

**CORPORATE GOVERNANCE COMMITTEE – 25 NOVEMBER
2020**

**JOINT REPORT OF THE DIRECTOR OF CORPORATE
RESOURCES AND THE DIRECTOR OF LAW AND
GOVERNANCE**

**UPDATE ON DEVELOPMENTS IN LOCAL (EXTERNAL) AUDIT
ARRANGEMENTS**

Purpose of Report

1. The purpose of this report is to provide the Corporate Governance Committee (the Committee) with an update on developments in local (external) audit arrangements, that are associated with the Committee's responsibilities.

Summary

2. A series of large scale corporate governance and financial failings in both the private and public sectors e.g. Carillion, BHS and Northamptonshire County Council, and criticisms of the roles taken by auditors prompted a number of reviews of audit and governance arrangements in all sectors.
3. At its meeting on 1 November 2019, the Corporate Governance Committee received a report providing information on a number of consultations that were underway, the findings of associated reviews and other developments and informed the Committee of the Council's plans to respond.
4. The responsibilities for how local authority audits are conducted is set down within the Local Audit and Accountability Act 2014. In June 2019 Sir Tony Redmond was asked by the Ministry of Housing, Communities and Local Government (MHCLG) to undertake an independent review of the effectiveness of local (external) audit and the transparency of local authority financial reporting. Announcement of the review met the MHCLG's commitment to undertake a post implementation review of the audit framework and financial reporting elements of the Act.
5. Redmond released his review report on 8 September. In short, he found the current local audit arrangements not fit for purpose and he made a number of recommendations, some of which will require primary legislation, but others were more localised recommendations which could be implemented if chosen to do so. The general view amongst interested parties is that should all the recommendations be implemented, the local audit experience should be much improved, but it may come at some additional cost.
6. Almost in tandem to Redmond, the National Audit Office (NAO) consulted on changes to the Code of Audit Practice and associated guidance to local

auditors in support of the Code, to which auditors must have regard when carrying out their work. The Code must be reviewed, and revisions considered at least every five years.

7. The new Code came into force in April 2020. Among the changes adopted are the inclusion of additional narrative commentary by auditors to explain how audited bodies are improving value for money (VfM), along with greater attention to financial sustainability and governance. Redmond commended this improvement. The outcome of the consultation on this major change has recently been issued. Responses were on the whole positive but there is a risk that the extra work needed to form a more robust VfM opinion will increase fees. Audit work under the new Code will begin from the 2020-21 financial year onwards, meaning the first Auditor's Annual Reports will be issued in 2021.
8. Recommendations arising from other reviews of audit arrangements at the time (Kingman, the Competition and Markets Authority and Brydon) were evaluated and reflected in Redmond's review and report.
9. This report is for information only as an update one year on, because it is evident that the Council's officers and members will need to evaluate a lot of detail and agree on whether localised Redmond recommendations are accepted and the impact of changes to auditors' responsibilities under the new Code of Audit Practice.

Report

Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting (the Redmond review)

10. The guiding principles of the Redmond Review were accountability and transparency asking questions such as how are local authorities accountable to service users and taxpayers; how are auditors accountable for the quality of their work; how easy is it for service users and taxpayers to understand how their local authority has performed and what assurance they can take from external audit work.
11. The review team received 156 responses to 'Calls for Views' (including from the County Council) and carried out more than 100 interviews. Interested parties included local government practitioners, audit firms, professional accounting bodies, academia and the media and the general public. The review report (83 pages) was published on 8 September 2020. Substantial evidence collated from the 'Call for Views' and individual stakeholder meetings formed the basis of the report's findings. It contains an Executive Summary and 19 recommendations that are applicable to larger sized local authorities. It is broken down into four key component areas: -
 - a. The direction, regulation, procurement and performance of local (external) audit: Sections 2-4;

- b. Governance arrangements in place locally for responding to audit recommendations: Section 5;
- c. Audit work on the financial resilience of local authorities: Section 6 – (this links to the next section in this update report on the new Code of Audit Practice (2020) and associated Audit Guidance Notes (AGN) in particular AGN 03 which sets out how local auditors are expected to approach and report on their Value for Money (VfM) work);
- d. Financial reporting in local government: Section 7.

