

REPORT TO:	DATE	CLASSIFICATION	REPORT NO.	AGENDA NO.
Audit Committee	28 June 2011			
REPORT OF: Corporate Director, Resources ORIGINATING OFFICER(S): <i>Peter Hayday, Financial Services, Risk and Accountability</i>		THE FUTURE OF LOCAL AUDIT Ward(s) Affected: N/A		

1. Summary

- 1.1. This report updates the Audit Committee on the Government's plans for the future of local external audit and the potential impact on Tower Hamlets and sets out a proposed response to the Government consultation

2. Recommendation

- 2.1. The Audit Committee is asked to note the report and to consider the draft response to the consultation at Appendix A.

3. Background

- 3.1. The independent audit of local authorities is enshrined in legislation going back to the first part of the 19th Century.
- 3.2. Since 1983, the Audit Commission has been the body responsible for appointing local authority auditors and undertakes the largest proportion of audits itself. On 13th August 2010, the Government announced the abolition of the Commission.
- 3.3. The ethos overlaying the Government's approach is to "refocus audit of local public bodies on helping local people hold those bodies to account for local spending decisions, the very essence of localism". The aim is to "replace the current, centralised audit systems managed by the Audit Commission, with a new decentralised regime, which will support local democratic accountability, and one that will also cut bureaucracy and costs, while ensuring that there continues to be robust local public audit".

- 3.4. Full consultation on “The Future of Local Audit” was launched on 30th March and runs until 30th June. A proposed response is at out at **Appendix A**
- 3.5. The consultation covers three areas affecting Tower Hamlets;
- * Regulation of local public audit
 - * Commissioning local public audit services
 - * Scope of audit and the work of auditors

3.6. The main proposals are;

Regulation of local public audit

- 3.7. The Audit Commission is currently responsible for setting audit standards and Codes of Practice for local government and health bodies. It is also responsible for commissioning and appointing auditors to each local authority and local health body and for monitoring the quality and consistency of audit work.
- 3.8. Under the proposals;
- The National Audit Office (NAO) would develop and maintain codes of audit practice and supporting guidance.
 - The Financial Reporting Council (FRC), which is an independent regulator funded by the Government and the accountancy profession to set standards for accounting, would determine who can undertake public sector audit work under a system similar to that operating for the private sector.
 - Recognised supervisory bodies under the umbrella of the accountancy profession would supervise the quality of audit work undertaken.
- 3.9. There would thus be a list of audit firms eligible to bid for local authority work created by the FRC and maintained by the recognised supervisory bodies.
- 3.10. The CLG has subsequently announced that it does not intend to create a company from the Audit Commission’s audit practice which could then bid for work, although presumably Audit Commission staff could still do this independently at the risk that they might not be accredited by the FRC.

Commissioning of local public audit services

- 3.11. The consultation proposes that all larger local public bodies would appoint their own auditors from among those on the list.
- 3.12. The appointment would be made by Full Council, on the advice of the Audit Committee. The Secretary of State will retain a reserve power to appoint when a local authority fails to do so.
- 3.13. The audited body would undertake a competitive re-appointment process within five years. No appointed auditor would be allowed to undertake more than two consecutive five year terms with the same authority. The auditor would be reappointed by the Council each year on the recommendation of Audit Committee.
- 3.14. The consultation proposes new arrangements for the Audit Committee;
- The chair and vice-chair would be independent of the authority (ie not elected Members)
 - One option is that a majority of members of the Audit Committee would be independent of the authority.
 - The elected Members on the Committee would be non-executive, non-Cabinet Members. At least one should have recent and relevant financial experience.
 - Independent members would not be permitted to be Members or officers of another authority, or to have been a Member or an officer of the same authority within the last five years.
- 3.15 The Audit Committee in a local authority currently has no statutory role. The paper consults on whether the Audit Committee should have a mandatory role in addition to advice to the Council on the appointment of the auditor.

