



## Future of local public audit Consultation



Future of local public audit

**Consultation**

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## Ministerial foreword

*“...The Audit Commission has lost its way. Rather than being a watchdog that champions taxpayers' interests, it has become the creature of the Whitehall state. We need to redress this balance.”*

Secretary of State for Communities and Local Government 13 August 2010

On 13 August, the Secretary of State for Communities and Local Government announced our plans to disband the Audit Commission and re-focus audit on helping local people hold their councils and other local public bodies to account for local spending decisions.

We want to drive power downwards to people. We want local public bodies to be more accountable to their citizens, to you the taxpayer, rather than upwards to Whitehall. That is what localism is all about.

The current arrangements for local audit, whereby a single organisation - the Audit Commission - is the regulator, commissioner and provider of local audit services are inefficient and unnecessarily centralised. The Audit Commission has increased the professionalism and the quality of local government audit, but, it has also become too focused on reporting to central Government and supporting the previous era of a target driven Government.

We are clear that centralised inspection and supervision have no part in localism and that they can be an unnecessary burden on frontline services at a time when they must be tightening their belts and focusing on service delivery; they also drive a culture of compliance rather than initiative and problem solving. If our local services are going to be genuinely responsive, tailored to the needs of local people, then they must be accountable to those same people. This is why we want to put in place a new locally focused audit regime, which is open and transparent but retains the high quality of audit that we expect.

This consultation sets out our vision for the future of local audit. This vision is firmly based on four principles. The first of these is localism. When reforms are complete local public bodies will be free to appoint their own independent external auditors from a more competitive and open market. The second is transparency; local public bodies will become increasingly accountable for their spending decisions to the people who ultimately provide their resources. The third is to remove the overheads charged by the Audit Commission to service the central government machine. At a time when we are taking decisive action to reduce the deficit, we think it is important that we deliver a framework which sees a reduction in the overall cost of audit to local bodies. The fourth principle is high standards of auditing. Make no mistake, we are determined that audit will remain both robust and efficient and that the new framework will follow the established principles of public audit.

To meet these principles, the consultation sets out proposals which would see all local public bodies with a turnover of over £6.5m appointing their own independent auditor. This appointment would be made on the advice of an independent audit committee.

Auditors would be regulated under a system which mirrors that of the audit of companies with a role for the Financial Reporting Council and the professional audit bodies. We envisage that the National Audit Office will set the code of audit practice and we have put forward options for the scope of audit in the new framework. The consultation document also sets out how transparency will be increased in the new framework and our proposals for auditing smaller bodies with a turnover below £6.5m in a proportionate way.

Alongside these proposals, the consultation asks a number of questions, to which I would welcome your responses. Your contribution will help us to further develop the framework before publishing legislation in draft in the autumn.

We look forward to hearing your comments on how we can make the future of local audit robust and efficient while ensuring that local public bodies are truly accountable to those they serve.

A handwritten signature in black ink, appearing to read 'Grant Shapps'.

Rt. Hon Grant Shapps MP

# Glossary

## **Accountancy and Actuarial Disciplinary Board**

An independent board which has the ability to investigate and discipline accountants and actuaries who are members of the following professional bodies: the Association of Chartered Certified Accountants; the Chartered Institute of Management Accountants; the Chartered Institute of Public Finance and Accountancy and the Institute of Chartered Accountants in England and Wales; the Institute of Chartered Accountants of Ireland and the Institute of Chartered Accountants of Scotland.

<http://www.frc.org.uk/aadb/>

## **Charities Act 1993**

The Charities Act 1993 sets out the regulatory framework in which charities operate.

[http://www.charity-commission.gov.uk/About\\_us/Regulation/default.aspx](http://www.charity-commission.gov.uk/About_us/Regulation/default.aspx)

## **CIPFA**

Chartered Institute of Public Finance and Accountancy is the professional body for people in public finance.

[www.cipfa.org.uk](http://www.cipfa.org.uk)

## **Companies Act 2006**

The Companies Act 2006 forms the primary source of UK company law.

<http://www.companieshouse.gov.uk/companiesAct/companiesAct.shtml>

## **Comptroller and Auditor General**

Created by the Exchequer and Audit Departments Act 1866 to authorise funding to Government departments and examine departmental accounts, reporting the results to Parliament.

## **Drainage Boards**

An operating authority, established in areas of England and Wales with particular drainage needs. The Board is responsible for work to secure clean water drainage and water level management.

<http://www.ada.org.uk/>

## **Financial Reporting Council**

The Financial Reporting Council is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment.

They also oversee the regulatory activities of the professional accountancy bodies and operate independent disciplinary arrangements for public interest cases involving accountants and actuaries.

<http://frc.org.uk/>

### **Freedom of Information Act 2000**

Legislation which enables any member of the public to request information from a public body.

### **Grant Certification**

The Audit Commission is required by the Audit Commission Act 1998 to make arrangements for the certification of grant claims when requested to do so by public bodies in receipt of grant funds.

### **Health and Social Care Bill**

The Bill takes forward the areas of Equity and Excellence: *Liberating the NHS* (July 2010) and the subsequent Government response *Liberating the NHS: legislative framework and next steps* (December 2010). It also includes provision to strengthen public health services and reform the Department's arm's length bodies.

### **International Financial Reporting Standards**

IFRS is an independent, not for profit private sector organisation which works on behalf of the public sector to develop standardised financial reporting standards.

<http://www.ifrs.org/>

### **LASAAC**

The Local Authority (Scotland) Accounts Advisory Committee (LASAAC) develops and promotes proper accounting practice for local government in Scotland in line with legislation, International Financial Reporting Standards (overseen by the International Accounting Standards Board) and the work of the Financial Reporting Advisory Board.

<http://www.cipfa.org.uk/pt/cipfalasaac/index.cfm>

### **Lord Sharman**

Liberal Democrat peer, previously the spokesman for Business, Enterprise and Regulatory Reform and former chairman of KMPG. Lord Sharman's review of audit and accountability for central government, *Holding to Account: the Review of Audit and Accountability in Central Government* was published in February 2001.

[http://archive.treasury.gov.uk/docs/2001/sharman\\_1302.html](http://archive.treasury.gov.uk/docs/2001/sharman_1302.html)

### **Management Commentary**

A narrative report which provides the context or background to the financial position, performance and cash flow of an authority or public body.

### **National Fraud Initiative**

Since 1996 the Audit Commission has run the National Fraud Initiative (NFI), an exercise that matches electronic data within and between audited bodies to prevent



and detect fraud. This includes police authorities, local probation boards and fire and rescue authorities as well as local councils.

[www.audit-commission.gov.uk/nfi](http://www.audit-commission.gov.uk/nfi)

### **Police Reform and Social Responsibility Bill**

The Bill will make the police service more accountable to local people by replacing police authorities with directly elected police and crime commissioners to be introduced from May 2012.

### **Professional Oversight Board**

The Professional Oversight Board (POB), formerly known as the Professional Oversight Board for Accountancy, is a UK regulatory body specialising in the accounting, auditing and actuarial professions.

[www.frc.org.uk/pob](http://www.frc.org.uk/pob)

### **Public Audit Forum**

The public audit agencies, the National Audit Office, the Northern Ireland Audit Office, the Audit Commission for Local Authorities and the National Health Service in England, the Wales Audit Office and Audit Scotland have established the Public Audit Forum to provide a focus for developmental thinking in relation to public audit.

<http://www.public-audit-forum.gov.uk>

### **Public Interest Reports**

Under Section 8 of the Audit Commission Act 1998, the appointed auditor is required to consider whether to issue a report in the public interest on any significant matter coming to his or her notice in the course of an audit, and to bring it to the attention of the audited body and the public.

### **Public Interest Disclosure Act 1998**

The Public Interest Disclosure Act 1998 is an Act that protects whistleblowers from detrimental treatment by their employer.

### **Remuneration report**

Companies produce a report containing certain information concerning director's remuneration, governed by the Directors' Remuneration Report Regulations 2002,

### **Section 151 officer**

Section 151 of the Local Government Act 1972 requires every local authority to make arrangements for the proper administration of their financial affairs and requires one officer to be nominated to take responsibility for the administration of those affairs.

**Special Health Authorities**

Special health authorities are health authorities that provide a health service to the whole of England, not just to a local community. They have been set up to provide a national service to the NHS or the public under section 9 of the NHS Act 1977. They are independent, but can be subject to ministerial direction in the same way as other NHS bodies.

**Unitary Authority**

Since 1996 the two-tier structure of local government has ceased to exist in Scotland and Wales, and in some parts of England, and has been replaced by single-tier unitary authorities, responsible for all local government services.

**Whole of Government Accounts**

Whole of Government Accounts (WGA) are full accruals based accounts covering the whole public sector and audited by the National Audit Office. WGA is a consolidation of the accounts of about 1500 bodies from central government, devolved administrations, the health service, local government and public corporations.

# Section 1

## 1. Introduction

- 1.1. On 13 August 2010, the Secretary of State for Communities and Local Government announced plans to disband the Audit Commission, transfer the work of the Audit Commission's in-house practice into the private sector and put in place a new local audit framework. Local authorities would be free to appoint their own independent external auditors and there would be a new audit framework for local health bodies. A new decentralised audit regime would be established and councils and local health bodies would still be subject to robust auditing.
- 1.2. The Secretary of State was clear that safeguards would be developed to ensure independence, competence and quality, regulated within a statutory framework.
- 1.3. This consultation paper discusses the Government's proposals for how a new local audit framework could work and seeks your views.
- 1.4. This document has been developed by the Department for Communities and Local Government. Our proposals have been discussed with a wide range of partners and bodies which will be affected by the changes. These include the Audit Commission, the National Audit Office, the Financial Reporting Council, accountancy professional bodies, local government, other local public bodies and Government departments with an interest.

### **What is audit and why is it important?**

- 1.5. An audit is the review of financial statements, resulting in the publication of an independent opinion on whether those statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework and present a true and fair view. A summary of accounting arrangements for local bodies other than those in the health sector is at appendix A.
- 1.6. The audit of public bodies plays a key role in ensuring that those responsible for handling public money are held accountable for the use of that money. Public audit strengthens accountability, both upwards to the elected or appointed members who make decisions about the allocation of resources, and outwards to the consumers and beneficiaries, taxpayers and the wider community. Regular public audit also provides assurance on bodies' arrangements for managing their finances properly, including their arrangements for value for money and to safeguard public money.