A further section (8) covers issues related to smaller audits, including parish/town councils that councillors may be interested to note.

Summary of Key Findings – note these may not be applicable to the County Council

12. **The direction, regulation, procurement and performance of local (external) audit** – the review found there is a lack of coherence in local audit arrangements. Currently there are six different entities with a statutory role in overseeing and/or regulating elements of the local authority accounting and audit framework including regulating the quality, price and effectiveness of external audit. However, none of the six entities has a statutory responsibility, either to act as a system leader or to make sure that the framework operates in a joined-up and coherent manner. A very high percentage of respondents and stakeholders who were interviewed, expressed a preference for a single regulatory body. Additionally: -
- a. Almost all education authorities responding questioned auditors qualifying their VfM opinion solely because of an “inadequate” Ofsted rating. There was no evidence of reports by other inspectorates leading to modifications to the auditor’s opinion. The review thought auditors should engage more with other inspectorates to discuss reports or take into consideration any improvements that a local authority may have made since an inspectorate rating had been issued.
 - b. The report raised concerns at various points regarding the balance of audit price and quality. Audit fees in the local authority sector have dropped significantly at the same time that fees in other sectors have significantly risen. Overall levels of audit fees have dropped significantly from 2014/15, whilst fee variations have increased, much to local authorities concerns. Evidence gathered suggested that the cost of local audit is 25% lower than is required to fulfil current local audit requirements. As a result the quality of auditors has reduced. A very high proportion of local authorities think that the current procurement process does not drive the right balance between cost reduction, quality of work, volume of external auditors and mix of staff undertaking the work.
 - c. There is concern that outside of the Key Audit Partners, auditors do not have sufficient experience or knowledge of local authorities. The two areas of particular concern were the knowledge and continuity of working level audit staff and whether audit work always covered the most important areas of the accounts from a financial resilience and service user perspective. Underpinning the concerns about the quality

and continuity of working level audit staff is a concern that there are not enough audit examiners with local authority expertise, and that this is an area in which accountancy trainees no longer wish to specialise.

- d. Internal Audit is not used much by External Audit as the Code of Audit Practice does not require them to liaise with internal audit work although there is a feeling that they could assist.
- e. For the first time in 2019-20, having insufficient qualified individuals to deliver all audits at the appropriate time was included as a reason for some of the delays in audit opinions being issued by the statutory publication deadline.
- f. There is a large expectation gap between what local authorities expect a VfM opinion should provide and what it actually provides. The VfM conclusion is viewed by many local authorities to be an exercise with limited use to them as it is too retrospective and often states what the local authority often already knows.

13. **Governance arrangements in place locally for responding to audit recommendations** – the review questioned whether on the whole Audit Committees are equipped to provide effective challenge to Auditors or Statutory Officers in an effective way. Additionally: -
 - a. There are relatively low numbers of independent Audit Committee members.
 - b. In practice the auditor tends to present matters to the Audit Committee, which decides if a matter is serious enough to be referred to Full Council. Whilst most local authorities feel that this arrangement is appropriate, the review identified some bad examples where external auditors had insights from their work, that could have provided assurance to Elected Representatives whether their local authority was not being run effectively. The review suggests that the external auditor should report to Full Council on risks identified and conclusions reached, in a transparent and understandable format.
 - c. The review questioned the role of the three statutory officers in relationship to audit – do they engage with the auditor together on an informal or formal basis and how regularly.
 - d. There is not always the expertise in local authority finance departments in completing the accounts process.
14. **Audit work on the financial resilience of local authorities** – this section of the report attempts to draw a definition of financial resilience, including drawing reference to potential risks to it, such as commercialisation agendas. Section 6.3 reviews the audit assessment of this resilience through judgement of going concern and value for money (VfM) work. The report notes the need for a new model for England and refers to the Auditor Guidance Note (AGN) 03.
15. **Financial reporting in local government** - Section 7 raises questions and concerns regarding the format and usefulness of local authority statement of accounts and states that they are complex and challenging for a service user or other taxpayer to understand. The current arrangements do not allow for the public to understand the accounts and more can be done to improve transparency of what local authorities do. The focus of audit on areas of

