.
- 6.4. In both local government and the NHS, the principal bodies subject to audit are by any objective measure 'big' and, for both professional and practical reasons, this limits the number of firms that could potentially take on this work. In practice, the barriers to entry, in terms of technical knowledge and expertise, are high, and once a firm has left the market it is unlikely to re-enter. Depending on what form it takes, the transfer of the Commission's audit practice to the private sector may result in new firms entering the market, by enabling them to acquire specialist knowledge and expertise, and thus increase competition.
- 6.5. The specialised nature of the work means that firms need to have certainty of a sufficient amount of work over the medium term to sustain investment in their professional infrastructure and specialist technical support.
- 6.6. The number of firms in the market for local public audit and their relative market share has fluctuated over the years, from 13 firms with 15 per cent of the total market when the Commission was established in 1983 to five firms with 30 per cent of the market for principal bodies today. They are:

Firm	Value of audit work at April 2010 £ million
Deloitte	6
Grant Thornton	11
KPMG	11
PKF	5
PricewaterhouseCoopers	12
Total	45

- 6.7. Baker Tilly and Mazars have recent experience of principal body audits, but were unsuccessful in the latest procurement exercise on grounds of price.
- 6.8. Historically, the Commission has managed the market for the supply for audit services to:
- a) drive up audit quality;
 - b) maintain downward pressure on costs;
 - c) ensure geographical coverage; and
 - d) maintain a sufficient number of suppliers of sufficient size to guard against market domination, ensure meaningful competition in any future procurements and to guard against the risk of market failure or changes in the structure of the market.
- 6.9. As the largest purchaser of audit services from the private sector in the UK and a significant client of the major firms, the Commission has been able to use its strong market position to secure the best deal for audited bodies and the taxpayer. The last procurement exercise in 2006/07 succeeded in driving down firms' prices and realised savings in the cost of bought-in audit services of £30 million over five years. Recently, we have also been able to renegotiate these contracts to secure a further £11 million (8 per cent) reduction in costs over the period to 2016/17.
- 6.10. The benefit of these economies of scale can be passed back to audited bodies in the form of reduced scales of audit fees.

Issues for consideration

- 6.11. The Commission's role in managing the market ensures that only firms that can demonstrate that they have the skills and expertise to carry out public sector audits to a high standard can be appointed. **The firms' current contracts run to 2016/17. The future of these contracts will need to be considered, in the light of any decisions on transitional arrangements.**
- 6.12. It has been suggested that in the future the National Audit Office should have a role in approving a 'panel of approved auditors' who would be accredited as competent to audit bodies in particular sectors. **A panel (or panels) of approved auditors could easily be established by means of a framework agreement, let following an EU-compliant procurement procedure. Such a procedure could be run by OGC with technical and professional advice from the NAO. Framework agreements can only run for four years and any services provided under them conclude within a reasonable period after the end of the four year period. This is less than the normal term of an audit appointment.**
- 6.13. Currently, firms have only to bid for large blocks of work every five years, or longer if contracts are rolled over. Our experience has been that prices fall as the guaranteed volume of work increases: in other words, there is a volume discount. Under the proposed decentralised system, this benefit will be lost, as audit suppliers could not be assured of sufficient work overall to be in a position to bid

as competitively as they do in the present system. This is likely to impact on prices.

- 6.14. Bulk purchasing of audit services has also reduced procurement costs that would otherwise be factored into the firms' prices. It also means that audited bodies do not have to cover these costs themselves. If every local body can choose its auditor, they and the firms will incur significant procurement costs. While some councils may procure audit services jointly, others may find themselves carrying out this exercise alone and the overall cost of procurement is likely to increase. The firms' costs of engaging in such multi procurements will be factored in to their prices.
- 6.15. Such a system could also have adverse market consequences, as without specific safeguards there would be no controls to guard against further market concentration or capture.
- 6.16. The firms will also be free to choose whether to bid for particular audits. They may decide not to do so, perhaps because a particular audit is too risky, or because its size or location makes it commercially unattractive. Under current arrangements, firms must accept a mixed portfolio comprising both those appointments they regard as more attractive (single tier and county councils and larger NHS bodies) and those they regard as less attractive (district councils, for which fees are generally regarded as low, and particularly those in remote geographical locations). The current arrangements therefore provide a failsafe to ensure that no public body is denied access to effective public audit.
- 6.17. We are aware that the firms are already considering which audits they would look to drop under the new arrangements. **In a free market, we believe there is a risk that some local authorities may find it hard to attract an auditor with the necessary skills and experience, at a reasonable price. Consideration should be given to the need to appoint an 'auditor of last resort'.**
- 6.18. Managing the market for supply enables the Commission to 'equalize' audit fees to similar bodies within the regime through a 'Post Office pricing' system, whereby the different costs of different suppliers are pooled. Section 7(7) of the Act states that 'the fee payable for an audit shall be the same whether the auditor who carries it out is an officer of the Commission or not'. The prices bid by firms for block contracts with the Commission currently cover all costs incurred, irrespective of the mix and geographical spread of the firm's portfolio of appointments. This means that, apart from differences in fees arising as a result of the auditor's professional assessment of the need to carry out more or less work on a specific audit, a particular type of body currently has the same fee irrespective of whether it is audited by firm A or firm B or the Commission's own audit practice, or where it is located in the country.
- 6.19. **Under a free market model, the current benefits of pooling auditors' costs will be lost and councils in remote geographical locations will have to meet the economic cost of the audit. In some cases this may be significantly higher than historical fee levels.**