## **Current arrangements for the audit of local public bodies in England**

- 1.7. There are approximately 11,000 local public bodies which, together, are responsible for some £200bn of public money. Of these, there are 353 local authorities; 268 NHS bodies (in addition to Special Health Authorities audited by the National Audit Office, and Foundation Trusts); 38 police authorities; and 215 other bodies, including fire and rescue authorities; national park authorities; conservation boards; larger internal drainage boards, joint committees; and probation trusts. The remaining 9,800 bodies, with income or expenditure ranging from £1m down to £1,000 or less, comprise: 9,400 parish and town councils; 150 internal drainage boards; and 250 other bodies (for example, charter trustees and port health authorities). A list of the categories of bodies audited by the Audit Commission is set out in Appendix B.
- 1.8. The current system for the audit of local public bodies is operated and overseen by the Audit Commission under the provisions of the Audit Commission Act 1998 (as amended). Since its inception in 1983, the Audit Commission has acted as the regulator, commissioner and provider of local audit services.
- 1.9. Acting as the overall regulator, the Audit Commission publishes two statutory Codes of audit practice - one for local government bodies and one for health bodies - which are approved by Parliament. These set the standards for audit and require auditors to comply with the auditing and ethical standards issued by the Auditing Practices Board<sup>1</sup> (which is part of the Financial Reporting Council)<sup>2</sup>. The Commission monitors the quality of audit, although the professional accountancy bodies also monitor their members.
- 1.10. Acting as the commissioner, the Audit Commission appoints auditors, either from its in-house practice or from firms contracted to the Commission, to local public bodies.
- 1.11. The Audit Commission also acts as the main provider in the current system, with 70 per cent of local public audits undertaken by its in-house practice.

## **Proposals for a new audit framework for local public bodies**

- 1.12. The Government believes that the current arrangements for local public audit, whereby a single organisation is the regulator, commissioner and provider of local audit services are unnecessarily centralised. There is a lack of transparency and clarity as well as potential conflicts between the roles.
- 1.13. The proposals set out in this consultation build on the statutory arrangements and professional ethical and technical standards that currently apply to companies. However, those arrangements have been adapted to ensure that the principles of public sector audit are maintained.

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<sup>1</sup> <http://www.frc.org.uk/apb/>

<sup>2</sup> <http://www.frc.org.uk/>

- 1.14. The proposed new local audit regime would continue to provide Parliament with the assurances it needs on public spending. The National Audit Office would prepare the Codes of audit practice, which prescribe the way in which auditors are to carry out their functions, and which would continue to be approved by Parliament, and associated guidance. The National Audit Office would also continue to audit Government departments providing funding to local public bodies and will continue to receive Whole of Government Accounts returns. Registration of audit firms and auditors, as well as monitoring and enforcement of audit standards, would be undertaken by the accountancy professional bodies, under the supervision of the Financial Reporting Council (as this builds on their existing role in the regulation of private sector auditors) and its operating bodies.
- 1.15. Principal local authorities would appoint their own auditors, with decisions made by full council, taking into account advice from an independently chaired audit committee. Different arrangements would apply for some other local public bodies and these are explained in section 3.
- 1.16. Localism and decentralisation can only work if central government is prepared to trust local bodies, communities and citizens. We have aimed to design a local audit system which provides the rigour needed for Parliament, but allows local public bodies to take more responsibility in the way they procure audit services. These changes go hand in hand with the Government's actions to increase transparency in local government and will help enable local people and local organisations to hold their local public bodies to account for the way that their money is spent.

## Design principles

- 1.17. In proposing a new framework for local public audit, we have followed a set of design principles:
- **localism and decentralisation** – freeing up local public bodies, subject to appropriate safeguards, to appoint their own independent external auditors from a more competitive and open market, while ensuring a proportionate approach for smaller bodies
  - **transparency** – ensuring that the results of audit work are easily accessible to the public, helping local people to hold councils and other local public bodies to account for local spending decisions
  - **lower audit fees** – achieving a reduction in the overall cost of audit
  - **high standards of auditing** – ensuring that there is effective and transparent regulation of public audit, and conformity to the principles of public audit
- 1.18. These principles are not wholly independent. For instance, there is a clear relationship between the quality and scope of the audit and the level of audit fees. We wish to find the right balance to ensure an effective, robust, quality audit for local bodies while keeping fees as low as possible.

1.19. We have also had regard to the principles of local public audit, which were codified in 1998 by the Public Audit Forum, but have deep historical roots. They are:

- **Independence of public sector auditors from the organisations being audited.** Auditors must be independent, to avoid improper influence and allow work to be carried out freely. Independence encompasses the methods of appointment of auditors; the financial relationship between auditor and audited bodies, discretion in the amount of work necessary, the ability to follow up the implementation of recommendations, and the ability to have access to information necessary for audit work.
- **The wide scope of public audit, covering the audit of financial statements, regularity, propriety and value for money.** Public audit involves more than an opinion on accounts. It also covers issues such as regularity, propriety and value for money. In this way, it helps to contribute to corporate governance arrangements of public bodies.
- **The ability of public auditors to make the results of their audits available to the public, to democratically elected representatives and other key stakeholders.** To be effective, there must be appropriate reporting arrangements, under which auditors report the results of their work both to the bodies responsible for funding and to the public.

**Q1: 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?**

### **What this consultation covers**

1.20. This consultation focuses on the audit of local public bodies that currently have auditors appointed by the Audit Commission. It sets out, in sections 2 and 3, our proposals for the regulation and commissioning of audit, including the various elements of the new regulatory framework and the role local public bodies will have when appointing an auditor. Section 4 covers the scope of local public audit and the work of auditors, while section 5 deals with the way that the proposed framework would apply to smaller local bodies, such as parish councils.

### **LOCAL BODIES COVERED BY THIS CONSULTATION**

1.21. This document sets out proposals for a new framework for most bodies currently audited by the Audit Commission and listed in appendix B.

1.22. However, the Police Reform and Social Responsibility Bill, which is currently before Parliament, aims to make a number of significant reforms to the policing system. This includes provisions to abolish police authorities (excluding the City of London) and replace them with directly elected Police and Crime Commissioners for each police force outside London, and the Mayor's Office for Policing and Crime for the Metropolitan Police.

- 1.23. Police and Crime Commissioners (and Mayor's Office for Policing and Crime) will be responsible for holding the Chief Constable (and Commissioner for London) of their police force to account for the full range of their responsibilities.
- 1.24. Probation services, which used to be part of Local Government's remit, have been a responsibility of central government since consolidation into the Home Office in 2000-01. The financial results of probation trusts have been consolidated into the National Offender Management Service accounts, which are audited by the Comptroller and Auditor General. We believe, therefore, that probation trusts should in future be audited by the Comptroller and Auditor General.

**Q2: Do you agree that the audit of probation trusts should fall within the Comptroller and Auditor General's regime?**

- 1.25. Pension funds are not statutorily subject to a full audit separate from that of the local authority. However, the Audit Commission has used its regulatory powers to require pension funds to be audited separately. We propose to include pension funds on the list of local public bodies subject to the new local audit framework.
- 1.26. We consider that Joint Committees should remain subject to audit, but it will be for the constituent authorities making up the Joint Committee to decide whether the Joint Committee is audited separately or as part of one of the authorities' own audits.
- 1.27. The abolition of the Audit Commission will also impact on the audit arrangements for local health bodies. Currently, the Strategic Health Authorities, Primary Care Trusts and NHS Trusts are audited under the Audit Commission framework. The Health and Social Care Bill, currently before Parliament, aims to abolish Strategic Health Authorities and Primary Care Trusts and provides for all NHS Trusts to become Foundation Trusts by 2014. The Department of Health is considering the governance and accountability arrangements for the new health landscape and these will help determine the appropriate audit arrangements. The local public bodies referred to in this consultation paper do not therefore include local health bodies. However, health bodies will be included in draft legislation on the proposals for the new local audit framework. The Department of Health will publish a paper summarising its proposals at the same time.

### **Audit Commission functions excluded from this consultation**

- 1.28. There are a number of functions that are or have been carried out by the Audit Commission that are not considered as part of this consultation. The Secretary of State has announced that the Commission's inspection and research activities would cease. In general, local government and others outside of central Government are well-placed to decide when and where research should

be undertaken. In addition, the National Audit Office, following confirmation of its existing powers, will be able, when reporting to Parliament on the activities of central Government departments, to examine the impact of policies administered by local bodies. As well as contributing to parliamentary accountability, this will provide useful insights for local communities by drawing out examples of what works successfully in different circumstances and how barriers to good value for money are being overcome.

1.29. It will also be possible for an auditor to undertake value for money studies connected to audit work, with the agreement of the audited body. In addition, the National Audit Office would be able to identify and report on wider issues of concern about local bodies' use of resources or common themes of interest, should such issues be identified by the audit process. They could do this, in part, by drawing upon the work of local auditors.

1.30. Other functions, such as grant certification, operation of the National Fraud Initiative and the auditor function of reporting on Whole of Government Accounts returns will continue in some form, but are not considered in detail here. These issues will be covered in the forthcoming draft bill and accompanying consultation.

1.31. The Audit Commission appoints auditors to all local public bodies in England. It appoints its own auditors from the in-house practice to 70 per cent of local public bodies, with the remaining 30 per cent of auditors employed by accountancy firms under contract to the Commission. We are considering a range of options for transferring the Commission's in-house audit practice into the private sector. We expect that an announcement on our preferred option for privatisation of the Commission's audit work will be made ahead of publication of a draft audit bill.

### **Timing and how to get involved**

1.32. This initial consultation will run for 12 weeks with responses invited by 30 June. Following this period, we will consider the responses we receive and will publish a summary and a Government response.

1.33. We then propose to publish draft legislation on the proposals for a new local audit framework which will be subject to pre-legislative scrutiny by Parliament and other interested parties. As part of this process, we will consult again on our proposals, and will publish a consultation stage impact assessment. Following pre-legislative scrutiny, we will prepare for final legislation to be introduced at the earliest opportunity.

### **Costs**

1.34. We are developing an impact assessment which will be published alongside the draft Bill. We would therefore be interested in your views on the costs and benefits of the proposals and options set out in this consultation. This evidence will inform the draft bill proposals and help refine the impact assessment.



## Who are we consulting?

1.35. We would welcome comments from organisations affected by the change to the audit of local public bodies, and any other bodies or individuals. This document is available on the Department for Communities and Local Government website ([www.communities.gov.uk](http://www.communities.gov.uk)) and we will be drawing it to the attention of all public bodies currently audited by the Audit Commission, to professional bodies and those involved in regulating audit in England. It is open to all to make representations on the proposed new system of local audit and all submissions will be carefully considered.

## How to respond

1.36. Your response must be received by 30 June 2011 to:

[foia@communities.gsi.gov.uk](mailto:foia@communities.gsi.gov.uk)

Or to:

Luke Scofield  
The Department for Communities and Local Government  
Zone 3/G6  
Eland House  
Bressenden Place  
London SW1E 5DU

1.37. Please use the title 'Response to future of local audit consultation'.

1.38. It would be helpful if you could make clear in your response whether you represent an organisation or group, and in what capacity you are responding.