technical nature (not cash or budget), such as Property, Plant and Equipment and depreciation is considered over complex. The report identified three options to address this concern.

- a. Review International Financial Reporting Standards (IFRS) as a basis for preparation of the accounts and move to cash accounting – not favoured due to concerns regarding lack of consistency.
- b. Expansion and standardisation of the current narrative statement – again this is not favoured due to the expansion of potential audit coverage and no guarantee it would address the visibility or clarity of the statements.
- c. Introduce a new summary statement – this is the favoured option and a number of examples are given for certain types of councils. These statements would still be subject to audit for consistency with the main statements

Review conclusions

16. In summary, the review concluded that current local audit arrangements fail to deliver, in full, policy objectives underpinning the Local Audit and Accountability Act 2014. The overriding concern was a lack of coherence and public accountability within the existing system. Redmond emphasised that for local audit to be wholly effective it must provide a service which is robust, relevant, and timely; it must demonstrate the right balance between price and quality; and be transparent to public scrutiny. He thought that the evidence is compelling to suggest that the current local audit service does not meet those standards.

Review recommendations

17. The recommendations in the report centred on three aspects, namely: External Audit Regulation; Financial Resilience of local authorities and Transparency of Financial Reporting.
18. External Audit Regulation:
 - a. A new Office of Local Audit Regulation (OLAR) will be established and have responsibility for procuring, managing, overseeing and regulating local audits.
 - b. The current roles and responsibilities relating to local audits discharged by the six entities with a statutory role in overseeing and/or regulating elements of the local authority accounting and audit framework will be transferred to the OLAR.
 - c. A Liaison Committee will be established comprising key stakeholders and chaired by MHCLG, to receive reports from the new regulator on the development of local audit.
 - d. The governance arrangements within local authorities should be reviewed by local councils with the purpose of: -
 - i. an annual report being submitted to full Council by the external auditor;

- ii. consideration being given to the appointment of at least one independent member, suitably qualified, to the Audit Committee;
 - iii. formalising the facility for the Chief Executive Officer, Monitoring Officer and Chief Financial Officer to meet with the Key Audit Partner at least annually.
- e. All auditors engaged in local audit be provided with the requisite skills and training to audit a local authority irrespective of seniority.
- f. The current fee structure for local audit be revised to ensure that adequate resources are deployed to meet the full extent of local audit requirements.
- g. That quality be consistent with the highest standards of audit within the revised fee structure. In cases where there are serious or persistent breaches of expected quality standards, OLAR has the scope to apply proportionate sanctions.
- h. Statute be revised so that audit firms with the requisite capacity, skills and experience are not excluded from bidding for local audit work.
- i. External Audit recognises that Internal Audit work can be a key support in appropriate circumstances where consistent with the Code of Audit Practice.
- j. The deadline for publishing audited local authority accounts be revisited with a view to extending it to 30 September from 31 July each year.
- k. The revised deadline for publication of audited local authority accounts be considered in consultation with NHS (England) and the Department of Health & Social Care, given that audit firms use the same auditors on both Local Government and Health final accounts work.
- l. The external auditor be required to present an Annual Audit Report to the first Full Council meeting after 30 September each year, irrespective of whether the accounts have been certified; OLAR to decide the framework for this report.
- m. The changes implemented in the 2020 Audit Code of Practice are endorsed; OLAR to undertake a post implementation review to assess whether these changes have led to more effective external audit consideration of financial resilience and value for money matters.