7. The appointment of auditors

The freedom to appoint auditors

The timetable for transition

- 7.1. The Secretary of State has announced that local government bodies will be free to appoint their own auditors, but it is not clear whether this will be a permissive power or whether they will have a new statutory requirement to do so.
- 7.2. **The timing of any new duty to appoint auditors needs to be considered carefully, to ensure a smooth transition from the Commission's system to the new arrangements.**
- 7.3. For example, bodies could be given a specific period in which to make their first appointment, say three years. Such a transition would require a successor body to oversee the run down of any audit appointments, to the point at which all bodies have appointed their own auditors.
- 7.4. During this transition period, the auditor appointed by the Commission under section 3 of the Act could remain the appointed auditor until such time as the body appoints its own auditors. This is the arrangement that applies in the foundation trust sector when an NHS Trust acquires foundation trust status. It reflects the fact that auditors need to be in post throughout the financial year, because of the wider scope of the audit and, in local government, the auditor needs to be available to respond to matters raised by members of the public.
- 7.5. In this respect, we also note that the Department of Health has indicated that it wishes the Commission's current arrangements to remain in place until the end of the 2012/13 financial year, to coincide with the abolition of primary care trusts and the transfer of their assets and liabilities to new organisations.
- 7.6. Issues relating to the timetable for transition are considered further in the separate paper on the options for the transfer of the Commission's audit practice to the private sector.

Application of the new duty

- 7.7. **If there is a new statutory duty to appoint an auditor, there will need to be a mechanism for ensuring that all relevant bodies have complied with this duty.** We envisage potential challenges in tracking compliance by small bodies, for example parish councils and joint committees.
- 7.8. **The bodies to be covered by the new duty will need to be considered. For example, will there be a requirement for local government pension funds to appoint their own auditor?** Currently, the Commission requires auditors of the administering authority to carry out a separate audit of the pension fund. We believe that this enhances the governance and accountability of funds which are responsible and accountable for significant sums of public money, but there is no statutory requirement for these accounts to be audited separately.
- 7.9. **Will all local government bodies be free to appoint their own auditor, including 'small bodies'?** We think this raises particular issues and challenges, which we address in section 10.

7.10. Although described as local government bodies in the Act, probation trusts are in effect central government bodies. Their inclusion in the Commission's local audit regime is anomalous. In these circumstances, **we suggest it might now be appropriate to transfer probation trusts into the Comptroller and Auditor General's regime.**

Extraordinary audit

7.11. Finally, section 25 of the Act gives the Commission the power to direct an 'extraordinary audit'. This power predated the powers of auditors to issue advisory notices or seek judicial review and has not been exercised since the 1980s. **The power to direct an extraordinary audit is, in our view, no longer needed.**

The appointments process

Code of Practice on Appointment of Auditors

7.12. Bodies will need guidance on how to manage the technical aspects of the appointments process, including:

- a) the process for approving the appointment;
- b) the qualifications of auditors;
- c) the period of appointment;
- d) the terms and conditions of appointment;
- e) independence issues;
- f) termination or resignation; and
- g) publication of the auditor's contact details.

7.13. **We suggest that guidance on issues relating to appointment of auditors could be issued through a Code of Practice on Appointment of Auditors. Such a Code should be given statutory force, either on the face of the legislation or through subsidiary regulations, such as the Accounts and Audit Regulations.**

7.14. **The Code might be developed and maintained, and compliance with it might be monitored, by CLG for local government bodies; the Department of Health for the NHS; or the NAO.**

The process for approving the appointment

7.15. The process for approving the appointment of auditors needs to be transparent and open, to safeguard auditors' independence. **We suggest that, in local government, the legislation should reserve decisions on the appointment of auditors to the full Council. The recommendation on the appointment of auditors could be made on the advice of the s151 officer and/ or Audit Committee. In this context it may now be timely to make Audit Committees mandatory. Equivalent arrangements will need to be developed for other local government bodies.**

7.16. **In the NHS, the appointment of auditors would be a matter for the body's Board, on the advice of the Audit Committee.**

The qualifications of auditors

- 7.17. The Act currently defines the minimum professional qualifications of auditors. But in managing the market for supply, the Commission requires higher technical qualifications. To win a contract with the Commission, firms have to demonstrate that they have individuals with relevant knowledge and experience of local government and/ or the NHS and that the firm can provide appropriate technical and professional support to the teams involved on Audit Commission work.
- 7.18. In its guidance to Governors and Boards of NHS Foundation Trusts, Monitor requires that auditors 'must have an established and demonstrable standing within the healthcare sector and be able to show a high level of experience and expertise. The work is of a specialised nature, and so general audit experience is not sufficient'. **Criteria for the qualifications of auditors of bodies in each of the different sectors will need to be developed.**

The period of appointment

- 7.19. **Bodies will need guidance on the minimum and maximum period of any appointment.** Currently, auditors are appointed for an initial period of five years, which can be extended, allowing auditors to add significant value and insight. But it is clearly important to guard against too close a relationship. So, in accordance with the ethical standards for auditors issued by the independent Auditing Practices Board, there is a change of the engagement lead on every audit at least once every seven years (with a review after five years). Auditor appointments are also rotated from time to time between one supplier and another to provide a fresh perspective, and to reinvigorate the audit.
- 7.20. **The legislation, or supporting guidance, will need to specify the latest date by which an appointment for a financial year must be made.** In the private sector, auditors are normally re-appointed partway through the year at the AGM. This would not be appropriate in the public sector, as auditors need to be in place at the start of the financial year in question, given the wider scope of their responsibilities.