## Publication of responses – confidentiality and data protection

1.39. Information provided in response to this consultation, including personal information, may be published, or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000, the Data Protection Act 1998 and the Environmental Information Regulations 2004).

1.40. If you want any information you provide to be treated as confidential you should be aware that under the Freedom of Information Act, there is a statutory Code of Practice with which public authorities must comply, and which deals, amongst other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential.

1.41. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give any assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer

generated by your IT system will not, of itself, be regarded as binding on the Department.

- 1.42. The Department will process your personal data in accordance with the Data Protection Act and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

# Section 2

## 2. Regulation of local public audit

2.1. Audit systems in the UK for both the public and private sector follow the International Standards on Auditing. These include the following common elements of regulation:

- **standards** – setting out what comprises the audit and the quality standards that apply
- **registration** – determining who can audit and ensuring that auditors have the necessary skills, expertise and qualifications in order that there can be confidence in the auditors' work
- **monitoring and enforcement** – ensuring that standards are met and that appropriate action is taken in the case of failure

2.2. The Government believes that having a specific regulator for the local government and the local health sectors in England - less than 10% of the audit market – risks duplication. We therefore consider that, to the extent possible, there should be a consistent regulatory regime for audit, covering the private sector and the local government and local health sectors. This local public audit regime should be focused on local accountability, in the way that the commercial sector is tailored to accountability to shareholders.

### Standards and codes of practice

#### CURRENT SYSTEM

2.3. Under the current system the Audit Commission sets audit standards through Codes of audit practice for the local government and health sectors, which are approved by Parliament. These Codes build on the ethical, auditing and other standards issued by the Auditing Practices Board and are therefore broadly consistent with audit standards applied in other sectors.

2.4. However, the Commission's Codes contain additional standards to reflect the principles of public audit and its wider scope, particularly in terms of regularity and propriety and value for money. They specify the approach to audit for areas not already covered by professional audit standards (such as the 'value for money' conclusion). The Commission also publishes guidance and statements of responsibilities of auditors and audited bodies.

#### OTHER SECTORS

2.5. Standards for the audit of companies are set by the Auditing Practices Board (part of the Financial Reporting Council), which sets standards and issues guidance for the performance of external audit and in relation to the independence, objectivity and integrity of external auditors. The Auditing Practices Board is also responsible for setting ethical standards for auditors in the private and public sectors.

### **The Audit Commission's Codes of audit practice**

The Commission has a statutory duty to prepare, keep under review and publish statutory Codes of audit practice. There are currently two Codes: one for local government bodies and one for health bodies. The Codes, which are approved by Parliament and must be reviewed at least every five years, set out best professional practice with respect to the standards, procedures and techniques to be adopted by auditors. The latest versions of the Codes of practice were published in 2010.

The Codes are high level documents, which focus on the Audit Commission's core requirements and aspects of audit specific to its regime. Each Code:

- sets out the general principles to be followed by auditors in delivering their objectives
- outlines auditors' responsibilities regarding the audit of financial statements and use of resources and
- sets out the range of outputs through which the results of audit are reported

### **OUR PROPOSALS**

2.6. Under our proposals, auditors of local public bodies would continue to follow the auditing and ethical standards set by the Auditing Practices Board. We have considered which body would be best placed to produce the audit Codes of practice and supporting guidance. While this is a role that could possibly be undertaken by the Financial Reporting Council or the profession, we believe that the National Audit Office, given its role in providing Parliament with assurance on public spending, would be best placed to develop and maintain the audit Codes, which would continue to be approved by Parliament. The National Audit Office would also produce any supporting guidance.

**Q3: Do you think that the National Audit Office would be best placed to produce the Code of audit practice and the supporting guidance?**

### **Registration of auditors**

#### **CURRENT SYSTEM**

2.7. The Audit Commission Act 1998 stipulates that for an individual or a firm to be appointed as an auditor, the person/s conducting the audit must be a member of one of the specified professional bodies and has such qualifications as may be approved by the Secretary of State (none have been so approved). The Audit Commission regulates the quality of the work of auditors by setting minimum qualifications a public sector auditor must have in conjunction with standards set by the professional bodies for membership.

## **OTHER SECTORS**

- 2.8. As part of the statutory framework for the audit of companies under the Companies Act 2006, the Professional Oversight Board (part of the Financial Reporting Council), essentially acts as the main regulator, with statutory powers delegated to it by Government for the recognition and supervision of those professional accountancy bodies responsible for supervising the work of auditors or offering an audit qualification – recognised qualifying body and recognised supervisory body e.g. Institute of Chartered Accountants in England and Wales.
- 2.9. Recognised supervisory bodies are responsible for putting rules and arrangements in place which their members must fulfil before they can be registered auditors, both as regards eligibility for appointment as a statutory auditor and the conduct of statutory audit work. A list of recognised supervisory bodies and recognised qualifying bodies for the purposes of the Companies Act is at annex C. The Institute of Chartered Accountants for Scotland maintains the list of registered auditors for the whole of the UK on behalf of the recognised supervisory bodies.
- 2.10. People with responsibility for company audit work at the firm must also hold a recognised qualification, awarded by a recognised qualifying body.
- 2.11. Looking elsewhere, in Finland, auditors who are eligible to audit municipal authorities are included in a register of eligible auditors maintained by the Finnish Board of Chartered Public Finance Auditing. In Italy, auditors who can carry out local public audit are included on a register of auditors managed by the Ministry of Justice.

## **OUR PROPOSALS**

- 2.12. We propose that, as under the Companies Act 2006 (“the Companies Act”), an overall regulator would have responsibility for authorising professional accountancy bodies to act as recognised supervisory bodies for local public audit. Any such body would need to comply with the statutory requirements set out in the proposed primary legislation. It would have the roles of registration, monitoring, and discipline in relation to local public audit.
- 2.13. The Financial Reporting Council is the regulator for Companies Act audit and we propose that it takes on a similar role for the local public audit regulatory regime in England, provided that it can assure the Government that it has both the resources and the expertise to undertake the role, and wishes to do so. It is likely that setting up a separate regulator for local public audit would lead to duplication of work as entirely new systems and procedures would need to be developed.
- 2.14. Recognised supervisory bodies for local public audit could include supervisory bodies recognised under the Companies Act 2006 and any other bodies with sufficient expertise and capacity.
- 2.15. A recognised supervisory body for local public audit could have rules and practices covering:

- the eligibility of firms to be appointed as local public auditors and
- the qualifications, experience and other criteria individuals must reach before being permitted to lead a local public audit engagement and/or sign off an audit report

2.16. We propose to set out, in primary legislation, certain high level criteria that specify that the auditor must be:

- a member of a recognised supervisory body and
- eligible for appointment under the rules of that body

2.17. The legislation will include provisions enabling the supervisory body to develop appropriate detailed rules and practices on other criteria.

2.18. The eligibility criteria will be based on those for the audit of companies as we would like to ensure enough flexibility in the criteria to enable new firms to enter the local public audit market. However, there will need to be additional criteria to ensure that auditors have the necessary experience to be able to undertake a robust audit of a local public body.

2.19. We propose that all eligible local public auditors would be placed on a public register. This register could be kept by the recognised supervisory bodies for local public audit, or it could be kept by another body.

**Q4: 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?**

**Q5: Who should be responsible for maintaining and reviewing the register of statutory local public auditors?**

**Q6: 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?**

**Q7: 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?**

## **Monitoring and enforcement**

### **CURRENT SYSTEM**

2.20. The Audit Commission currently monitors the quality of auditors' performance through its annual quality review programme. The Audit Inspection Unit of the Financial Reporting Council reviews the quality of the financial statements audits carried out by the Commission's own audit practice and by private firms on behalf of the Commission.

### **OTHER SECTORS**

2.21. Under the Companies Act, the recognised supervisory bodies are responsible for monitoring the quality of the statutory audits undertaken by their members and for disciplining their members where this is appropriate.

2.22. Some companies that are of public significance because of the nature of their business, their size, or their number of employees can be designated as "public interest entities". In the case of these bodies, the Professional Oversight Board has an additional role in monitoring the quality of the auditing function and the Accountancy and Actuarial Disciplinary Board has a role in investigating significant public interest disciplinary cases and imposing sanctions to those found guilty of misconduct.

### **OUR PROPOSALS**

2.23. We propose that recognised supervisory bodies for local public audit would have responsibility for monitoring the quality of audits undertaken by their members, as they do in the private sector. This work would fall under the monitoring units of these bodies, and would include:

- reviews of individual audit engagements
- reviews of the policies, procedures and internal controls of those firms licensed to carry out the public sector audits
- reporting on the quality of audit to the registration body

2.24. The recognised supervisory bodies for local public audit would investigate complaints or disciplinary cases, as well as issues identified during their monitoring process. They would also be able to stop a firm being eligible for appointment as a statutory local public auditor and remove them from the register of eligible local public auditors.

2.25. We are considering whether the overall regulator (i.e. the body that authorises the recognised supervisory bodies) should have a role in assuring the quality, and undertaking independent investigation of the audit of local public bodies that might be considered analogous to public interest entities for the public sector. The overall regulator would have powers to investigate and discipline in these cases. The process undertaken would be similar to that above, but would provide an additional level of assurance in respect of those bodies.

However, the costs that would fall on the Financial Reporting Council from undertaking this role would be passed on to the audit firms and therefore could be reflected in fees.

**Q8: 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?**

**Q9: 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?**

**Q10: What should the role of the regulator be in relation to any local bodies treated in a manner similar to public interest entities?**



# Section 3

## 3. Commissioning local public audit services

- 3.1. The Government believes that a localist approach, without an independent central body having a role in appointing an auditor, is an important element of driving accountability to local people rather than to central government. However, maintaining the independence of the auditor in the new system is central to the principles of public audit. Our proposals therefore need to include measures to safeguard the independence of the auditor.

### **Duty to appoint an auditor**

#### **CURRENT SYSTEM**

- 3.2. Under the current system, all auditors of local public bodies included in Schedule 2 of the Audit Commission Act are appointed by the Audit Commission. Before making appointments of auditors to local government bodies, the Commission has a statutory duty to consult the body. The Commission has voluntarily extended this practice to health bodies.

#### **OTHER SECTORS**

- 3.3. Commissioning takes different forms in different sectors. Under the Companies Act the annual general meeting must agree a resolution on the appointment of the auditor, although this will be based on a recommendation from directors and input from an audit committee.
- 3.4. Looking elsewhere, it is clear that there are different systems for commissioning audit services. However, in the USA local authorities procure their own auditors: an audit committee often appoints 'internal auditors' for their local authority, who then procure the external auditor.