19. Financial Resilience of local authorities

- a. MHCLG reviews its current framework for seeking assurance that financial sustainability in each local authority in England is maintained.
- b. Key concerns relating to service and financial viability be shared between Local Auditors and Inspectorates including Ofsted, Care Quality Commission and HMICFRS prior to completion of the external auditor's Annual Report.

20. Transparency of Financial Reporting

- a. A standardised statement of service information and costs be prepared by each authority and be compared with the budget agreed to support the council tax/precept/levy and presented alongside the statutory accounts.
- b. The standardised statement should be subject to external audit.

- c. The optimum means of communicating such information to council taxpayers/service users be considered by each local authority to ensure access for all sections of the communities.
- d. CIPFA/Local Authority (Scotland) Accounts Advisory Committee (LASAAC) be required to review the statutory accounts, in the light of the new requirement to prepare the standardised statement, to determine whether there is scope to simplify the presentation of local authority accounts by removing disclosures that may no longer be considered to be necessary.

Post report publication and next stages

- 21. Sir Tony Redmond has presented his review outcomes to a number of bodies with an interest in local audit arrangements amongst them audit firms, Public Sector Audit Appointments Ltd, the Local Government Association (LGA) and CIPFA. There has been general support for the direction of the recommendations from all institutions. CIPFA (the professional public finance accountancy body which maintains four statutory codes that local authorities are required to 'have regard to) has a view that if the recommendations are fully implemented, and there is some primary legislation required to do that, then there will be a better audit service although changes will take time to bed in. The passage of time could however be a significant risk if audit firms choose to withdraw from an already fragile market.
- 22. At a recent CIPFA conference, Redmond revealed that the MHCLG had reacted generally positively to his recommendations. He could not guarantee how the Department will react to individual parts of the report, but he had been given assurance that it would be taken extremely seriously by the Department Ministers.
- 23. Whilst some of his recommendations (creation of the new regulatory body and liaison committee, changing the audit deadline etc) will require primary legislation, Redmond considers many of the recommendations around governance could be considered in the short-term. These include: -
 - a. training of local authority audit committee members;
 - b. the appointment of independent members;
 - c. how could Key Audit Partners report to full council;
 - d. CIPFA could look at a simplified statement of accounts and induction and training;
 - e. CIPFA/LASAAC could review the statutory accounts;
 - f. audit firms could review how they can conduct their work in the future and how to ensure they get the necessary training and support to the individuals who are engaged in local audit.
- 24. Officers and members of the County Council will need to fully understand and debate all options relating to the review outcomes and recommendations to fully understand the implications. A further report will be brought to the Corporate Governance Committee in due course.

The new Code of Audit Practice (2020)

25. The 2014 Local Audit and Accountability Act makes the National Audit Office (NAO) under the leadership of the Comptroller and Auditor General (C&AG) responsible for the preparation and maintenance of the Code of Audit Practice (the Code) and gives the C&AG power to issue guidance to auditors in support of the Code, to which auditors must have regard when carrying out their work. The Code must be reviewed, and revisions considered at least every five years.
26. In April 2020 a new Code of Audit Practice came into force and consultation started shortly afterwards on its application and guidance for 2020/21 external audits. County Council officers responded to the consultation. The abovementioned Redmond Review included reference to the Audit Code. Consultation on the associated Auditor Guidance Notes closed early September 2020.
27. The C&AG has retained a single Code covering the audit of different types of local public body. This reflects the fact that the core statutory responsibilities placed on the auditors of the different types of local public body covered by the Code are essentially the same. The Code continues to take a principles-based, rather than a rules-based approach. A principles-based approach helps to ensure that the Code does not become out of date as the regulatory environment evolves. It allows the auditor to adopt a flexible approach that is responsive to sector developments and to the specific circumstances faced by the audited body.
28. The new Code of Audit Practice puts greater emphasis on timely and effective reporting by local auditors. It's focus on the areas that are important to local bodies will help them to strengthen their arrangements for securing value for taxpayers and provide transparency and accountability for the public on how well their money is being spent.
29. The revised code will focus even more on auditors obtaining assurance of organisational efficiency. Among the changes adopted are the inclusion of additional narrative commentary by auditors to explain how audited bodies are improving value for money, along with greater attention to financial sustainability and governance. Rather than require auditors to focus on delivering an overall, binary, conclusion about whether or not proper arrangements were in place during the previous financial year, the new code requires auditors to issue a commentary on each of the key criteria of financial resilience, governance and economy, efficiency and effectiveness. This will allow auditors to tailor their commentaries to local circumstances.
30. However, the proposed work on value for money, including the emphasis on more impactful reporting, will likely require greater audit resource, as well as a higher skill mix. It will be important for the NAO to provide guidance on the indicative likely range of days and specialist skill input required. This will help to manage the expectations of local bodies before auditors begin work on new year audits.

