

Non-Executive Report of the: <b>Audit Committee</b> 8 <sup>th</sup> November 2016	 <b>TOWER HAMLETS</b>
<b>Report of:</b> Zena Cooke - Corporate Director - Resources	<b>Classification:</b> Unrestricted
<b>Changes to Arrangements for the Appointment of External Auditors</b>	

<b>Originating Officer(s)</b>	Minesh Jani
<b>Wards affected</b>	All wards

## 1. SUMMARY

- 1.1. This report summarises the changes to the arrangements for appointing External Auditors following the closure of the Audit Commission and the end of the transitional arrangements at the conclusion of the 2017/18 audits.
- 1.2. The Council will need to consider the options available and put in place new arrangements in time to make a first appointment by 31 December 2017. In practical terms, this means that one of the options outlined in this report will need to be in place by spring 2017.

## 2. RECOMMENDATION

- 2.1. The Audit Committee members should note the following three available options:-
  1. Establishing a stand-alone independent Auditor Panel to make the appointment on behalf of the Council;
  2. Commencing work on exploring the establishment of local joint procurement arrangements with one or more other authorities.
  3. Join the Sector Led Body, Public Sector Audit Appointment (PSAA) that has been set up by the Local Government Association (LGA).
- 2.2. Note that option 2.1.3 is at this stage the preferred option, but this does not commit the Council at this point.
- 2.3. Note that further decisions will be required by the Council to either (a) set up an auditor panel should the recommendation be to carry out a procurement exercise or (b) approve any Sector Led Body recommendation.

### **3. BACKGROUND**

- 3.1. The Local Audit and Accountability Act 2014 abolished the Audit Commission and established transitional arrangements for the appointment of external auditors and the setting of audit fees for all local government and NHS bodies in England. On 5<sup>th</sup> October 2015 the Secretary of State Communities and Local Government (CLG) determined that the transitional arrangements for local government bodies would be extended by one year to also include the audit of the accounts for 2017/18.
- 3.2. The Council's current external auditor is KPMG. This appointment was made under a contract negotiated by the Audit Commission. Following the abolition of the Audit Commission the contract is currently managed by Public Sector Audit Appointments Limited (PSAA), the transitional body set up by the LGA with delegated authority from the Secretary of State, DCLG. Over recent years we have benefited from a reduction in fees in the order of 50% compared with historical levels. This has been the result of a combination of factors including new contracts negotiated nationally with the firms of accountants and savings from the abolition of the Audit Commission. The Council's current external audit fees are £0.2 million per annum.
- 3.3. When the current transitional arrangements come to an end on 31 March 2018, the Council will be able to move to a local appointment of the auditor. There are a number of routes by which this can be achieved, each with varying degree of risks and opportunities. Current fees are based on discounted rates offered by the firms in return for substantial market share. When the contracts were last negotiated nationally by the Audit Commission they covered NHS and local government bodies and offered maximum economies of scale.
- 3.4. The scope of the audit will still be specified nationally and the National Audit Office (NAO) is responsible for writing the Code of Audit Practice which all firms appointed to carry out Council's audits must follow. Not all accounting firms will be eligible to compete for the work; they will need to demonstrate that they have the required skills and experience and be registered with a Registered Supervising Body approved by the Financial Reporting Council. The registration process has not yet commenced and so the number of firms is not known but it is reasonable to expect that the list of eligible firms may include the top 10 or 12 firms in the country, including our current auditor. It is thought unlikely that small local independent firms will meet the eligibility criteria.

### **4. OPTIONS FOR LOCAL APPOINTMENT OF EXTERNAL AUDITORS**

- 4.1. There are three broad options open to the Council under the Local Audit and Accountability Act 2014 (the Act):

#### **Option 1 – To make a standalone appointment**

- 4.2. In order to make a stand-alone appointment the Council will need to set up an Auditor Panel. The members of the panel must be wholly or a majority independent members as defined by the Act and must be chaired by an independent member.