#### **OUR PROPOSALS**

- 3.5. We propose that all larger local public bodies (those with income/expenditure over £6.5m) will be under a duty to appoint an auditor. The auditor would need to be on the register of local public statutory auditors, which should help to ensure that the quality of auditors is maintained.
- 3.6. It is equally important as it is in other sectors that those to whom audit is directed have influence but that the independence of the auditor remains paramount. Therefore, for larger public bodies, we propose an approach whereby appointment is made by full council or equivalent, on the advice of an audit committee with opportunities for the electorate to make an input.
- 3.7. We consider that local public bodies will wish to co-operate to ensure that there is wide competition for external audit contracts, and that local public bodies will want to work together to procure an external auditor. We propose to ensure that legislation provides for both joint procurement and joint audit committees.

**Q11: 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?**

- 3.8. Lord Sharman, in his report, *Holding to Account: the Review of Audit and Accountability in Central Government*, was clear that, to maintain confidence, auditors must be independent to avoid improper influence and allow work to be carried out freely. Independence includes the way auditors are appointed. We consider that, as part of a new local audit regime, each larger local public body should have an audit committee with a majority of members independent of the local public body and, with some elected members to strike a balance between objectivity and in-depth understanding of the issues.
- 3.9. A possible structure is set out below. However, there could be alternative arrangements, for example:
- a) only the chair and perhaps a minority of members are independent of the local public body
  - b) a chair and a majority of members independent of the local public body, as described below
  - c) as for (b), but with independent selection of the members independent of the local authorities
- 3.10. We are keen to ensure that local public bodies have flexibility in the way that they constitute and run audit committees. But we need to balance this with ensuring that the minimum requirements for an audit committee set out in legislation provide for an independent audit appointment. We set out below a possible structure and role for the audit committee, some of which may be prescribed in legislation and some of which we would put forward as best practice.

## **Structure of audit committees**

We envisage that in the new system, an audit committee could be structured in the following way:

- The chair should be independent of the local public body. The vice-chair would also be independent, to allow for the possible absence of the chair.
- The elected members on the audit committee should be non-executive, non-cabinet members, sourced from the audited body and at least one should have recent and relevant financial experience (it is recommended that a third of members have recent and relevant financial experience where possible).
- There would be a majority of members of the committee who were independent of the local public body.

### ***Independent members of the committee***

When choosing an independent member of the committee, a person can only be considered for the position if:

- he or she has not been a member nor an officer of the local authority/public body within five years before the date of the appointment
- is not a member nor an officer of that or any other relevant authority
- is not a relative nor a close friend of a member or an officer of the body/authority
- has applied for the appointment
- has been approved by a majority of the members of the council
- the position has been advertised in at least one newspaper distributed in the local area and in other similar publications or websites that the body/local authority considered appropriate

**Q12: Do you think we have identified the correct criteria to ensure the quality of independent members? If not, what criteria would you suggest?**

**Q13: 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?**

**Q14: Do you think that sourcing suitable independent members will be difficult? Will remuneration be necessary and, if so, at what level?**

## **Role of the Audit Committee**

### **CURRENT SYSTEM**

3.11. As auditors are currently appointed by the Audit Commission there is no role for an audit committee in the appointment of auditors, although the Audit Commission always consults local public bodies before it confirms an audit appointment. However, some local public bodies do have Audit Committees (some of which are independent) with roles in relation to both internal and external audit.

3.12. Health bodies currently have their own form of audit committees following the Financial Reporting Council best practice guidance, comprising of independently appointed non-executive directors governed by their own rules and requirements.

### **OTHER SECTORS**

3.13. The Financial Reporting Council currently produces guidance for the establishment of audit committees for companies, stating that they should be made up of at least three, or in the case of smaller companies two, independent non-executive directors.

3.14. The main role and responsibilities of a company's audit committee are set out in written terms of reference and can include a number of roles, including:

- providing advice to the board in relation to the appointment of external auditors
- approving the remuneration and terms of engagement of the external auditor
- reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process
- developing and implementing policy on the engagement of the external auditor to supply non-audit services

3.15. Looking elsewhere, audit committees are statutory bodies in each municipality in Finland. Their remit includes preparing the choice and appointment of external auditors. In Canada, the local authority's audit committee also commissions audit services.

### **OUR PROPOSALS**

3.16. It is likely that we would want to specify in legislation some responsibilities that the audit committee should have in relation to the engagement of an auditor and monitoring the independence and quality of the external audit. However, we would not wish to limit the scope of an audit committee so that a local body had no flexibility in designing its role.

3.17. The expanded role of the audit committee would include the provision of advice and guidance to the full council or equivalent (the audit committee may wish to have regard to advice from the section 151 officer) on appropriate criteria for engaging an auditor and advice as to how these criteria could be weighted. The audit committee would be given copies of the bids to evaluate in order that they

may advise the full council or equivalent on the selection process and may, if they wish, indicate which auditor, in their view, presents the best choice.

- 3.18. The full council or equivalent would need to have regard to the advice of the audit committee but would not need to follow its advice. The full council or equivalent would be responsible for selecting an auditor and engaging that auditor on a contractual basis.
- 3.19. Advice provided by the audit committee to the full council or equivalent would be published, although consideration will need to be given to the treatment of commercially confidential material.
- 3.20. If the full council or equivalent did not follow the advice of the audit committee, then it would need to publish on its website a statement from the audit committee explaining its advice and a statement from the full council or equivalent setting out the reasons why the council or equivalent has taken a different position.

### **Option 1**

- 3.21. We could specify only one mandatory duty for the local public body's audit committee, i.e. to provide advice to the local public body on the engagement of the auditor and the resignation or removal of an auditor.
- 3.22. It would then be left up to the local public body and the audit committee to decide whether the audit committee should have a wider role in other issues, e.g. setting a policy on the provision of non-audit services by the statutory auditor or reviewing the relationship between the auditor and the audited body.
- 3.23. This option would ensure that the audit committee provided advice to the local public body at crucial moments, but would allow the local public body and the audit committee flexibility to decide on any other functions it may carry out. However, if only the minimum was followed, this may not provide an adequate check on ongoing independence through the auditor's term.

### **Option 2**

- 3.24. We could specify a much more detailed mandatory role for the audit committee which could include, but may not be restricted to the following:
- providing advice to the full council on the procurement and selection of their external auditor
  - setting a policy on the provision of non-audit work by the statutory auditor
  - overseeing issues around the possible resignation or removal of the auditor
  - seeking assurances that action is being taken on issues identified at audit
  - considering auditors' reports
  - ensuring that there is an effective relationship between internal and external audit
  - reviewing the financial statements, external auditor's opinions/conclusions and reports to members and monitor management action in response to the issues raised by external audit
  - providing advice to the full council on the quality of service they are receiving

- reporting annually to the full council on its activities for the previous year

3.25. This option would provide more assurance about the independence of the relationship between the audited body and its auditor, it would also ensure that the audit committee had a wider role in reviewing the financial arrangements of the local public body.

**Q15: 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?**

**Q16: 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?**

**Q17: Are these appropriate roles and responsibilities for the Audit Committee? To what extent should the role be specified in legislation?**

**Q18: 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?**

## **Involvement of the public in the appointment of an auditor**

### **CURRENT SYSTEM**

3.26. There is no involvement of the public in the appointment of auditors by the Audit Commission to audited bodies.

### **OUR PROPOSALS**

3.27. We envisage that the appointment of an auditor by the local public body should be as transparent as possible so that local people are able to hold their local public bodies to account for the appointment.

#### ***Pre-appointment***

3.28. The audited body could ask for expressions of interest from audit firms for the audit contract one month prior to the publication of the invitation to tender. The list of those firms that have expressed an interest would then be published on the audited body's website. The public would then be able to make representations to the audited body's audit committee about any of these firms. The audit committee would consider these representations when providing advice to the full council or equivalent.

### **Post - appointment**

3.29. The public would be able to make representations at any time to the local public body's audit committee. If a representation identified a significant, or potentially significant, issue relating to the auditor, then the audit committee would be able to provide advice to the audited body on that issue and investigate as appropriate. If the issue identified was material to the ongoing work of the auditor (such as an undisclosed material conflict of interest) then the audited body would need to take such steps as appeared necessary, in accordance with the terms of the contract with the auditor, to address that issue. We may also wish to specify in legislation some statutory requirements relating to conflicts of interest.

**Q19: Is this a proportionate approach to public involvement in the selection and work of auditors?**

### **Applicability to other sectors**

3.30. The policy of audit committees acting as a safeguard to independent appointment is applicable to all larger local public bodies covered by this framework. The approach may differ depending on the constitution and governance arrangements of those bodies.

3.31. For Police and Crime Commissioners (and Mayor's Office for Policing and Crime) and Chief Constables (and Commissioner for London) we are considering whether the Police and Crime Panel should have a role similar to that of the audit committee. Arrangements for the audit of these policing bodies will be finalised once the Police Reform and Social Responsibility Bill has completed its passage.

**Q20: How can this process be adapted for bodies without elected members?**

### **Failure to appoint an auditor**

#### **CURRENT SYSTEM**

3.32. As the Audit Commission is responsible for appointing the auditors for all audited bodies specified in the Audit Commission Act 1998, the situation where an audited body fails to appoint an auditor does not arise.

#### **OTHER SECTORS**

3.33. The Companies Act 2006 provides a default power for the Secretary of State, so that if a private company fails to appoint an auditor or auditors, the Secretary of State may appoint one or more persons to fill the vacancy. If the company fails to make the necessary appointment, the company is required to give notice to the Secretary of State that his power has become exercisable and if the

company fails to give this notice then the company has committed an offence and can be liable for a fine.

### **OUR PROPOSALS**

3.34. The audited body would be under a duty to appoint an auditor. However, there could be some instances under the new system where a body does not fulfil this duty.

#### **Option 1**

3.35. In these circumstances we propose that the Secretary of State would be able to direct the local public body to appoint an auditor.

#### **Option 2**

3.36. Alternatively, where a local public body does not fulfil its duty to appoint an auditor the Secretary of State could be provided with the power to make the auditor appointment. In addition to meeting the cost of the appointment the local public body could be subject to a sanction for failing to make the appointment.

**Q21: 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?**

3.37. It would clearly be against our design principles for the new local audit framework for the Secretary of State to make the auditor appointment for local public bodies. However, some form of assurance will be required that local public bodies have fulfilled their duty to appoint an auditor.

**Q22: 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?**

3.38. Given that we envisage that the Recognised Supervisory Bodies will hold the register of eligible local public auditors there is an argument that they should be notified if a local public body has appointed or failed to appoint an auditor. However, this could involve a significant cost.