Scope of audit and the work of auditors

- 3.16 The consultation paper provided four options for the scope of the audit;

Option 1: Similar to that of private companies with the auditor giving an opinion on the authority's accounts but not undertaking a value for money judgement

Option 2: Similar to the current system of local government audit with the auditors giving an opinion on the accounts, the Annual Statement of Governance and giving a value for money opinion.

Option 3: As at present but with stronger assurances on regularity and propriety, financial resilience and value for money.

Option 4: A requirement for authorities to prepare an annual report which would be reviewed and reported upon by the auditor.

- 3.17. Auditors would continue to have the power to prepare reports in the public interest
- 3.18. It is proposed that the audit is brought within the scope of the Freedom of Information Act, but that local electors would lose the right to object to the accounts.

4. Impact on the Council

- 4.1. Depending upon the option that is chosen, the impact of the changes on the way the Council is audited will probably be manageable. A requirement to produce an Annual Report would add to the workload, but it would not be likely to cover matters that are not already audited.
- 4.2. The value for money assessment is part of the current audit regime. It is uncertain to what extent an auditor can truly assess value for money, or whether the auditor should get involved in what can be value judgements which are probably best left to elected representatives.
- 4.3. The need to tender for an auditor every five years, but arguably, it may be viewed as giving the authority, as the audited body, more buy-in to the process as opposed to being automatically assigned an auditor.
- 4.4. The Audit Committee may in future be controlled by independent members, and the degree of independence to be required suggests Government's determination to ensure that Audit Committees are not seen as functionaries of the local government system (eg officers and Members from other authorities). The drive to independence appears to be about creating more public confidence in the system but it also clearly impacts and arguably undermines democratic accountability. Among the practical issues which would need to be worked out at local level would be the relationship between Audit Committee and Overview & Scrutiny

- 4.5. It seems unlikely that the changes will lead to cost savings. Contracts will be open to a relatively small number of providers which will reduce the level of competition in the market place. The Audit Commission has been able to keep the price of audit down for public authorities and the costs of audit for public bodies, is less than the fees paid by similar sized private companies. . There will be pressure on audit firms not to profit excessively at the expense of the public sector, but it seems more likely that the costs of public audit will increase over time rather than reduce.

5. Response to the Consultation

- 5.1 The consultation is designed to elicit views on the proposals from all public bodies affected by the change (local authorities, primary care trusts, probationary service etc), and to aid this, the consultation is structured with a list of questions for public bodies to consider. The attachment at Appendix A sets out Tower Hamlets' response to the most pertinent questions raised the consultation document.

6. Comments of the Chief Financial Officer

- 6.1 These are contained within the body of this report.

7. Concurrent Report of the Assistant Chief Executive (Legal Services)

- 7.1 The external audit of local authorities is presently governed by Part 2 of the Audit Commission Act 1998. The audit system is overseen by the Audit Commission, which appoints the auditor for each local authority, amongst other things. It is understood that the Government's present consultation is intended to result in significant change to the existing legislative regime, as outlined in the report. Given that the changes will impact on the Council, it is appropriate for the Council to make submissions as part of the consultation exercise.

8. One Tower Hamlets

- 8.1 There are no specific one Tower Hamlets considerations.
- 8.2 There are no specific Anti-Poverty issues arising from this report.

9. Risk Management Implications

- 9.1 This report highlights changes in the governance of the Council. The proposals set out in this document will result in changes to the Council's constitution. There are no specific risk implications at this stage.

10. Sustainable Action for a Greener Environment (SAGE)

- 10.1 There are no specific SAGE implications.

Local Government Act, 1972 SECTION 100D (AS AMENDED)

List of "Background Papers" used in the preparation of this report

Brief description of "background papers"

Contact :

The Future of Public Audit, Consultation,
March 2011

N/a

Appendix A

Response to Consultation by London Borough of Tower Hamlets

THE FUTURE OF LOCAL PUBLIC AUDIT

The London Borough of Tower Hamlets welcomes the opportunity to comment on the Consultation Paper "Future of Local Public Audit" issued by DCLG on 30th March 2011.