31. The NAO consulted on the detailed statutory guidance that will support auditors to deliver work under the new Code. The consultation on Auditor Guidance Note 03 (AGN 03) Auditors' Work on Value for Money (VFM) Arrangements was launched on 10 June 2020 and closed on 2 September 2020. AGN 03 is 18 pages long and extremely detailed guidance.
32. The consultation outcome has only recently been released but seems to have been positively received. In summary (extracted from the response document):
 - a. respondents agreed that the scope of proper arrangements covers the key areas of focus within the public sector that auditors should consider and that this would help to improve consistency and quality of assessments. Some useful suggestions were made to help tighten the scope further.
 - b. There was strong support from respondents that it was helpful to define whether a weakness in arrangements is significant for both the auditor, and to aid the body's own understanding. Respondents were broadly supportive of the characteristics and illustrative examples.
 - c. There was agreement from respondents that the characteristics of a significant weakness are helpful. There was also general agreement that the examples to help consider whether or not a weakness is 'significant' are helpful.
 - d. Under reporting, respondents were generally supportive of the considerations for deciding how to report a significant weakness
 - e. Very important was that respondents were generally supportive of the move to a commentary-based approach and recognised the objective to provide more meaningful reporting, where respondents stated this would provide a clearer focus for discussions with senior management and boards.
 - f. Nevertheless, there were some concerns regarding the impact on the audit fee and capacity of auditors and that the commentary should not be just a description of what auditors have done.
33. AGN 03 contains two new important specific references to Audit Committees.
 - a. Firstly, when reporting on the local body's arrangements to secure economy, efficiency and effectiveness in its use of resources, the 2020 Code requires auditors to consider whether the body has put in place 'proper arrangements'. In terms of 'Governance', the body should ensure that it makes informed decisions and properly manages its risks, supported by appropriate evidence and allowing for challenge and transparency. This includes arrangements for effective challenge from those charged with governance/audit committee.
 - b. Secondly, the guidance advises that a weak or ineffective audit committee that fails to provide appropriate challenge or hold officers and members to account, could illustrate a significant weakness in the body's governance arrangements.
34. The NAO's primary goals are to ensure that auditors are commenting publicly on key areas such as financial sustainability and governance, and for auditors

to provide more timely and meaningful reporting that helps bodies understand what auditors see as the high priority issues so that they can take action. This could have implications for both the resources local auditors may need and the skill mix they may need to deploy.

35. Implementation of AGN 03 should provide clarity and consistency to VfM opinions.
36. The Committee will be kept informed of any changes.