Independent members for this purpose are independent appointees, this excludes current and former elected members (or officers) within the last five years and their close families and friends. This means that elected members will not have a majority input in assessing bids and advising which firm of accountants to award the contract for the Council's external audit. A new independent auditor appointment panel established by the Council will be responsible for selecting the auditor.

***Advantages/benefit***

- 4.3. The Council has full ownership of the process, a bespoke contract with the auditors and tendering process that reflects local circumstances (within EU procurement rules).

***Disadvantages/risks***

- 4.4. Recruitment and servicing of the Auditor Panel, running the bidding exercise and negotiating the contracts is estimated by the LGA to cost in the region of £15,000 plus ongoing expenses and allowances. It is also unclear whether the Council will be able to attract sufficient individuals with the requisite skills and experiences to undertake the role on the board or as chair.
- 4.5. The Council will not be able to take advantage of reduced fees that may be available through joint or national procurement contracts.
- 4.6. There is a more fundamental issue. Selecting one's own external auditor may seem superficially attractive, but many would argue that it creates a risk of conflict of interest and does not promote best governance. Independent appointment of the auditor provides a separation which strengthens any audit findings especially if they are positive. Whilst the establishing of an independent auditor appointment panel is intended to create this separation, it is unclear the extent to which it would in practice achieve this.

**Option 2 – Set up a joint auditor panel / local joint procurement arrangements**

- 4.7 The Act enables the Council to join with other authorities to establish a joint auditor panel. Again this will need to be constituted of wholly or a majority of independent appointees (members). Further legal advice will be required on the exact constitution of such a panel having regard to the obligations of each Council under the Act and the Council will need to liaise with other local authorities to assess the appetite for such an arrangement.

***Advantages/benefits***

- 4.8. The costs of setting up the panel, running the bidding exercise and negotiating the contract will be shared across a number of authorities.
- 4.9. There is greater opportunity for negotiating some economies of scale by being able to offer a larger combined contract value to the firms.

### ***Disadvantages/risks***

- 4.10. The decision making body will be further removed from local input, with potentially no input from elected members where a wholly independent auditor panel is used or possible only one elected member representing each Council, depending on the constitution agreed with the other bodies involved.
- 4.11. Although this creates more separation and independence and hence reduces the risk of conflict of interests set out in paragraph 4.6 it does not wholly remove the issue.
- 4.12. The Council may not end up with first choice of auditor, compared to an individual auditor panel. If a large group of authorities work together and decide to appoint one joint audit contract across all the authorities, a joint panel may be more likely to advise appointment of an auditor it considers suitable for all authorities taken together.
- 4.13. An alternative solution to a joint auditor panel or joint procurement arrangement could be using another authority's panel. This option was not considered due to it being difficult to find an authority willing to enter into such arrangement and have adequate liaison with the Council's own Audit Committee. Also another local authority's would not understand the specific needs of the authority.

### **Option 3 – Opt-in to a Sector Led Body**

- 4.14. In response to the consultation on the new arrangement, the LGA successfully lobbied for Councils to be able to 'opt-in' to a Sector Led Body (SLB) appointed by the Secretary of State under the Act. An SLB would have the ability to purchase on behalf of many authorities at once, thereby maximising the economic advantages created by high volume purchases when they approach the market place. In turn this will increase the opportunities for the most economic and efficient approach to procurement of external audit on behalf of the whole sector.
- 4.15. PSAA is an independent, not-for-profit company limited by guarantee and established by the LGA. It already carries out a number of functions in relation to auditor appointments under powers delegated by the Secretary of State for CLG. In July 2016, the Secretary of State for DCLG specified PSAA as an appointing person under regulation 3 of the Local Audit (Appointing Person) Regulations 2015. They are currently working on the details of the scheme, including a timetable, and will provide further information as soon as possible.
- 4.16. It is anticipated that invitations to opt in will be issued before December 2016 and authorities will have a minimum period of eight weeks to respond to the invitation. In accordance with regulation 19 of the Local Audit (appointing Person) Regulations 2015, the Council would need to make the decision to opt in by the Audit Committee.