3.39. As the Secretary of State would be able to direct the local public body to appoint an auditor, or could be provided with the power to make the auditor appointment where a local public body does not fulfil its duty to appoint an auditor, an alternative option would be for the local public body to notify the appropriate government department, or a body that the government department specifies, of the auditor appointment. The cost of doing this could be met by the appropriate department, and would provide an effective route for the Secretary of State to exercise his powers to direct the local public body to appoint an auditor, or to make the auditor appointment where the body did not fulfil its duty to appoint an auditor.



**Q23: If notification of auditor appointment is required, which body should be notified of the auditor appointment/failure to appoint an auditor?**

## **Rotation of audit firms and audit staff**

### **CURRENT SYSTEM**

3.40. The Auditing Practices Board's ethical standards, which apply to the audit of both private and public entities, require an audit firm to establish policies and procedures to monitor the length of time that audit engagement partners and other key staff serve as members of the engagement team for each audit. These procedures are in place to help ensure the independence and objectivity of auditors.

3.41. The Audit Commission appoints audit firms or its own staff for an initial period of five years. The audit engagement partner can then be appointed for an additional period of up to two years in accordance with the Auditing Practices Board's Ethical Standards (i.e. a maximum of seven years, provided there are no threats to the auditor's independence). The audit manager (the second in command to the audit engagement partner) can be appointed for a maximum of ten years. After this period individuals should then have no further direct relationship with or involvement in work relating to the body concerned until a further period of five years has elapsed.

### **OTHER SYSTEMS**

3.42. In the case of listed companies, the audit firm must have policies and procedures so that:

- no-one shall act as audit engagement partner for more than seven years and
- anyone who has acted as the audit engagement partner for a particular entity for a period of seven years, shall not subsequently participate in the audit engagement with that entity until a further period of five years has elapsed

3.43. The audit committee of a company assesses the independence and objectivity of the external auditor annually, taking into consideration regulatory and professional requirements. This assessment involves a consideration of all relationships between the company and the audit firm (including the provision of non-audit services) and any safeguards established by the external auditor. The audit committee seeks from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.

### **OUR PROPOSALS**

3.44. We envisage that the new audit framework would be in line with the current ethical standards regarding the rotation of staff within the audit firm.

3.45. The audited body's audit committee would have a role in monitoring the independence and objectivity of the body's external auditor.

- 3.46. In relation to the rotation of the firm, an audit firm would be reappointed annually by the full council on the advice of the audit committee (who may want to provide advice on the quality of service received in the previous year) but the audited body could be required to undertake a competitive appointment process within five years. The audited body would be able to re-appoint the same firm for a second consecutive five year period, following competition.
- 3.47. To preserve independence, we propose that the audited body would need to procure a different audit firm at the end of the second five year period. This will help to ensure that in carrying out their responsibilities auditors are not influenced by their desire to secure re-appointment.

**Q24: Should any firm's term of appointment be limited to a maximum of two consecutive five-year periods?**

**Q25: 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?**

**Q26: 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?**

## **Resignation or removal of an auditor**

### **CURRENT SYSTEM**

- 3.48. In the current situation there is not a direct contractual relationship between the auditor and the audited body - the relationship is with the Audit Commission. It is therefore not possible for the audited body to remove the auditor and the auditor does not need to resign because of issues arising with the audit.
- 3.49. In the event that there was a breakdown in the relationship between the auditor and audited body the Audit Commission can consider rotating suppliers.
- 3.50. The audit engagement partner or audit team may change during the appointment and the Audit Commission can and does rotate between firms and its in-house practice undertaking the audit, including if the audited body requests it.

## **OTHER SECTORS**

### ***Resignation***

3.51. In the companies sector, if an auditor ceases for any reason to hold office, he must deposit a statement at the company's registered office which will usually set out the circumstances connected with his ceasing to hold office. If the circumstances are set out in the statement (in the case of a quoted company), the company must send a copy of the statement to all members of the company unless it makes a successful application to the court to stop this.

3.52. If (in the case of an unquoted company) the circumstances are not set out in the statement, the auditor must deposit a statement with the company to that effect but the company does not have to circulate this statement to its members.

3.53. When an external auditor resigns, the audit committee of the company will investigate the issues giving rise to such resignation and consider whether any action is required.

### ***Removal***

3.54. The members of a company may remove an auditor from office at any time during their term of office. They, or the directors, must give 28 days notice of their intention to put to a general meeting a resolution to remove the auditor. The company must send a copy of the notice to the auditor, who then sends it to the company's members. The auditor may speak at the meeting where the resolution is to be considered. Although a company may remove an auditor from office at any time, the auditor may be entitled to compensation or damages for termination of appointment.

## **OUR PROPOSALS**

3.55. We envisage that a body might wish to remove its auditor, or an auditor might wish to resign, only in exceptional circumstances, for example, an auditor being in breach of the ethical standards, or a complete breakdown in the relationship between the auditor and audited body.

3.56. However, we recognise the importance of having stringent safeguards in place for the resignation and removal of an auditor to protect the independence of the auditor and the quality of the audit. These safeguards would broadly mirror those in the Companies Act, but would be adapted to reflect the principles of public audit. The process would be designed to ensure that auditors are not removed, or do not resign, without serious consideration.

### ***Resignation***

3.57. We envisage that in the first instance, the audited body and the auditor should discuss and seek to resolve any concerns. If the auditor still wished to resign he should give 28 days written notice of his intention to the audit committee and the audited body, setting out his intention to resign. The audited body should then make a written response, which it should send with the auditor's written notice, to its members and the audit committee. The auditor will then be required to deposit a statement at the audited body's main office and with the audit committee, which should be published on its website. The statement

would set out the circumstances connected with the resignation of the office that are relevant to the business of the audited body.

3.58. The audited body would need to notify the body responsible for maintaining the register of appointed auditors, and the auditor will need to notify the appropriate regulatory supervisory body. We envisage a role for the audit committee and the regulatory supervisory body in investigating the issues that have led to the resignation and considering whether any action is required.

### **Removal**

3.59. Again, we envisage that in the first instance, the audited body and the auditor should discuss and seek to resolve any concerns. If the audited body still wished to remove its auditor, it should give 28 days written notice of its intention to the audit committee and to the auditor. The audited body should put to a public meeting, or full council meeting, a resolution to remove the auditor. The audited body would also send a copy of this notice to the auditor.

3.60. The auditor would then have the right to make a written response, which the body would need to send to its members and the audit committee, and to speak at the meeting where the resolution is to be considered. A representative from the audit committee should also be able to speak at the meeting. The auditor would be required to deposit a statement at the audited body's main office and with the audit committee, which would need to be published on its website. This statement would set out the circumstances connected with the cessation of their office that are relevant to the business of the audited body.

3.61. The audited body would need to notify the appropriate regulatory supervisory body. We envisage a role for the audit committee and the regulatory supervisory body in investigating the issues that have led to the removal and considering whether any action is required.

3.62. A right of access to the previous auditor's audit working papers (from the previous year and/or current) should be provided to incoming auditors in cases of resignation or removal or any other instances where the audit firm changes. This right should extend to all aspects of the previous auditor's responsibilities and not just to work on the audit of the financial statements.

**Q27: 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?**

## **Auditor liability**

3.63. In the private sector, auditors are concerned about the consequences of the risks of litigation, as a result of actual or perceived failing by auditors. These concerns have been fuelled by legal judgments about the extent of auditors' duty of care to third parties, such as potential investors and the banks. 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. Public authorities can sue their auditor for breach of duty.

### **CURRENT SYSTEM**

3.64. There are particular issues in the public sector where auditors may exercise special powers. The Audit 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.

### **OTHER SECTORS**

3.65. In the companies sector, the Companies Act provides that general provisions that protect auditors from liability for negligence, default, breach of duty or breach of trust in relation to the company, or provide an indemnity against liability are void, but:

- does not prevent a company from indemnifying an auditor against any costs incurred by him in defending proceedings in which judgment is given in his favour or in the granting of relief by the court in the case of honest and reasonable conduct
- allows for a "liability limitation agreement" to be put in place if it is authorised by the members of the company, provided it complies with the content permitted in the Companies Act

### **OUR PROPOSALS**

3.66. In the absence of a central body providing indemnity to audit firms, it could be possible for audited bodies and auditors to deal with auditor liability as part of their contractual negotiations. A legislative framework, similar to that in the companies sector, could set out the process for setting and agreeing liability limitation agreements. Without a liability agreement, audit firms may increase their fees to match the increased risk they face in undertaking their work.

**Q28: 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?**

# Section 4

## 4. Scope of audit and the work of auditors

4.1. In this chapter, we look at the scope of the audit and the options for the elements of local public bodies' finance and the arrangements that auditors should assess. The duty for the auditor to issue a report in the public interest is also considered. This section asks whether auditors should be able to carry out additional, non-audit, work for the audited body, and considers the various safeguards that could be introduced to ensure that auditor independence is not compromised.

### **Scope of local public audit**

4.2. The starting point is the principles of public audit, in particular the wide scope of the audit covering the audit of financial statements, regularity and propriety and value for money.

### **CURRENT SYSTEM**

4.3. Public sector accounting in the UK has recently moved to adopt International Financial Reporting Standards adapted as necessary for the public sector (for local government audits from 2010-11).

4.4. Currently, the auditor of larger local public bodies is required to:

- give an opinion on whether the accounting statements give a true and fair view of the audited body's financial position and of its income and expenditure
- provide a conclusion as to whether the body has proper arrangements for securing value for money, having regard to specified criteria (such as financial resilience and to regularity and propriety) and in accordance with guidance issued by the Commission
- review and report on as appropriate, other information published with the financial statements, including the statement on internal control/annual governance statement and the remuneration report and
- (for local government) review and report on the Whole of Government Accounts return

4.5. Smaller local public bodies are currently subject to a limited assurance regime. We believe that it is important for smaller bodies to continue to be dealt with proportionately under the new framework and discuss this in more detail at Section 5.

### **OTHER SECTORS**

#### ***Companies***

4.6. The scope of audit for companies is based around the financial statements produced by the company and a report that the directors are required to produce which must describe the company's principal activities, a review of the business and an indication of future developments.

4.7. Statutory auditors of companies include in their report, statements as to whether, in their opinion:

- the accounts have been prepared in accordance with the Companies Act 2006
- the accounts give a “true and fair “ view of the company’s financial statements
- the director’s report is consistent with the accounts
- the remuneration report is properly prepared

### **Charities**

4.8. Any charity which has income above the audit threshold in the financial year must have an audit of its financial statements undertaken by a registered auditor. This is in line with the treatment of companies.

4.9. The Charities Act 1993 also requires all registered charities to prepare a Trustees’ Annual Report. The length of the report and the amount of detail included in it can be in proportion to the charity’s size so for small charities it can be a very simple report.

### **Central government**

4.10. The Comptroller and Auditor General, with the support of the National Audit Office, is responsible for auditing the financial statements of all central Government departments, executive agencies and a wide range of other public sector bodies.