Other developments relating to the wider external audit field

37. Whilst the updates above are specifically relevant to the local government sector, in the past three years, three independent reviews were published on elements of the statutory audit framework. Whilst the Kingman Review made specific recommendations regarding the local audit framework, the Competition and Markets Authority Study and the Brydon Review were solely focussed on the audit of Public Interest Entities (listed companies or entities with listed debt). Ministers have yet to decide whether/how to take forward all recommendations made by these reviews.
38. However, given that local authority audit is delivered by assurance practices that undertake both public and private sector audits and conducted in accordance with a common set of quality standards, some of the recommendations made by these reviews may be relevant to the future of local audit.
39. The Redmond Review listed the relevant recommendations made by all three reports and commented on how it had addressed them and/or how they may impact on the future of local authority audit.
 - a. 'The Independent Review of the Financial Reporting Council (FRC)' – the Kingman review was concluded in December 2018. The FRC regulates auditors, accountants and actuaries in the UK, sharing this responsibility with the professional membership bodies. The review recommended that the FRC be replaced with an independent statutory regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers. The new regulator would be called the Audit, Reporting and Governance Authority.

Redmond concurred with four relevant recommendations and expanded two of them. One other was outside of the scope.

- b. 'Statutory Audit Services Market Study', final report, April 2019. The Competition and Markets Authority (CMA). recommended changes to the statutory audit market that will impact on local audit. This review also made a specific recommendation that audit committees should come under greater scrutiny by the new regulator (see Kingman). This should increase accountability of audit committees. This

recommendation could translate into the public sector and local government.

Redmond commented on four recommendations mostly with concern that the CMA proposals could affect the local audit market which is already fragile.

- c. 'Independent review into the quality and effectiveness of audit' (the Brydon review). The review was commissioned in response to the perceived widening of the "audit expectations gap" - the difference between what users expect from an audit and the reality of what an audit is and what auditors' responsibilities entail. Recent company failures have brought this gap into greater focus. There may be an additional gap between the information users of audited accounts believe is needed and what is available to them through audited financial statements or other publicly available information. A report to the Secretary of State for Business, Energy and Industrial Strategy is expected by the end of 2019.

Redmond was fairly even in agreeing to or asking for further detail over twenty recommendations that aligned to its review. However on one Brydon recommendation, 'creating a separate new audit profession', Redmond was concerned that it has the potential to have a significant impact on the sustainability of the local authority and indeed the wider public sector audit market. Government and the proposed local authority audit regulator (OLAR) may need to consider whether the proposed corporate audit profession would continue to generate skills that are transferrable for public sector audit. If not, and it develops as suggested by Brydon, there is a risk that local audit market could come under even more stress. If skills are transferrable, consideration will need to be given to how to ensure that members of the new corporate audit profession retain the skills, knowledge and expertise to deliver high quality local authority audits.

40. The position with these other reviews will continue to be monitored and reported to Committee.

Resource implications

41. There are no resource implications arising directly from this report at this stage, although there is a potential for higher external audit fees and accounts preparation costs in future years.

Legal Implications

42. The proposals in the recent review call for some potentially significant changes to how the Corporate Governance Committee performs its functions. Further reflection and analysis will follow, after which time any local Constitutional implications can be considered.

Equality and Human Rights Implications

43. There are no discernible equality and human rights implications resulting from the audits listed.

Recommendation

44. The Committee is asked to note the outcomes of the Redmond Review, the new Code of Audit Practice and other developments in local (external) audit arrangements.

Background Papers

Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting (the Redmond review)

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/916217/Redmond_Review.pdf

The new Code of Audit Practice (2020)

https://www.nao.org.uk/code-audit-practice/wp-content/uploads/sites/29/2020/01/Code_of_audit_practice_2020.pdf

Auditor Guidance Note 03 (AGN 03) Auditors' Work on Value for Money (VFM)

<https://www.nao.org.uk/code-audit-practice/wp-content/uploads/sites/29/2020/06/New-draft-AGN-3-For-consultation-final.pdf>

Report to the Corporate Governance Committee on 1 November 2019 –
“Developments in Audit and Governance” –

<http://politics.leics.gov.uk/ieListDocuments.aspx?CId=434&MId=5782&Ver=4>

Circulation under the Local Issues Alert Procedure

None.

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