Question 1: Have we identified the correct design principles? If not what other principles should be considered? Do the proposals in this document meet these design principles?

No view on this question.

Question 2: Do you agree that the audit probation trusts should fall within the Comptroller and Auditor General's regime?

No view on this question.

Question 3: Do you think that the National Audit Office would be best placed to produce the Code of audit practice and the supporting guidance?

Our view is that in the absence of a separate audit body for local governance, the NAO is a suitable body to provide this guidance.

Question 4: Do you agree that we should replicate the system for approving and controlling statutory auditors under the Companies Act 2006 for statutory local public auditors?

Public bodies are different from Companies in the way they are managed, governed and scrutinised. If there is an argument for bringing the audit regimes of public and private bodies closer together, it would be to provide greater public scrutiny of Companies, some of which have lost the confidence of the public in their financial practices of late.

Question 5: Who should be responsible for maintaining and reviewing the register of statutory local public auditors?

No view on this question.

Question 6: How can we ensure that the right balance is struck between requiring audit firms eligible for statutory local public audit to have the right level of experience, while allowing new firms to enter the market?

No view on this question.

Question 7: What additional criteria are required to ensure that auditors have the necessary experience to be able to undertake a robust audit of a local public body, without restricting the market?

If firms are admitted to the market simply to provide competition and prove to be not up to the job, public confidence in local public audit could be undermined.

Question 8: What should constitute a public interest entity (i.e. a body for which audits are directly monitored by the overall regulator) for the purposes of local audit regulation? How should these be defined?

No view on this question.

Question 9: There is an argument that by their very nature all local public bodies could be categorised as 'public interest entities.' Does the overall regulator need to undertake any additional regulation or monitoring of these bodies? If so, should these bodies be categorised by the key services they perform, or by their income or expenditure? If the latter, what should the threshold be?

No view on this question.

Question 10: What should the role of the regulator be in relation to any local bodies treated in a manner similar to public interest entities?

No view on this question.

Question 11: Do you think the arrangements we set out are sufficiently flexible to allow councils to cooperate and jointly appoint auditors? If not, how would you make the appointment process more flexible, whilst ensuring independence?

No view on this question.

Question 12: Do you think we have identified the correct criteria to ensure the quality of independent members? If not, what criteria would you suggest?

Tower Hamlets appreciates that the Government may have a concern about Audit Committees becoming clogged with public sector 'insiders' but the Government needs to be careful not to restrict the supply and to exclude competent and independent minded individuals who may wish to give their free time to work as independent Audit Committee members.

Question 13: How do we balance the requirements for independence with the need for skills and experience of independent members? Is it necessary for independent members to have financial expertise?

It is not necessary for independent members to have financial expertise, but experience of governance in large, complex organisations would be valuable.

Question 14: Do you think that sourcing suitable independent members will be difficult? Will remuneration be necessary and, if so, at what level?

Yes it will be difficult for some authorities to recruit, although we do not envisage that Tower Hamlets would have a problem. Some form of remuneration will be necessary if suitable people are to be expected to give up their time.

Question 15: Do you think that our proposals for audit committees provide the necessary safeguards to ensure the independence of the auditor appointment? If so, which of the options described in paragraph 3.9 seems most appropriate and proportionate? If not, how would you ensure independence while also ensuring a decentralised approach?

There are a number of important issues bound up in this question.

The main issue in relation to the independence on Audit Committees is the way independent scrutiny operates alongside democratic accountability. It is important that any independent element of scrutiny complements but does not undermine the important fiduciary relationship that democratically elected Members have with the taxpayer and with communities at large. Officers in Tower Hamlets have not had the opportunity to consult the full Tower Hamlets Council on the question of the future structure of the Audit Committee and so we are unable to give a view on paragraph 3.9.