The terms and conditions of appointment

- 7.21. Similarly, **there may be a need to develop some standard terms and conditions of appointment, which set out the expectations of appointed auditors.**
- 7.22. In the private sector, auditors are concerned about the consequences of the risks of litigation, as a result of actual or perceived audit failure. These concerns have been fuelled by legal judgements about the extent of auditors' duty of care to third parties, such as potential investors and the banks, and by the collapse of Andersen following the Enron scandal. They have increasingly caused auditors to caveat their audit opinions by explicitly limiting their duty of care and by seeking to limit their liability. Case law has established that the duty of care of auditors appointed by the Commission is to the audited body itself and not to third parties. But potentially, the body itself could sue its auditor.
- 7.23. In the absence of a standard form of letter of engagement, there is a potential risk that different firms will seek to impose different limitations in a way that may disadvantage the audited body or taxpayers.

7.24. There are particular issues in the public sector where auditors may exercise special powers. The Commission currently indemnifies auditors for the costs they incur where they are engaged in litigation arising from the exercise of such powers. This ensures that auditors are able to exercise their functions with the certainty that their costs will be met. These costs are not passed directly to the individual body concerned. **Consideration will need to be given to how the costs of litigation arising from the exercise of auditors' powers will be funded under the new arrangements.**

Independence issues

7.25. **Bodies will need guidance on the type of independence issues that may arise and that they need to consider in the appointments process.** Before appointing or accepting an appointment, audited bodies and auditors will need to consider any threats – actual or perceived – to the auditor's independence arising from a previous or existing relationship with an individual body. For example, a firm that has provided consultancy advice or internal audit services to a body cannot be appointed as its auditor until a suitable period has elapsed. What that period should be will be a matter of professional judgement, depending on the nature of the business relationship. In a situation where bodies are appointing their own auditors, there is a risk that those responsible for making the appointment will not have the skills and expertise to make such a judgement. It may therefore be necessary to put in place appropriate safeguards to mitigate this risk.

7.26. The range of threats to auditors' independence is potentially wider in the public sector, given the wider scope of the audit, and so these are not all currently covered in the Ethical Standards issued by the Auditing Practices Board. For these reasons, the Commission specifies in its terms of appointment rules on the acceptance of non-audit work by appointed auditors, which go beyond the requirements of Ethical Standards.

7.27. **Bodies will also need guidance on the safeguards to be applied when deciding whether to subsequently award non-audit work to their auditor.**

Termination or resignation

7.28. **The legislation or supporting guidance should mirror the safeguards included in companies' legislation on the termination of auditors' appointments and resignation by auditors.** These provide for auditors to make a statement to shareholders on the circumstances surrounding the termination of their appointment or the grounds for their resignation. The new arrangements will need to make provision for such statements to be in the public domain.

Publication of the auditor's contact details

7.29. Finally, **we think there should be a duty on audited bodies to publish the identity and contact details of the appointed auditor.**

8. Specification of auditors' work

The Codes of Audit Practice

Background

- 8.1. Under section 4 of the Act, the Commission has a duty to 'prepare, and keep under review, a code of audit practice, prescribing the way in which auditors must carry out their functions under the Act'. The Code must 'embody what appears to the Commission to be the best professional practice with respect to the standards, procedures and techniques to be adopted by auditors'.
- 8.2. The Code has to be approved by both Houses of Parliament at five yearly intervals and auditors have a statutory duty to comply with it. It constitutes secondary legislation, and the way it is drafted and the process for reviewing and revising it have to reflect that. Parliament approved the current Codes in March 2010 – these apply to all audit work relating to financial years ending on or after 31 March 2010.
- 8.3. There are separate Codes for local government and the NHS, primarily to reflect the increasingly divergent accounting, corporate governance and performance management frameworks in the two sectors.
- 8.4. Section 4(8) of the Act requires the Commission to agree with the Care Quality Commission those parts of the NHS Code which relate to auditors' local value for money work at NHS bodies.
- 8.5. In preparing the Codes, the Commission consults widely, engaging key organisations that represent audited bodies in local government and the NHS, the accountancy profession and the public audit agencies at each stage.
- 8.6. The Codes are high level documents, which serve to define the scope, nature and extent of local audit work. Each Code:
 - a) sets out the general principles to be followed by auditors in delivering their objectives;
 - b) outlines their responsibilities regarding the audit of financial statements and use of resources; and
 - c) sets out the range of outputs through which the results of audit are reported.
- 8.7. The Codes focus on those responsibilities that are specific to the Commission's audit regime. This reflects the fact that the professional standards governing auditors' work on the financial statements of local government and NHS bodies are no different from those applying in the private sector and are set by the independent Auditing Practices Board (APB), which has also issued guidance on the application of its International Standards on Auditing (UK and Ireland) to audits in the public sector (specifically Practice Note 10, Audit of Financial Statements of Public Sector Bodies in the United Kingdom). However, the APB's standards apply only to the audits of financial statements.
- 8.8. The local government Code also outlines how auditors should meet their responsibilities to members of the public and how they should exercise their

special powers to challenge local government bodies where unlawful expenditure has or is about to be incurred.