### ***Advantages/benefits***

- 4.17. The costs of setting up the appointment arrangements and negotiating fees would be shared across all opt-in authorities.
- 4.18. By offering large contract values the firms would be able to offer better rates and lower fees than are likely to result from local negotiation.
- 4.19. Any conflicts at individual authorities would be managed by the SLB who would have a number of contracted firms to call upon.
- 4.20. The appointment process would not be in the remit of locally appointed independent members. Instead the PSAA would act in the collective interests of the 'opt-in' authorities. This therefore resolves the point about conflict and governance that arises from local appointment.

### ***Disadvantages/risks***

- 4.21. Individual elected members will have little or no opportunity for direct involvement in the appointment process other than through the SLB and/or stakeholder representative groups.
- 4.22. In order for the SLB to be viable and to be placed in the strongest possible negotiating position the SLB will need Councils to indicate their intention to opt-in before final contract prices are known.
- 4.23. Rates may be set at a national level, which could arguably involve a degree of cross-subsidy from larger authorities to smaller ones. It is difficult at this stage to estimate what, if any, would be the impact of this for Tower Hamlets.

## **5. Comments of the Chief Finance Officer**

- 5.1 This report seeks a view from the Committee on their preferred option for the selection of an external audit firm to carry out the statutory audit of the Council's Statement of Accounts after the 2017/18 audit process has concluded; as such there are no direct financial implications arising from the report although there are clearly uncertainties about the cost of providing external audit services after 2017/18 which will be dependent on the approach taken and fees negotiated.

## **6. Legal Comments**

- 6.1. The Audit Commission was established under the Audit Commission Act 1998 ('the 1998 Act'), which was abolished by the Local Audit and Accountability Act 2014 ('the 2014 Act'). The 2014 Act established transitional arrangements for the appointment of external auditors and the setting of audit fees for all local government and NHS bodies in England, which have now been extended by one year to include the audit of the accounts for 2017/18.
- 6.2. Under Regulation 3 of the Accounts and Audit Regulations 2015 ('**the 2015 Regulations**'), the Council is required to ensure that it has a sound system of

internal control that facilitates effective exercise of the Council's functions and includes arrangements for the management of risk. The Council is also required by Regulation 5 to maintain an effective system of internal audit to evaluate the effectiveness of its risk management, control and governance processes, taking into account public sector internal auditing standards and guidance. The option selected must enable the Council to comply with these duties.

- 6.3. In determining which of the three options to select in respect of the arrangements for appointing External Auditors, the Council has a duty to make arrangements to secure continuous improvement in the way in which its functions are exercised, having regard to a combination of economy, efficiency and effectiveness by virtue of section 3 of the Local Government Act 1999. This is known as its Best Value Duty.
- 6.4. The principal way that the Council demonstrates compliance with its Best Value Duty is by subjecting the purchases it makes to a competitive tendering exercise. Also, services of this nature are ordinary services for the purposes of the Public Contracts Regulations 2015. This means that where the estimated value of the contract is greater than £164,176.00 then the full regime will apply to any such purchase, meaning that regardless of the option selected by the Council the identity of the final contractor should be found by running some form of full European Procurement.
- 6.5. With regard to Option 1 (a local procurement) it would be a straight forward task and one which would be entirely under the Council's control to comply with the 2015 regulations. In essence the Council would have to comply directly with the methods of advertising and evaluation and also the timescales prescribed by the Regulations with the winning contractor being determine on a Most Economically Advantageous basis given an appropriate blend of price and quality of the evaluation.
- 6.6. With options 2 and 3 the Council would be relying on a third party to satisfy the Council's procurement obligations under the Regulations. This is possible although the Council should not commit itself to a given path unless it is certain that the Council's own procurement obligations have been properly satisfied.
- 6.7. With regard to Option 2 the appointment of the final contractor would be down to the joint Audit Panel. However, the contractual relationship would be a direct one between LBTH and the winning bidder for the provision of the audit services. Therefore, the relevant procurement exercise would be that of a joint procurement between the participating boroughs and the European Advert would have to specifically state the identities of the parties who will ultimately purchase through the procured route. The role of the joint panel would be to operate the procurement evaluation and recommend to each borough the identity of the winning bidder. Each borough would then be responsible for following its own constitutional requirements and enter into the relevant contract.
- 6.8. The difficulty is one of control as the Council may not be able to influence the shape of the procurement and where the Council fundamentally believes that its own procurement obligations have not been satisfied then the Council should not and would not be able to enter into the contract.