If public confidence in the appointment of independent auditors is paramount, the best way of ensuring it would have been to leave it with an independent, arms length body such as the Audit Commission. However Tower Hamlets does not envisage that there will be a problem appointing independent auditors.

Question 16: Which option do you consider would strike the best balance between a localist approach and a robust role for the audit committee in ensuring independence of the auditor?

No view on this question.

Question 17: Are these appropriate roles and responsibilities for the Audit Committee? To what extent should the role be specified in legislation?

Given the large variation in the size and nature of local public bodies, a legislative approach to the functions of Audit Committees should be avoided.

Question 18: Should the process for the appointment of an auditor be set out in a statutory code of practice or guidance? If the latter, who should produce and maintain this?

No view on this question.

Question 19: Is this a proportionate approach to public involvement in the selection and work of auditors?

The responsibility of elected Members for the governance of the local body should not be overlooked. There is already a misunderstanding among some members of the public that it is the auditor who is responsible, and that he/she is in a position to prevent certain controversial decisions being taken. Public consultation is important in raising awareness and community involvement but needs to avoid raising expectations about what the auditor reasonably can and cannot do.

Question 20: How can this process be adapted for bodies without elected members?

No view on this question.

Question 21: Which option do you consider provides a sufficient safeguard to ensure that local public bodies appoint an auditor? How would you ensure that the audited body fulfils its duty?

No view on this question.

Question 22: Should local public bodies be under a duty to inform a body when they have appointed an auditor, or only if they have failed to appoint an auditor by the required date?

No view on this question.

Question 23: If notification of auditor appointment is required, which body should be notified of the auditor appointment/failure to appoint an auditor?

No view on this question.

Question 24: Should any firm's term of appointment be limited to a maximum of two consecutive five-year periods?

The principle of maximum periods is correct to avoid auditors and clients becoming too familiar with each other. If anything, 10 years seems a little too long and perhaps a single 7 year contract would be more appropriate.

Question 25: Do the ethical standards provide sufficient safeguards for the rotation of the engagement lead and the audit team for local public bodies? If not, what additional safeguards are required?

No view on this question.

Question 26: Do the proposals regarding the reappointment of an audit firm strike the right balance between allowing the auditor and audited body to build a relationship based on trust whilst ensuring the correct degree of independence?

No view on this question.

Question 27: Do you think this proposed process provides sufficient safeguard to ensure that auditors are not removed, or resign, without serious consideration, and to maintain independence and audit quality? If not, what additional safeguards should be in place?

No view on this question.

Question 28: Do you think the new framework should put in place similar provision as that in place in the Companies sector, to prevent auditors from seeking to limit their liability in an unreasonable way?

No view on this question.

Question 29: Which option would provide the best balance between costs for local public bodies, a robust assessment of value for money for the local taxpayer and provides sufficient assurance and transparency to the electorate? Are there other options?

Option 1 should be ruled out on the basis that a reduction in the audit requirements on local bodies is inappropriate at the present time. Option 4 should be ruled out on the basis that no public body should be required to produce an Annual Report purely for the benefit of the auditors. Either Option 2 or 3 would be closer to Tower Hamlets view.

Question 30: Do you think local public bodies should be required to set out their performance and plans in an annual report? If so, why?

There should not be a requirement to produce an Annual Report for audit purposes. Annual Reporting for the purpose of informing the public is another matter, but it should be a matter for local determination how an authority delivers its duty to inform.

Question 31: Would an annual report be a useful basis for reporting on financial resilience, regularity and propriety, as well as value for money, provided by local public bodies?

No view on this question.

Question 32: Should the assurance provided by the auditor on the annual report be 'limited' or 'reasonable'?

No view on this question.

Question 33: What guidance would be required for local public bodies to produce an annual report? Who should produce and maintain the guidance?

No view on this question.

Question 34: Do these safeguards also allow the auditor to carry out a public interest report without his independence or the quality of the public interest report being compromised?