- 8.9. A schedule to the local government Code outlines the distinct approach to the audit of smaller bodies, such as small parish councils, to which it is inappropriate to apply the same level of audit scrutiny as principal bodies because of the relatively small amounts of public money controlled by the bodies in question.
- 8.10. **We think there is a continuing need for a statutory Code of Audit Practice and that the requirement for the Code to be approved on a periodic basis (five years) should be retained.** However, we do not believe it needs to be approved by affirmative resolution. Given its technical nature we think it would be sufficient for any Code simply to be laid before Parliament.
- 8.11. **The new Code could be developed by: CLG for local government bodies; the Department of Health, for NHS bodies; or the NAO.**
- 8.12. **Because they include internal references to the Commission, the current Codes will need to be revised before the new arrangements come into effect.**

Technical specification

- 8.13. The current Codes are principles-based, reflecting the fact that they are underpinned by a large volume of detailed guidance and advice. **We believe the Codes should continue to be high-level documents, so there needs to be some mechanism to replicate the detailed guidance and advice that underpins the Codes.**
- 8.14. The scope of auditors' work in local government and the NHS extends beyond the financial statements to include:
- a) arrangements to secure value for money;
 - b) legality;
 - c) probity and propriety;
 - d) public reporting powers;
 - e) the exercise of special statutory powers;
 - f) dealing with members of the public;
 - g) certification of claims and returns; and
 - h) limited assurance audits of small bodies.
- 8.15. Although there is some relevant professional guidance available, such as Technical Release Audit 3/03, 'Public Sector Special Reporting – Grant Claims' and Technical Release AAF 01/10, 'Grant Claims: Accountants' Reports to Grant-Paying Bodies', which are issued by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW), the approaches to auditors' responsibilities in most of these areas are unique.
- 8.16. **So there will continue to be a need for a body to:**

- a) **specify the approaches to be followed, to ensure consistency across the sectors;**
- b) **provide guidance and advice to auditors on their application; and**
- c) **respond to technical queries.**

8.17. The body taking on these functions needs to be authoritative and independent. It could be CLG for local government bodies; the Department of Health for the NHS; the Home Office for police; the NAO; or the profession (the ICAEW or CIPFA).

Certification of claims and returns

Background

8.18. Under section 28 of the Act, the Commission makes arrangements for the certification of audited bodies' claims for specific grants and subsidies from government departments, for example housing and council tax benefit subsidy payable to administering authorities by the Department for Work and Pensions. Auditors also certify other financial returns, for example contributions payable to the national non-domestic rating pool. For 2008/09, this work covered £46 billion of claims and returns submitted predominantly by local government bodies. Certification provides assurance that claims and returns under a threshold set by the Commission are in accordance with underlying records and that claims and returns over the threshold are fairly stated and in accordance with scheme terms and conditions.

8.19. Under the Act, making arrangements for certifying claims and returns is a Commission, rather than an auditor, function. In discharging this responsibility, the Commission works with grant paying bodies to develop specific instructions for each claim or return ('Certification Instructions').

Issues for consideration

8.20. Although there is professional guidance on the audit of grant claims (see paragraph 8.15), it provides only a framework and is not specific to individual claims and returns.

8.21. Auditors' certification provides assurance to grant paying bodies that public money has been spent for the purposes intended and forms part of the grant-paying bodies' wider systems of internal control.

8.22. There will need to be discussions, involving the NAO, HM Treasury and key departments, such as DWP, on any future arrangements for the certification of claims and returns.

8.23. The latest auditor deadline for claims and returns relating to 2011/12 will be 31 December 2012.

8.24. Consideration needs to be given to the transitional arrangements for the completion of the last round of certification work under the Commission's current arrangements. Arrangements will need to be put in place to resolve any queries on auditor qualifications and chase stragglers.

Technical support for auditors

Background

- 8.25. One of the Commission's key regulatory aims is to promote a consistent approach by appointed auditors across the country. This reflects the fact that audited bodies are entitled to expect a uniform and consistent, high quality audit service, regardless of whether a firm or District Auditor from the Commission's audit practice is appointed.
- 8.26. Currently the Commission invests significant resources in providing technical guidance and advice, and support to its appointed auditors, to ensure so far as possible a consistent approach, for example on emerging technical issues, across the regime.
- 8.27. We liaise closely with auditors on emerging technical issues and provide technical support to auditors through:
- a) web-based technical directories, which contain all extant guidance and advice, including the key issues and implications for auditors of specific developments and the considerations auditors should have regard to in planning their audits or carrying out their audits of final accounts;
 - b) an e-mail helpline for auditors, the Audit Commission Technical Service (ACTS); and
 - c) specific audit tools, to help them meet their responsibilities under specific parts of the Code.

Issues for consideration

- 8.28. **We believe there will be a continuing need to provide technical support to auditors.** But under the new arrangements this will have to be on a 'self help' basis. The firms in the market have a good track record of working together on technical issues and this is likely to continue.
- 8.29. **We suggest that a Technical Issues Group should be established, with a representative from each firm in the market, to discuss and where possible agree lines to take on emerging issues. This group could be established under the auspices of the NAO.**
- 8.30. **In the NHS, the Department of Health may wish to take on this role.**