4.11. When certifying the accounts of central government departments, the Comptroller and Auditor General states whether, in his opinion:

- the financial statements give a “true and fair” view of the financial position of the body
- the financial statements have been properly prepared in accordance with underpinning legislation
- in all material respects the transactions recorded in the financial statements are in accordance with Parliamentary or other authority (regularity)
- information given in the Management Commentary/Annual Report is consistent with the financial statements
- the audited part of the Remuneration Report has been properly prepared in accordance with relevant guidance

4.12. The Comptroller and Auditor General also has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.

### **OUR PROPOSALS**

4.13. When looking at the future scope of audit for local public bodies we have considered whether we should move to a more transparent model, such as that followed by companies and charities which must produce a director or trustee’s report. Central Government departments are also required to prepare an Annual Report along similar lines. However, we recognise that public money

must be accounted for in a certain way, including assuring regularity and propriety and with the necessary focus on value for money. With this in mind, for larger public bodies we have identified the following three options to deliver effective audit that conforms to the principles of public audit.

### **Option 1**

4.14. The scope of audit could be reduced to be more in line with that for companies, with no assessment of value for money. The auditor would:

- give an **opinion** on whether the financial statements give a true and fair view of the audited body's financial position and of its income and expenditure and
- review, and report on as appropriate, other information published with the financial statements, including the statement on internal control/annual governance statement, the remuneration report and the whole of government accounting summarisation schedules

4.15. This option would reduce the information available to local citizens on how local bodies are spending their money or on whether bodies are securing value for money.

### **Option 2**

4.16. As under the current system, the auditor would:

- give an **opinion** on whether the financial statements give a true and fair view of the audited body's financial position and of its income and expenditure; and
- provide a **conclusion** as to whether it has the proper arrangements in place to secure value for money (based on locally defined policy priorities) having regard to specified criteria (including financial resilience and regulatory and propriety)
- review, and report on as appropriate, other information published with the financial statements, including the statement on internal control/annual governance statement, the remuneration report and the whole of government accounting summarisation schedules

4.17. This option would maintain the current scope of audit. However, this option would not provide any additional information to local citizens on how local public bodies are spending their money or on whether bodies are securing value for money.

### **Option 3**

4.18. New arrangements could provide stronger assurances on the way local public bodies spend money. Under this option, the auditor would still give an **opinion** on the financial statements, but would provide **conclusions** on:

- regularity and propriety – a conclusion on compliance with relevant laws and regulations and the audited body's governance and control regime



- financial resilience – a conclusion about the future financial sustainability of the audited body and
- value for money – in addition to proper arrangements in place to secure value for money, a conclusion about the achievement of economy, efficiency and effectiveness within the audited body

4.19. We will need to consider carefully how a stronger value for money element to the audit would fit with other sectors, such as policing, who already have alternative systems for examining and reporting value for money publicly.

4.20. We believe that, compared to option 1 and 2, option 3 could lead to greater transparency for local citizens, and would help deliver the wide scope of public audit. It would also require a separate conclusion on regularity and propriety and financial resilience, rather than having regard to these aspects within a conclusion on value for money (as in option 2). However, the volume of work undertaken by the auditor would be significantly greater than for option 1. It is also possible that auditors would have difficulties in reaching a robust conclusion on value for money, regularity and propriety. We expect that reaching a conclusion on the achievement for value for money would involve more work for auditors, particularly in the case of complex organisations such as principal local authorities.

#### ***Option 4***

4.21. Local public spending should be transparent so that citizens can hold bodies to account. Companies are required, by law, to produce and publish an annual report, including the principal activities of the company during the year, and a business review which includes risks and uncertainties. Most public bodies also produce such a report, although local authorities are not currently required to do so.

4.22. Under this option, all local public bodies would be required to produce an annual report and to publish this report on their website. The report would set out the arrangements the audited body had put in place to secure value for money, whether they had achieved economy, efficiency and effectiveness, regularity and propriety and financial resilience.

4.23. The auditor would be required to:

- give an opinion on the financial statements
- review the audited body's annual report and
- provide reasonable assurance on the annual report

4.24. The annual report could be written in an accessible way and would be published. This option could therefore substantially increase the transparency of the local public bodies, compared to options 1 and 2. Citizens' increased knowledge of the local public body's financial performance could help drive greater local accountability. We would need to consider whether producing an annual report in an appropriate format would be a new burden for local authorities that do not currently produce an annual report in an appropriate format.

4.25. Another possible benefit of this option, is that it brings the format of audit for local public bodies (financial statements and reviewing a report) more in-line with that of other sectors.

**Q29: 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 provide sufficient assurance and transparency to the electorate? Are there other options?**

**Q30: Do you think local public bodies should be required to set out their performance and plans in an annual report? If so, why?**

**Q31: 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?**

**Q32: Should the assurance provided by the auditor on the annual report be 'limited' or 'reasonable'?**

**Q33: What guidance would be required for local public bodies to produce an annual report? Who should produce and maintain the guidance?**

## **Public interest reporting**

### **CURRENT SYSTEM**

4.26. Under Section 8 of the Audit Commission Act 1998, the auditor is currently required to consider whether to issue a report in the public interest on any significant matter coming to his or her notice in the course of an audit, and to bring it to the attention of the audited body and the public. The auditor can also make written recommendations to the audited body as part of this report. The audited body has a corresponding duty to consider and respond to these reports and any recommendations that might be made. The costs of the report fall on the audited body.

4.27. Appointed auditors have issued 131 public interest reports since 2002, of which 13 have related to principal local authorities, 85 to parish councils, 30 to health bodies and one each to a passenger transport authority (now an integrated transport authority), a passenger transport executive, and an internal drainage board.

4.28. In addition to the auditor's duties to report in the public interest, they also have the power to make a recommendation requiring a public response and can issue an advisory notice to the body if they have reason to believe the body is about to or has made a decision involving the unlawful incurring of expenditure.

## **OTHER SECTORS**

4.29. Although public interest reporting is a consequence of the principles of public audit, there are some similarities with processes in place in other sectors.

4.30. The auditor of a regulated entity generally has special reporting responsibilities in addition to the responsibility to report on financial statements. One of these special reporting responsibilities is a statutory duty to report certain information, relevant to the regulators' functions that come to the auditor's attention in the course of the audit work. This form of report is derivative in nature and is initiated by the auditor on discovery of a reportable matter.

## **OUR PROPOSALS**

4.31. We consider it is important that the duty on an auditor to consider whether to make a report in the public interest should be retained. Public interest reports are a key part of the current audit system and provide a vehicle through which the public are made aware of issues of significant interest to them. This is consistent with the design principles of localism and transparency.

4.32. We envisage that the current publication requirements for public interest reports would be retained, as would the audited body's responsibilities to consider the report at a meeting within one month of receipt and to publish a summary of the meeting's decision.

4.33. The costs of public interest reports will fall on the audited body. It has been suggested that the new direct contractual relationship between the audited bodies and their auditors could have, if unchecked, an impact on the ability or willingness of the auditor to issue a public interest report. However, we believe that if suitable safeguards are put in place for the resignation or removal of auditors, this will mitigate the risk.

4.34. We also propose to retain the power of an auditor to make a recommendation requiring a public response and to issue an advisory notice to the body if they have reason to believe the body is about to or has made a decision involving the unlawful incurring of expenditure.

<p><b>Q34: 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?</b></p>
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## **Provision of non-audit services**

### **CURRENT SYSTEM**

4.35. The auditor may be best placed to carry out certain types of additional work for the audited body. Therefore, the Audit Commission allows additional work to be undertaken without prior approval from the Commission, if the auditor is satisfied that:

- performance of such work will not compromise, nor be reasonably perceived by the public to compromise, his independence and
- the value of the work in total, in any audit year, does not exceed a de minimis amount (set by the Audit Commission as the higher of £30,000 or 20 per cent of the total audit fee, excluding fees for the certification of grant claims and returns)

4.36. Auditors are required to establish procedures to identify and address any potential breaches of these requirements.

4.37. All such work must be:

- agreed in advance with the audited body, on the understanding that such work is discretionary and is not required to meet the auditors' statutory responsibilities and
- billed separately from the audit work

The Commission requires applications for approval to carry out work exceeding the de minimis threshold at least ten days before the start of the work.

#### **OTHER SECTORS**

4.38. In other sectors, such as the companies sector, statutory auditors are allowed to provide other non-audit services to the company.

4.39. However, the audit committee of the company has a role in considering all relationships between the company and the audit firm, including the provision of non-audit services and whether, taken as a whole and having regard to the views, as appropriate, of the external auditor, management and internal audit, those relationships appear to impair the auditor's independence and objectivity.

4.40. The audit committee should also develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor, and keep the policy under review. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity.

#### **OUR PROPOSALS**

4.41. We propose that auditors will be able to provide non-audit services to the audited body, but safeguards will be built into the system to prevent any actual or perceived threats to the auditor's independence. We recognise that by adding a number of safeguards into the system we could reduce the number of auditors eligible for appointment to an audited body, which would in turn affect competition.

4.42. We propose that auditors should continue to adhere to the ethical standards produced by the Auditing Practices Board and permission should be sought from the audit committee who would provide advice to the body on whether non-audit work should be undertaken as well as continuing to monitor the relationship between the auditor and the audited body.

**Q35: 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?**

**Q36: Have we identified the correct balance between safeguarding auditor independence and increasing competition? If not, what safeguards do you think would be appropriate?**

## **Public interest disclosure**

### **CURRENT SYSTEM**

4.43. Under the current framework, the Audit Commission and appointed auditors are prescribed persons under the Public Interest Disclosure Act 1998 for disclosures relating to “the proper conduct of public business, value for money, fraud and corruption in local government and health service bodies”. The Audit Commission and appointed auditors consider information they receive as a result of a disclosure and determine what action, if any, to take in the context of their existing statutory and professional powers and duties.

4.44. We recognise the importance of the roles undertaken by prescribed persons including the Audit Commission and appointed auditors. It provides reassurance to workers that it is safe and acceptable for them to raise concerns internally and sets out the circumstances where the disclosure of the malpractice outside of the organisation is in the public interest and should be protected.