- 6.9. It is notable that the execution of such a contract should also be subject to its own delegated decision making process beyond that included in this report.
- 6.10. As regard Option 3 the nature of the contract would be a purchase of services between LBTH and the Sector Led Body (SLB). However, on the face of it this is a purchase that would not have been subject to competition and would not satisfy the Council's legal obligation to tender in accordance with the 2015 regulations.
- 6.11. However, Regulation 12 of the Public Contracts Regulations 2015 provides an exception. This is where the Council purchases services from an organisation where:
- a. the Council exercises over that organisation a control which is similar to that which it exercises over its own departments; and
  - b. more than 80% of the activities of that organisation are carried out in the performance of tasks entrusted to it by the Council; and
  - c. there is no direct private capital participation in the organisation
- 6.12. However, this will not be the case here as such. However, Regulation 12 goes further to say that where the other public body is jointly owned by a number of public authorities then each one will be deemed to have the necessary control where:
- 6.12.1. the Council exercises jointly with the other members a control over the set up organisation which is similar to that which they exercise over their own departments
  - 6.12.2. more than 80% of the activities of the set up organisation are carried out in the performance of tasks entrusted to it by the group members
  - 6.12.3. there is no direct private capital participation in the set up organisation
- 6.13 Also the Council will be said to be exercising joint control where:
- 6.13.1 the decision-making bodies of the set up organisation are composed of representatives of all participating member authorities
  - 6.13.2 those member authorities are able to jointly exert decisive influence over the strategic objectives and significant decisions of the set up company and
  - 6.13.3 the set up company does not pursue any interests which are contrary to those of the member authorities
- 6.14 Therefore, the constitution of the SLB would be vital to the success of option 3. It should be possible to set up an SLB which is jointly owned by all the authorities who wish to purchase services from it, who together are able to exert a sufficient level of control over it.
- 6.15 The key feature would be though that the level of control is over the company, rather than the subsequent contractor auditor consultancy, who would need to

maintain their specific independence in order to satisfy the requirements of the 2015 Audit Regulations

- 6.16 Any changes in provision or services brought about by the move to a pan-London model should be considered in accordance with the public sector equalities duty under the Equalities Act 2010, which requires the Council when exercising its functions to have 'due regard' to the need to eliminate discrimination (both direct and indirect discrimination), harassment and victimisation and other conduct prohibited under the Act, and to advance equality of opportunity and foster good relations between those who share a 'protected characteristic' and those who do not share that protected characteristic. The Council should perform a proportionate equality analysis before determining its preferred procurement option and prior to any changes being made.

## **7. One Tower Hamlets**

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

## **8. Best Value Implications**

- 8.1. The preferred option would provide good value for money to the Council. By offering large contract values, the firms would be able to offer better rates and lower fees than are likely to result from local negotiation. This will meet the Council's Best Value duty.

## **9. Risk Management Implications**

- 9.1. Whilst there is no immediate risk to the Council, early consideration by the Council of its preferred approach will enable detailed planning to take place so as to achieve Successful transition to the new arrangement in a timely and efficient manner

## **10. Sustainable Action for a Greener Environment (SAGE)**

- 10.1. There are no specific SAGE implications.

## **11. Crime and Disorder Reduction Implications**

- 11.1. There are no specific Crime and Disorder implications.