9. Monitoring and regulating the performance of auditors

Background

- 9.1. As a regulator, the Commission must be able to provide assurance to audited bodies and other key stakeholders that the audits carried out by its audit suppliers are being carried out to an appropriate standard. To be credible, such assurance needs to be – and seen to be – wholly independent.
- 9.2. In assessing the quality of financial statements audits, we use the work of the Financial Reporting Council's Audit Inspection Unit (AIU)¹. The AIU reviews the firms' systems for ensuring audit quality and a sample of their audits of listed companies. It publishes public reports on each of the firms in our regime which provide an independent view on the quality of the firms' work. In addition we commission the AIU to review, on a cyclical basis, the quality of the firms' financial statement audits at a sample of Commission engagements.
- 9.3. The AIU also reviews the quality of the financial statements audits carried out by the Commission's own audit practice. We publish its findings, together with the results of other quality review activity relating to the audit practice, in the audit practice's annual quality report.
- 9.4. We also monitor the delivery of audits, including whether auditors are meeting the target dates (specified by the Commission) for issuing audit opinions on the financial statements and VFM conclusions; giving opinions on the whole of government account (WGA) returns; and producing annual audit letters.
- 9.5. We publish annual reports on the results of our monitoring and quality review processes, for our stakeholders, which include our sponsoring departments, audited and inspected bodies (AIBs), the wider accounting and auditing profession and other interested parties.

Issues for consideration

- 9.6. **There will be a continuing need for the quality of audit work to be monitored and reported on, both to provide assurance to audited bodies, the taxpayer, government departments and other stakeholders, and to provide market intelligence to those procuring audits.**
- 9.7. The Commission already uses the AIU to assess the quality of financial statements audit work, on a contractual basis. **We suggest that the AIU should now take on the role of reviewing and reporting on the quality of local audits in its own right. The AIU has three years' experience of reviewing public sector audits, so might be willing to take on this responsibility and to extend the scope of its reviews to cover auditors' certification and value for money work. Clearly, any extension to the AIU's remit will need to be funded.**
- 9.8. **The way to give formal effect to this would be to include specified local public bodies in England in 'The scope of independent inspection' which is**

¹ The AIU was set up in 2003 in the aftermath of Enron to regulate and provide independent assurance on the quality of audits of public interest entities in the UK. In practice its remit covers the audits carried out by the 'big four' and 'other significant' audit firms of FTSE 350 companies.

determined annually by the Financial Reporting Council's Professional Oversight Board¹.

- 9.9. The AIU's remit covers larger 'public interest entities', so it is unlikely to agree to review the quality of limited assurance audits of 'small bodies'.
- 9.10. The Commission currently provides the NAO with information on the progress of audits or particular issues (eg post balance sheet events) that it needs to discharge its own responsibilities in relation to central government resource accounts and WGA. This arrangement is both efficient for all concerned and effective. **Some alternative mechanism to provide the NAO with information on the progress of audits relevant to its own responsibilities will need to be put in place under the new arrangements.**
- 9.11. **We suggest that a body should also be responsible for specifying standards of performance and monitoring the performance of appointed auditors against them, and for producing an annual report summarising the results. These could be roles for the NAO.**

¹ The AIU comes under the umbrella of the Professional Oversight Board (PoB).

10. The audit of 'small bodies'

Background

10.1. 9,800 bodies covered by the requirements of the Audit Commission Act 1998 are smaller public authorities, with an annual turnover of £1 million or less. They are:

- a) local councils (9,400);
- b) internal drainage boards^I (150); and
- c) other small bodies^{II} (250).

10.2. Since 2002, the Commission has operated a separate 'limited assurance' framework for these bodies, proportionate to the small amounts of public money they control. This is based on a limited review by auditors of a proforma that is prepared and issued by the Commission, comprising simplified accounts and a statement of assurances around key governance and legality issues. Initially the approach applied only to parish councils, but in 2006 new Accounts and Audit Regulations expanded the coverage to all small bodies with income or expenditure under £1 million, including internal drainage boards, larger local councils, charter trustees, port health authorities and a number of joint committees.

10.3. As part of CLG's current project to review the Accounts and Audit Regulations, we have proposed that the threshold should be increased to £6.5 million (the turnover threshold for small companies' audit exemption).

10.4. The limited assurance approach for auditors involves:

- a) review of an annual return completed by the body;
- b) review of limited additional information provided by the body (bank reconciliation, analysis of significant variances and an internal audit report); and
- c) issuing a negative opinion in the form of 'On the basis of our review, in our opinion the information contained in the annual return is in accordance with the Audit Commission's requirements and no matters have come to our attention giving cause for concern that relevant legislation and regulatory requirements have not been met'.

^I Internal drainage boards (IDBs) are independent bodies located in low lying areas of England with special drainage needs. IDBs are a strategically key part of DEFRA's national Flood Defence Strategy. As most of these bodies operate within the £1 million threshold, all but a handful qualify for the limited assurance approach.

^{II} These other bodies include charter trustees, conservation and harbour boards, port health authorities and currently, as LSPs seek to deliver local services cooperatively, an increasing number of joint committees of two or more local authorities.

- 10.5. Under this approach, bodies with income and expenditure below £200,000 produce receipts and payments accounts and receive a 'basic' audit. Larger bodies produce income and expenditure accounts and receive an 'intermediate' audit. All bodies use the same form of annual return. A 5 per cent sample of 'basic' audits undergoes intermediate audit annually at no extra cost. Assurance on internal controls is provided by internal audit, appointed by the councils themselves. The only requirement is that internal auditors must be competent and independent.
- 10.6. We envisage particular issues and challenges in developing new audit arrangements for these small bodies, because of their size and capacity, and the very low level of fees they can afford to pay for audit.