There is bound to be some question in the public mind as to whether an auditor with a contractual relationship with the authority is truly independent, especially in view of the occasional bad practice that has been revealed and much publicised in the private sector. If the Government believes this issue is paramount then a system in which auditors are independently appointed by a body such as the Audit Commission should be retained.

Question 35: Do you agree that auditors appointed to a local public body should also be able to provide additional audit-related or other services to that body?

Tower Hamlets does not believe it is appropriate in the interests of independence for auditors to provide additional services to the authority.

Question 36: Have we identified the correct balance between safeguarding auditor independence and increasing competition? If not, what safeguards do you think would be appropriate?

No view on this question.

Question 37: Do you agree that it would be sensible for the auditor and the audit committee of the local public body to be designated prescribed persons under the Public Interest Disclosure Act? If not, who do you think would be best placed to undertake this role?

Yes.

Question 38: Do you agree that we should modernise the right to object to the accounts? If not, why?

The provisions of the Audit Commission Act are a direct legacy of the 19th Century and are out of step with and to some extent at odds with the Freedom of Information Act and the Data Protection Act as well as with modern accounting technology. The Government should go further in modernising the requirements without compromising the rights of interested persons to inspect relevant materials. It is not necessary for the Government to remove the right to object to the accounts.

Question 39: Is the process set out above the most effective way for modernising the procedures for objections to accounts? If not, what system would you introduce?

No view on this question.

Question 40: Do you think it is sensible for auditors to be brought within the remit of the Freedom of Information Act to the extent of their functions as public office holders? If not, why?

No. The auditor needs to have access to all relevant documentation including that which is exempt under the Freedom of Information Act. Once this information is held by the auditor, the local public body, the owner of the information, would lose control of it and would not necessarily be involved in a decision to release it. A disagreement between the authority and its auditor on a matter of this kind could seriously undermine the auditor/ client relationship. Knowledge of this may discourage authorities and auditors from sharing exempt information.

Question 41: What will be the impact on (i) the auditor/audited body relationship, and (ii) audit fees by bringing auditors within the remit of the Freedom of Information Act (to the extent of their functions as public office holders only)?

The relationship could be seriously undermined. See above.

Question 42: Which option provides the most proportionate approach for smaller bodies? What could happen to the fees for smaller bodies under our proposals?

No view on this question.

Question 43: Do you think the county or unitary authority should have the role of commissioner for the independent examiners for smaller bodies in their areas? Should this be the section 151 officer, or the full council having regard to advice provided by the audit committee? What additional costs could this mean for county or unitary authorities?

No view on this question.

Question 44: What guidance would be required to enable county/unitary authorities to:

- a) Appoint independent examiners for the smaller bodies in their areas?
- b) Outline the annual return requirements for independent examiners?
- c) Who should produce and maintain this guidance?

No view on this question.

Question 45: Would option 2 ensure that smaller bodies appoint an external examiner, whilst maintaining independence in the appointment?

No view on this question.

Question 46: Are there other options given the need to ensure independence in the appointment process? How would this work where the smaller body, e.g. a port health authority, straddles more than one county/unitary authority?

No view on this question.

Question 47: Is the four-level approach for the scope of the examination too complex? If so, how would you simplify it? Should the threshold for smaller bodies be not more than £6.5m or £500,000? Are there other ways of dealing with small bodies, e.g. a narrower scope of audit?

No view on this question.

Question 48: Does this provide a proportionate, but appropriate method for addressing issues that give cause for concern in the independent examination of smaller bodies? How would this work where the county council is not the precepting authority?

No view on this question.

Question 49: Is the process set out above the most appropriate way to deal with issues raised in relation to accounts for smaller bodies? If not, what system would you propose?

No view on this question.

Question 50: Does this provide a proportionate but appropriate system of regulation for smaller bodies? If not, how should the audit for this market be regulated?

No view on this question.