### **The Audit Commission’s role in public interest disclosure**

The Audit Commission is a ‘prescribed person’ as set out in the Schedule to the Public Interest Disclosure Act. It exercises this role by:

- receiving the facts of a disclosure
- supporting the discloser by referring them to Public Concern at Work for further advice and guidance if subjected to victimisation or harassment;
- acknowledging receipt of the disclosure and stating in general terms what the procedures are
- forwarding information to the auditor and inform the discloser

#### *The current role of the appointed auditor*

The auditor’s role includes:

- evaluating the information provided by the Commission
- acknowledging receipt to the discloser, and providing an indication of the likely response, with an explanation for the decision
- undertaking appropriate audit work in response to the disclosure
- reporting the outcome of any work to the discloser and the Commission

## **OTHER SECTORS**

4.45. The Financial Reporting Council's guidance for the audit committees of companies sets out a role for the audit committee in reviewing arrangements under which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective is to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

## **OUR PROPOSALS**

4.46. We believe it is important that a similar system operates in the new framework. We propose that the Audit Commission's role (receiving, acknowledging receipt of and forwarding the facts of disclosure) should be broadly transferred to the audit committee of the local public body. The audit committee may choose to designate one of its independent members as a point of contact. As this role is an administrative role, which involves no need to consider the issue they are transferring, we do not see this as an additional burden on audit committees.

4.47. We envisage that the statutory auditor of the local public body would continue to be a prescribed person and would continue with his/her role with no change from the current system.

**Q37: 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?**

## **Transparency**

### **CURRENT SYSTEM**

4.48. Members of the public currently have rights to question the auditor of an audited body about its accounts and raise objections, if the audited body is not a health body, in respect of unlawful items of account or matters on which the auditor can make a report in the public interest. The auditor may also apply for a declaration to the Court. Objectors have the right to appeal to the Courts about an auditor's decision.

4.49. Auditors have only limited discretion to refuse to investigate objections, but the costs of investigating objections, which are recovered from the local public body and, therefore, funded by council taxpayers, can be disproportionate to the sums involved in the complaint, or to the normal audit costs of the local public body.

4.50. The right to object to the accounts was first introduced more than 150 years ago, at a time when the auditor was the only individual to whom an elector could raise issues of concern.

## **OUR PROPOSALS**

- 4.51. The public can now 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). Publication of all expenditure over £500 also makes spending more transparent and more readily available to the public.
- 4.52. With this in mind, we consider that the rights for local government electors to object to the accounts are both outdated and over-burdensome on auditors, local public bodies and council tax payers.
- 4.53. Under the new local audit framework, members of the public would retain the right to make representations to the auditor, raise issues with the auditor and to ask the auditor questions about the accounts.
- 4.54. While the right to make formal objections would be removed, the local public body would still be required to advertise that its accounts had been prepared and there will be increased publicity requirements for audited bodies. The auditor would still be open and transparent about the audit, and would consider any relevant representations from the public. The auditor would have discretion to decide whether to follow-up any issues raised by local citizens, having regard to the significance of the issue, the amounts of public money involved and the wider public interest. If the auditor decided not to consider a representation further, the decision would be amenable to judicial review, should the citizen who made the representation be dissatisfied with the decision.
- 4.55. We propose that auditors should also be brought within the remit of the Freedom of Information Act to the extent that they are carrying out their functions as public office holders. Therefore, only information in connection with a public audit would be within the remit of a freedom of information request. However, we recognise that there are costs associated with responding to freedom of information requests which could have an impact on audit fees. We would also need to consider whether this could be detrimental to the auditor and audited body's relationship.
- 4.56. We also envisage that local public bodies should be required to publish their accounts and the auditor's report on the website.
- 4.57. We consider that these proposals would provide a balance between transparency and disproportionate cost.

**Q38: Do you agree that we should modernise the right to object to the accounts? If not, why?**

**Q39: 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?**

**Q40: 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?**

**Q41: 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)?**



# Section 5

## 5. Arrangements for smaller bodies

### Current system

#### **The limited assurance audit regime**

The limited assurance audit regime was first introduced in 2001-02 for local councils (parish meetings and parish and town councils) where neither income nor expenditure exceeded £500,000. This threshold was increased to £1m in 2006.

The regime is designed specifically to minimise the audit requirement upon, and cost to, these small bodies. The audits are based on the submission by the body to the auditor of an annual return that is subject to a desk review. The audit report provides a limited level of assurance to the body commensurate with the amount of work undertaken.

The basic audit approach is common to all smaller bodies. However, for those bodies with annual income or expenditure over £200,000, auditors are required to carry out additional testing as part of their audit approach to reflect the higher risk to public funds; this is referred to as the intermediate audit. In addition, on a random sample basis, 5 per cent of those bodies operating below the £200,000 threshold will also be selected annually for intermediate audit at no extra cost.

5.1. Under the current legislation, the statutory audit requirements for smaller bodies are the same as those for larger bodies. However, since 2002, the Audit Commission has ensured that these are met proportionately through a separate “limited assurance” framework for bodies with an income or expenditure less than £1m. The smallest bodies currently do not pay any fees for their annual audit.

5.2. To bring this into line with the framework under the Companies Act the £1m threshold for local public bodies is being increased to not more than £6.5m.

#### **OTHER SECTORS**

5.3. The companies and charities sector, both have arrangements in place to ensure a more proportionate level of audit for smaller bodies.

#### **Charities**

5.4. The Charities Act 1993 put in place a system by which some small charities could be subject to independent examination rather than a full audit.

## Independent Examination v Audit (Charity Sector)

The two main differences between independent examination and audit relate to:

- Who can act
- The nature of the report.

	Who can act	The nature of the Report
<b>Independent Examination</b>	An independent person who is reasonably believed by the body to have the requisite knowledge and practical experience to carry out a competent examination of the accounts. No specific qualification is necessarily required but the person must have a good understanding of accounts.	Provides a "negative assurance" on the accounts. The independent examiner declares that no evidence was found of lack of accounting records, of accounts failing to comply with the records, nor of other matters that need to be disclosed.
<b>Audit</b>	Must be a registered auditor	An audit report will need to provide an opinion on the financial statements

5.5. The level of independent examination is dictated by the level of gross income of the charity.

Level of Gross Income	External scrutiny	Annual Report
Not exceeding £10,000	There is no requirement to have the accounts independently examined or audited	The trustees must prepare an annual report but it may be simplified.
Over £10,000 but not exceeding £100,000	Accounts must be subject to outside scrutiny but trustees may choose either independent examination or audit by a registered auditor	An Annual Report must be prepared but it may be simplified
Over £100,000 but not exceeding £500,000 (total assets not exceeding £2.8m)	Accounts must be subject to outside scrutiny but trustees may choose either independent examination or audit by a registered auditor.  If an independent examination is chosen and gross income exceeds £250,000 then the independent examiner appointed must be a member of a body specified under the 2006 Act.	An Annual Report must be prepared but it may be simplified
Exceeds £500,000 (or a charity whose gross assets exceed £2.8m and gross income exceeds £100,000)	A statutory audit is required (subject to specified exceptions) and the accounts must be audited by a registered auditor.	A full Annual Report must be prepared

- 5.6. Company charities used to be dealt with under the Companies Act 2006 system. However, from the financial year beginning on or after 1 April 2008 all charities (including company charities) are subject to the Charities Act 1993 system. The purpose of this change was to ensure that the scrutiny of small company charities was consistent with charity law requirements and in particular allowed for the independent examination of eligible small company charities.
- 5.7. Company charities which meet the Companies Act definition of a small company may elect for exemption from audit under the Companies Act and opt to have their accounts audited or independently examined under the Charities Act 1993.
- 5.8. Independent examination offers a lower cost alternative to charities that do not require the higher level of assurance that audit can provide. Changes effective from this date also result in new requirements for the audit of small groups when their accounts are prepared by parent company charities.

### **Companies**

- 5.9. The Companies Act 2006 sets out the thresholds which must be met for a company to be deemed a small company. These are, at least two of the following three conditions:
- annual income or expenditure (gross income for charities) not exceeding - £6,500,000
  - balance sheet total not exceeding - £3,260,000
  - average numbers of employers not exceeding – 50
- 5.10. These thresholds are subject to periodic amendment.
- 5.11. There is exemption from audit for **certain** small companies if they are eligible and wish to take advantage of it. To qualify for audit exemption, a company must:
- qualify as small (per paragraph 5.9) **and**
  - have an income or expenditure of not more than £6.5m **and**
  - have a balance sheet total of not more than £3.26m
- 5.12. Even if a small company meets these criteria, it must still have its accounts audited if this is demanded by a member or members holding at least 10 per cent of the nominal value of issued share capital or holding 10 per cent of any class of shares. Public companies are not eligible for exemption.

### **OUR PROPOSALS**

- 5.13. Both the limited assurance and independent examination regimes outlined above provide a simpler, more proportionate, form of external scrutiny than a full audit, but still provide assurance that the accounts of the bodies involved have been reviewed by an independent person.

- 5.14. We aim to bring arrangements for smaller local public bodies into line with other sectors. We are therefore considering a process under which the income and expenditure of a body determines what 'level' of audit or scrutiny is required; the greater the income/expenditure, the more scrutiny is required.
- 5.15. We propose that the 1,200 or so bodies with income or expenditure less than £1,000 would not be subject to an external examination or audit, as the risk to public funds is low and any external examination or audit fees would be disproportionate to their income or expenditure. These bodies do not currently pay a fee for an audit or examination, and requiring them to now do so would clearly increase their costs.
- 5.16. Bodies with an income or expenditure between £1,000 and the upper threshold of £6.5m would be subject to an independent examination rather than a full audit.
- 5.17. Examiners of small bodies should act for a maximum period of 10 years (which is in line with the current practices of the Audit Commission).
- 5.18. We propose that the independent examination of smaller bodies should be similar to that followed in the charities sector. As we have set out above, the charities sector provides for a reduced audit for bodies with income or expenditure below £500,000. However, the Audit Commission has provided limited assurance to all bodies with income or expenditure under £1m recently raised to not more than £6.5m. We are keen to ensure that smaller bodies are not disproportionately affected by our proposals. Therefore we propose a staged model such as the model followed in the charities sector, where the level of examination and the qualifications that the independent examiner must have are based on the income or expenditure of the body. However, this staged model would reflect the current £6.5m threshold used by the Audit Commission for their limited assurance regime. The independent examination of smaller bodies might therefore look as follows:

	Number	% small bodies market	Income/Expenditure	Scrutiny
<b>Level 1</b>	1,200	12%	Public bodies with expenditure less than £1,000	<ul style="list-style-type: none"> <li>Existing governance and accounting arrangements</li> <li>Annual accounts published</li> <li>Positive confirmation that annual accounts have been produced and published via the precept request (or equivalent)</li> <li>No external audit/scrutiny</li> </ul>
<b>Level 2</b>	Approx 6,400 bodies	64%	Public bodies with expenditure between £1,000 and £50,000	<p>As level 1, but</p> <ul style="list-style-type: none"> <li>(Under option 1 below) the county or unitary council to appoint an independent examiner (no specific qualifications needed, but County or unitary council should assure itself that the relevant person has the requisite experience and expertise) to assess its accounts. In practice the Section 151 officer or full council, having regard to advice provided by the audit committee, would make this appointment. The independent examiner might be an officer of the county or unitary council.</li> <li>The body must also publish the details of the examiner.</li> </ul>
<b>Level 3</b>	Approx 1,625 bodies	16%	Public bodies with expenditure between £50,000 and £250,000	<p>As level 2, but:</p> <ul style="list-style-type: none"> <li>Existing internal audit arrangements</li> <li>Independent examiner must hold a professional qualification to assess its accounts.</li> </ul>
<b>Level 4</b>	Approx 675 bodies	7%	Public bodies with expenditure between £250,000 and £6.5m	<p>As level 3, but</p> <ul style="list-style-type: none"> <li>Independent examiner must hold a professional qualification and be registered as a public auditor.</li> </ul>

## Appointing the examiner

### OPTION 1

5.19. We consider that the appointment process for the independent examiner should be proportionate. An audit committee could be a significant cost for a smaller body. Instead, where an independent examiner is required, we propose that the county or unitary authority should be responsible for appointing the independent examiner (see table above). If smaller bodies were responsible for appointing their own examiner in the absence of an audit committee there would be a lack of independence in the appointment process. In addition, they may not achieve a good price for this service.