Issues for consideration

Managing the market

- 10.7. One of the imperatives for developing the new approach was that, in 1999/ 2000, all the firms that then comprised the market for principal audits gave notice of their withdrawal from the small bodies' audit market.
- 10.8. We have since established successfully a secondary market of suppliers, which are able to apply the limited assurance approach at the low level of fees these bodies can afford to pay.
- 10.9. Each firm is given all the appointments in a contract area based on county boundaries. They carry out the audits from specialist regional centres to achieve economies of scale.
- 10.10. The limited assurance approach is now well established and we have contracts with four firms to carry out around 70 per cent of small body audits:
- a) BDO;
 - b) Clement Keys;
 - c) Mazars; and
 - d) Moore Stephens.
- 10.11. The remaining 30 per cent are audited by the Commission's audit practice.
- 10.12. **It is unlikely that, in an unmanaged market, the efficiencies of scale that are essential to the viability of the limited assurance regime for small bodies could be sustained. There is a real risk that the skills and experience of current audit suppliers would be lost, as it is unlikely that they would wish to be appointed to individual councils other than on a very selective basis.**

Appointments and fees

- 10.13. In our experience of dealing with small bodies, it is conceivable that many bodies may view the freedom to appoint their own auditor as an additional and unwelcome burden. Moreover, it is difficult to see how a failure to appoint an auditor would be spotted.

10.14. In 2000/01, we ran a trial in five county areas, in which we offered nearly 1,400 parishes the opportunity to appoint their own auditors. Only 300 expressed an interest in doing so and only just over 80 proceeded to the final stage of carrying out their own tendering exercise. Many of those not proceeding said that the costs of tendering were prohibitive. Our review showed that all bar a handful of the 24 firms of auditors selected by parish councils failed to recognise conflicts of interest and to understand local government law and the special accountabilities associated with public funds. The quality of audits was generally poor.

10.15. It also needs to be recognised that fees for these bodies are very low. They are fixed for five year periods by income/expenditure bands. They are thus predictable, easy to understand, transparent and proportionate to the ability to pay.

10.16. The current scales, which run to 2011/12, are:

Income/expenditure band (£) (fees are payable on whichever is the higher)	Type of audit	Total fee charged to audited body (£)	Number of bodies in range
0–1,000	Basic	No fee payable	1,200
1,001–5,000	Basic	50	1,900
5,001–10,000	Basic	120	1,400
10,001–25,000	Basic	135	2,000
25,001–50,000	Basic	285	1,100
50,001–100,000	Basic	400	900
100,001–200,000	Basic	550	600
200,001–300,000	Intermediate	875	250
300,001–400,000	Intermediate	1,050	150
400,001–500,000	Intermediate	1,450	100
500,001–750,000	Intermediate	1,950	100
750,001–1 million	Intermediate	2,500	100

10.17. **For bodies with expenditure below £1,000, (some 1,200 bodies), the audit is carried out free of charge. For those bodies with expenditure above £1,000, but below £5,000 (a further 1,900 bodies), the fee is only £50. Unless special arrangements are made, if fees are to be set at an economic level, these bodies will experience a significant increase in audit costs. Indeed, there is a risk that, for some bodies, audit fees will be disproportionate to total expenditure.**

10.18. Total fees from this sector now amount to some £2.5 million or just over 1 per cent of the Commission's total income. Out of this the Commission is able to

meet the costs of auditors where no, or only a nominal, fee is payable, and to finance the necessary support arrangements for bodies and their auditors.

- 10.19. Against this background, **we think it would be timely to review the wider governance and accountability arrangements for small local bodies. One option would be for them to be subject to internal audit by the relevant District council, which already acts as the precepting authority, on a cyclical basis. Internal drainage boards could be supervised by the Environment Agency. However, such changes in independence may not be welcomed and would appear to run counter to the policy of localism.**
- 10.20. **Another option would be to introduce a system of ‘independent examination’, similar to that which applies to smaller charities.**

Specification and support

- 10.21. Current support arrangements for the sector and auditors will need to be maintained if the advances in governance and accountability that we have seen in the sector over the past decade are not to be jeopardised. **Technical support to small bodies and their auditors could be provided by the sectors themselves (NALC^I/ SLCC^{II} for local councils; the ADA^{III} for internal drainage boards), subject to resources being made available; CLG; the NAO; or the profession (CIPFA or the ICAEW).**
- 10.22. Finally, it needs to be noted that the Local Government Ombudsman does not cover small bodies. In the absence of any other agency able to deal with these issues, they are currently dealt with by local council auditors. Clearly, if the role of the Ombudsman were to be expanded to include local councils and to include financial matters as well as procedural ones, this would become less of an issue. **Consideration should be given to expanding the role of the Local Government Ombudsman to include financial and governance issues at local councils.**

^I National Association of Local Councils

^{II} Society of Local Council Clerks

^{III} Association of Drainage Authorities

11. The Commission's work in relation to fraud

Background

11.1. The National Fraud Authority estimates that fraud costs the UK £30 billion each year. Losses from public sector expenditure fraud are estimated to cost £7 billion a year. The Audit Commission currently plays an important role in the fight against fraud.

The annual fraud survey

11.2. The annual survey of fraud in local government provides the National Fraud Authority with the most comprehensive and authoritative information on the level of fraud in the sector. **We believe the annual fraud survey of local government should be continued. It could be undertaken by the National Fraud Authority or by CLG.**

The National Fraud Initiative

11.3. The National Fraud Initiative (NFI) is a data matching exercise. It compares information held by different organisations and within organisations to identify potentially fraudulent claims and overpayments. When there is a match, there may be something that warrants investigation. For example, when data matching shows a person listed as dead and also in receipt of a pension, the relevant body will investigate and, if appropriate, stop pension payments.

11.4. The NFI 2008/09 identified fraud, overpayments and errors with a value of £215 million. The figure for 2008/09 represents a 54 per cent increase on the figure of £140 million identified in the 2006/07 NFI exercise. The total fraud, overpayments and errors detected across the UK since the NFI began amounts to £664 million. This includes £80 million detected in Scotland, Wales and Northern Ireland.

11.5. A key strength of the NFI is that it combines several bodies in tackling fraud. It helps individual organisations go beyond what they could do acting alone. In the UK, 1300 public and private organisations now take part.

11.6. The Commission runs the NFI for Audit Scotland, the Wales Audit Office and the Northern Ireland Audit Office, which each have their own data matching powers. Each agency uses the Audit Commission's existing systems, processes, and expertise. This delivers economies of scale, reduces the cost for organisations taking part and allows cross-border matching where permitted.

11.7. In 2006, the Attorney General led a government-wide review to recommend ways of reducing fraud and the harm it does to the economy and society. The final report of the *Fraud Review*, in July 2006, praised the NFI's role in tackling fraud and recommended that 'The remit of the National Fraud Initiative (NFI) should be widened across more public sector authorities...'

11.8. The government legislated in the Serious Crime Act 2007 to implement the recommendations of the *Fraud Review* and gave the Commission new specific data matching powers inserted as Part 2A of the Act. It created a new framework for data matching and put in place important safeguards on the use and

disclosure of data, including a requirement for a new statutory Code of Data Matching Practice.

11.9. Immediately after the Secretary of State's announcement, the Chief Executive of the National Fraud Authority wrote to our Chief Executive expressing concern that the valuable contribution that the NFI makes to the national fight against fraud might be lost. **We believe that the NFI and the Commission's data matching powers should be retained in some form.**

11.10. We are aware that the NAO is currently seeking equivalent powers for itself. Against this background, **we suggest that the Commission's data matching powers should be transferred to either: the NAO or the National Fraud Authority.**

The principles of public audit – further analysis

1. Those responsible for spending public money are accountable for its use. They must conduct public business in accordance with the law and proper standards and ensure that public money is safeguarded, handled with absolute integrity, properly accounted for, and spent wisely.
2. External auditors in the public sector give an independent opinion on public bodies' financial statements. They also assess whether public bodies have made arrangements to ensure the proper conduct of their financial affairs and to manage their performance and use of resources.
3. External audit is therefore an essential element in the process of accountability for the use of public money and makes an important contribution to the stewardship of public resources and the corporate governance of public services. It helps to maintain confidence in those to whom responsibility for spending public money is entrusted and in their effective stewardship of funds.
4. The accountabilities that are attached to the use of public money and the conduct of public business are inherently 'special' because:
 - a) public money is raised by compulsory levy – principally, taxation – so tax payers do not have the 'exit option' that shareholders in the private sector have;
 - b) public money can only be used for the purposes intended and authorised by law;
 - c) those dealing with public money must be able to demonstrate to citizens that they have conducted themselves in accordance with the highest standards of integrity and probity; and
 - d) there is little, if any, choice of service provider, so citizens rely on external scrutiny to identify scope for improvement.
5. To reflect these special accountabilities, current arrangements for the external audit of public sector bodies (public audit) in the UK has distinctive features:
 - a) auditors are independent of the audited body;
 - b) auditors may report widely to the public and other key stakeholders; and
 - c) the scope of auditors' work covers not only the audit of financial statements, but also 'regularity' (legality), propriety (probity) and use of resources (value for money).

Independence

6. Independence is the first principle of public audit. Public auditors must be independent of the organisations being audited so that they cannot be improperly influenced by those whose work they audit.
7. Whether in the private or public sectors, confidence in auditing rests to a great degree on the independence and objectivity of the auditor. The methods of appointment of the auditors of public services should therefore ensure that appointed auditors:
 - a) are, and are seen to be, independent of the audited body;
 - b) can carry out their role freely; and
 - c) can report without fear or favour, because they are not at risk of losing the appointment if they act or report in a way that is unwelcome to the audited body.
8. The financial relationship between auditors and the audited body should be such that it does not compromise the independence of the auditor.
9. In 1864, a Select Committee recommended that the appointment of auditors in local government should be completely independent of the bodies under audit. In 1976 the Layfield Committee of Inquiry into local Government Finance concluded that it was wrong, in principle, that any public body should be able to choose its own auditor.
10. This is particularly important where bodies have tax raising powers and the auditor can report publicly on issues relating to corporate governance and value for money, and has powers to challenge the legality of transactions.
11. The current system, in which the Audit Commission has the statutory duty to appoint auditors to local government and NHS bodies, ensures that those responsible, and accountable, for the stewardship and use of public money are not involved in appointing those responsible for scrutinising how it is spent.
12. In the private sector, it is generally the shareholders who appoint the auditor annually, to hold to account the directors of the company for their stewardship of the money invested in the business. In local government, the shareholders are the local electors and the taxpayer. Local electors elect members to run the council, and members in turn discharge their accountability to the electors for their stewardship and use of resources through the audited annual accounts.
13. Clearly, the 'shareholders' of individual local public bodies cannot be identified in the same way as for a company. So, historically, Parliament has legislated for an independent body to exercise that responsibility on behalf of the national and local taxpayer. Under current arrangements, this is the function of the Audit Commission. In exercising this responsibility, the Commission has a statutory

duty to consult local government bodies and will have regard to their preferences.