5.20. If the county or unitary authority was responsible for the appointment this would provide a degree of independence to the appointment process for smaller bodies, and they would have the ability to appoint independent examiners for all of the smaller bodies in their areas, providing the opportunity to make savings through economies of scale.

### OPTION 2

5.21. The small body would be required to make arrangements for the appointment of the independent examiner, **including** the involvement of an audit committee. This would give the body the freedom to make the necessary arrangements which might include joining up with other small bodies, either locally or providing similar services. The smaller bodies would be able to arrange a joint audit committee, with safeguards to provide for independence. Alternatively, the small body would be able to join with a larger local public body and utilise their audit committee. Under this option the scope of the examination would still be as set out in the table above.

**Q42: Which option provides the most proportionate approach for smaller bodies? What could happen to the fees for smaller bodies under our proposals?**

**Q43: 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?**

**Q44: 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?**

**Who should produce and maintain this guidance?**

**Q45: Would option 2 ensure that smaller bodies appoint an external examiner, whilst maintaining independence in the appointment?**

**Q46: 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?**

**Q47: 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?**

### **Public interest reporting for smaller bodies**

5.22. There would be no auditor to receive queries or objections from the public, and there would be no public interest reporting. However, if the examiner identified issues giving cause for concern we propose that these could be raised with the audited body, or the county or unitary authority. The county or unitary authority could be given the power to appoint an auditor to then carry out a public interest report on the matters raised with the audited body. Sanctions could include a power to make the next precept (partly or wholly) conditional on the matters raised being addressed.

**Q48: 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?**

### **Objections to accounts of smaller bodies**

5.23. For bodies with an income or expenditure greater than £6.5 million we are proposing to modernise the system for dealing with objections to accounts.

5.24. In the case of smaller bodies, we propose that the independent examiner would be able to consider whether to refer issues raised by citizens to the proper officer (possibly the s151 officer) of the county or unitary authority. That authority would be provided with powers to take action, which might include appointing an auditor to consider those issues and report in public to the examined body. The costs for dealing with the representation would fall to the smaller body.

**Q49: 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?**

### **Regulatory regime for smaller bodies**

5.25. For smaller bodies the more proportionate approach described of independent examination would not give rise to the same level of scrutiny as an external audit.

5.26. However, if appointing the independent examiner to the smaller body, or if provided with powers to take action, which might include appointing an auditor to carry out a public interest report, the county or unitary council would, essentially, be the regulator for this sector.

**Q50: Does this provide a proportionate but appropriate system of regulation for smaller bodies? If not, how should the audit for this market be regulated?**



# Section 6

## 6. List of consultation questions

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?
2. Do you agree that the audit probation trusts should fall within the Comptroller and Auditor General's regime?
3. Do you think that the National Audit Office would be best placed to produce the Code of audit practice and the supporting guidance?
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?
5. Who should be responsible for maintaining and reviewing the register of statutory local public auditors?
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?
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?
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?
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?
10. What should the role of the regulator be in relation to any local bodies treated in a manner similar to public interest entities?
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?
12. Do you think we have identified the correct criteria to ensure the quality of independent members? If not, what criteria would you suggest?

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?
14. Do you think that sourcing suitable independent members will be difficult? Will remuneration be necessary and, if so, at what level?
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?
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?
17. Are these appropriate roles and responsibilities for the Audit Committee? To what extent should the role be specified in legislation?
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?
19. Is this a proportionate approach to public involvement in the selection and work of auditors?
20. How can this process be adapted for bodies without elected members?
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?
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?
23. If notification of auditor appointment is required, which body should be notified of the auditor appointment/failure to appoint an auditor?
24. Should any firm's term of appointment be limited to a maximum of two consecutive five-year periods?
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?

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?
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?
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?
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?
30. Do you think local public bodies should be required to set out their performance and plans in an annual report? If so, why?
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?
32. Should the assurance provided by the auditor on the annual report be 'limited' or 'reasonable'?
33. What guidance would be required for local public bodies to produce an annual report? Who should produce and maintain the guidance?
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?
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?
36. Have we identified the correct balance between safeguarding auditor independence and increasing competition? If not, what safeguards do you think would be appropriate?
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?
38. Do you agree that we should modernise the right to object to the accounts? If not, why?

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?
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?
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)?
42. Which option provides the most proportionate approach for smaller bodies? What could happen to the fees for smaller bodies under our proposals?
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?
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?
- Who should produce and maintain this guidance?
45. Would option 2 ensure that smaller bodies appoint an external examiner, whilst maintaining independence in the appointment?
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?
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?
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?
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?
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?

# Appendix A

## **Audited bodies' published accounts – current arrangements**

The annual accounting statements that audited bodies, other than NHS bodies and probation bodies, are currently required to publish are prescribed in Accounts and Audit Regulations made under section 27 of the Audit Commission Act 1998. A new consolidated set of the regulations has recently been issued. The accounting statements for all the bodies must cover the year ending on 31 March.

The larger bodies (broadly those with annual income or expenditure of more than £6.5m) must produce a “statement of accounts”, based, as from the 2010-11 financial year, on International Financial Reporting Standards as those standards are applied by the *Code of Practice on Local Authority Accounting in the United Kingdom*, published by CIPFA/LASAAC. The statement must also conform to specific requirements set out in the Accounts and Audit Regulations and other legislation. A statement of accounts includes all the elements that would be expected in a comprehensive set of accounts, including:

- movement in reserves statement
- comprehensive income and expenditure account
- balance sheet
- cash flow statement, and
- supporting notes, including a summary of significant accounting policies

Where the body has significant subsidiaries or associates Group Accounts must also be included. The statement of accounts is accompanied by a statement of internal control or annual governance statement, setting out the body's annual assessment of how it is managing and controlling the risks it faces in achieving its aims and legal obligations.

The smaller bodies are given a choice on the form of their annual accounting statements. They can prepare either:

- a statement of accounts on the same basis as a larger body or
- an income and expenditure account and statement of balances or
- where the body's annual income or expenditure is no more than £200,000, a record of receipts and payments

For the second and third options the requirements are specified in an Annual Return that the body is required to present to the auditor and publish. The form of the Annual Return is laid out in *Governance and Accountability for Local Councils, a Practitioners' Guide*, available from the National Association of Local Councils.

The accounting statements for both the larger and smaller bodies must be audited (for smaller bodies the audit is a ‘limited assurance’ - a simpler, more proportionate, form of external scrutiny than a full audit). The statements, together with the auditor's opinion on them, must then be published, and this should be done by 30 September following the financial year end. The larger bodies are required to publish the statements on their websites, and the smaller bodies by displaying them within their area, though both are free to use other means of publication in addition.

## Appendix B

### List of bodies to which the Audit Commission appoints auditors in England

The audit bodies which are specified in primary legislation are<sup>3</sup>:

- A local authority (meaning a county council, district council, London borough council and a parish council).
- A joint authority (which means an authority established by Part 4 of the Local Government Act 1985, includes metropolitan county fire and rescue authorities).
- The Greater London Authority.
- Passenger Transport Executive.
- A functional body (meaning Transport for London, the London Development Agency, the Metropolitan Police Authority and the London Fire and Emergency Planning Authority).
- The London Pensions Fund Authority.
- The London Waste and Recycling Board.
- A parish meeting of a parish not having a separate parish council.
- A committee of a local authority, including a joint committee of two or more such authorities.
- The Council of the Isles of Scilly.
- Any Charter Trustees constituted under section 246 of the Local Government Act 1972.
- A Health Service Body prepared under paragraph 3(1) of Schedule 15 to the National Health Service Act 2006.
- A Port Health Authority constituted under section 2 of the Public Health (Control of Disease) Act 1984.
- The Broads Authority.
- A national park authority.
- A conservation board established by order under section 86 of the Countryside and Rights of Way Act 2000.
- A police authority established under section 3 of the Police Act 1996.
- A fire and rescue authority constituted by a scheme under Section 2 of the Fire and Rescue Services Act 2004 or a scheme to which section 4 of that Act applies.
- An authority established for an area in England by an order under section 207 of the Local Government and Public Involvement in Health Act 2007 (joint waste authorities).
- A licensing planning committee.
- An internal drainage board.
- A local probation board established under section 4 of the Criminal Justice and Court Services Act.

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<sup>3</sup> It is proposed through the Police Reform and Social Responsibility Bill that police and crime commissioners and chief constables will be added to schedule 2 of the Audit Commission Act 1998 and thereby become a body for which the Audit Commission will appoint auditors to. In addition, the Health Bill refers to GP Consortia being brought within the Audit Commission Act 1998.

- A probation trust.
- An economic prosperity board established under section 88 of the Local Democracy, Economic Development and Construction Act 2009.
- A combined authority established under section 103 of that Act.
- The accounts of the collection fund of the Common Council and the accounts of the City fund.
- The accounts relating to the superannuation fund maintained and administered by the Common Council under the Local Government Pension Scheme Regulations 1995.

## Appendix C

### **Recognised supervisory bodies and recognised qualifying bodies in England**

In the companies sector, audit firms must be registered with, and subject to supervision by a recognised supervisory body and persons responsible for company audit work at a firm must hold a recognised qualification awarded by a recognised qualifying body.

There are currently five recognised supervisory bodies:

- Association of Authorised Public Accountants
- Association of Chartered Certified Accountants
- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants in Ireland
- Institute of Chartered Accountants in Scotland

and six recognised qualifying bodies:

- Association of Chartered Certified Accountants
- Association of International Accountants
- Chartered Institute of Public Finance and Accountancy
- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants in Ireland
- Institute of Chartered Accountants in Scotland



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