Public reporting

14. The principle of public reporting links directly to the principle of independence.
15. Reporting in public, whether through the annual audit letter, public interest reports, or (in local government) formal audit recommendations, which the audited body is required to consider and respond to in public, allows auditors of local public bodies to discharge their accountability to the tax payer, on whose behalf they are appointed and act.
16. Public reporting also acts as a powerful discipline on public sector bodies. In the Commission's experience, public censure by the auditor is something that audited bodies will generally try to avoid, so just the threat of issuing a public report can be used by auditors to make audited bodies act responsibly.

The wider scope of public audit

17. The third and final principle of public audit is its wider scope. This reflects the special accountabilities attached to public money.
18. Public servants are not only accountable for what they do, but also how they do it. Simply delivering against performance objectives and targets isn't enough. The public, quite rightly, expects public business to be conducted in accordance with due process and to conform to high standards of propriety.
19. The absence of market disciplines, arguably, means that there are not the same pressures on public sector bodies and their managers to make best use of scarce resources. There is no 'bottom line' other than the tax demand.
20. For these reasons, audit in the public sector extends beyond the audit of the financial statements, to include reviews of corporate governance, including legality and propriety, and reviews of arrangements to secure value for money.
21. Auditors of local government bodies also have specific responsibilities to members of the public who have the right to ask questions about the accounts and, in the case of local electors, make objections to the accounts.

What the Commission currently does

1. Managing the market

- Runs periodic procurement exercises for the provision of audit and related services, to secure high quality audits at the best price, while ensuring future contestability;
- Contracts with firms for the provision of those services;
- Under the terms of those contracts, meets the costs incurred in delivering audits;
- Monitors compliance with the terms of the contract; and
- Manages an ongoing relationship with the firms.

2. The appointment of auditors

- Appoints auditors to approximately 11,000 local government and NHS bodies, following consultation;
- Appoints auditors to NHS charities;
- Maintains and publishes a directory of audit appointments, so that members of the public, and other stakeholders can contact the auditor directly;
- Specifies the terms of auditors' appointment, through its Standing Guidance for Auditors;
- Develops and issues a standard letter of engagement;
- Develops, consults on and publishes scales of audit fees;
- Determines fees payable where they vary from published scale fees;
- Publishes details of planned audit fees in an Audit Fees Comparator tool;
- Deals with complaints and queries (including Parliamentary questions) about fees; and
- Provides an indemnity to auditors where they are exercising their special powers.

3. Specification of auditors' work

- Develops and maintains the statutory *Codes of Audit Practice*;
- Specifies the audit approach for those aspects of the audit not covered by professional standards:
 - the 'value for money conclusion'
 - review of Whole of Government Accounts consolidation packs

- certification of claims and returns (in liaison with grant-paying bodies)
- limited assurance approach for small audits
- exercise of special powers;
- Develops standard forms of audit reports;
- Develops a range of guidance and advice for auditors, and deals with technical queries from auditors on technical issues (in liaison with relevant standard setters), to promote consistency;
- Liaises, consults, and communicates with auditors regularly on technical and other issues;
- Acts as a conduit between government departments and auditors on audit issues; and
- Consults with and advises relevant government departments on financial reporting and audit issues.

4. Monitoring and regulating the performance of auditors

- Monitors delivery of audit and certification work against agreed standards;
- Publishes auditors' annual audit letters and public interest reports;
- Prepares and publishes summaries of the results of audits;
- Monitors issues arising in the course of audits;
- Considers requests from auditors to accept additional non-audit work at audited bodies;
- Commissions and carries out directly an annual programme of reviews of the quality of auditors' work, and reports on its findings;
- Coordinates requests for information from the NAO in connection with its audits of departmental resource accounts and Whole of Government Accounts; and
- Considers complaints about auditors.

5. The audit of 'small bodies'

- Runs periodic procurement exercises for the provision of audit and related services to groups of small bodies;
- Contracts with firms for the provision of those services;
- Under the terms of those contracts, meets the costs incurred in delivering audits;
- Monitors compliance with the terms of the contract;
- Appoints auditors after consultation with the audited body;

- Specifies the terms of auditors' appointment, through its Standing Guidance for Auditors;
- Develops and issues a standard letter of engagement;
- Develops, consults on and publishes scales of audit fees;
- Determines any fees that vary from published scale fees;
- Deals with complaints and queries (including Parliamentary questions) about fees;
- Develops and maintains the Schedule to the statutory Code of Audit Practice;
- Specifies the limited assurance audit approach;
- Develops, publishes and issues the statutory three part proforma annual return (summary accounts, annual governance statement, auditor opinion and report) for different types of small body;
- Provides the secretariat to the Joint Practitioners' Group which is responsible for developing and issuing *Governance and accountability in local councils in England and Wales*, which constitutes 'proper [accounting] practices' for relevant small bodies;
- Develops technical guidance and advice for small bodies and their auditors on financial reporting, governance and audit issues (in liaison with key stakeholders, including NALC, SLCC and the ADA);
- Deals with technical queries from auditors; and
- Liaises, consults, and communicates with auditors regularly on technical and other issues.

6. Work in relation to fraud

- Collects from auditors information on all frauds of £10,000 or more and all instances of corruption at audited bodies;
- Carries out an annual fraud survey of local government bodies;
- Publishes an annual report on levels of fraud in local government and guidance on how to counter fraud, in *Protecting the Public Purse*; and
- Runs a major data matching exercise to help detect and prevent fraud, the National Fraud Initiative (NFI).