

**NORTH LINCOLNSHIRE COUNCIL**

**AUDIT COMMITTEE**

**FUTURE OF LOCAL PUBLIC AUDIT CONSULTATION**

**1. OBJECT AND KEY POINTS IN THIS REPORT**

- 1.1 The object of this report is to advise Members of the consultation on a new audit regime published by the Department for Communities and Local Government
- 1.2 The consultation contains a number of questions and the responses will be used to inform the new audit framework. The council's response has been prepared by the Director of Finance in consultation with the Chairman of the Audit Committee and will be returned by the deadline date of 30<sup>th</sup> June.

**2. BACKGROUND INFORMATION**

- 2.1 The Department for Communities and Local Government has invited responses to consultation on a new audit regime. This follows the announcement last August of plans to disband the Audit Commission, transfer the work of the Commission's in-house practice into the private sector and put in place a new local audit framework. The consultation paper can be found on [www.communities.gov.uk](http://www.communities.gov.uk) or copies are available on request. It discusses the Government's proposals for how a new local audit framework could work and seek views.
- 2.2 The consultation is based on 4 principles:
- Localism: the freedom for public bodies to appoint their own independent external auditors from a more open and competitive market
  - Transparency: public bodies increasingly accountable for their spending decisions to the people who ultimately provide their resources
  - Reduction of in the overall cost of audit to local bodies
  - High standards of auditing; the new framework will follow the established principles of public audit.

2.3 The proposals will change the nature, membership and role of the Audit Committee. The main features contained within the proposals are:

- All local public bodies with a turnover of over £6.5m will appoint their own independent (external) auditor who would need to be on the register of local public statutory auditors
- This appointment would be made by full council, taking into account the advice of an independently chaired audit committee, and with an opportunity for the electorate to make an input
- The National Audit Office would prepare audit codes of practice and prescribe the way in which auditors are to carry out their functions.
- 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 and its operating bodies.
- Proposals include changes to the structure of audit committees, with the chair being independent of the local authority. The vice chair would also be independent to allow for possible absence of the chair. The elected members would be non executive, non cabinet members, and the majority of the members of the committee would be independent of the authority.
- The audit committee would have some responsibility for the engagement of the external auditor and also the monitoring of its independence and quality of work. The committee would advise full council or equivalent on the appropriate criteria for engaging an auditor and how these could be weighted. The committee would also be involved in the evaluation of bids. The full council would be responsible for selecting and engaging an auditor.
- Other proposals are made regarding failure to appoint an external auditor, rotation of audit firms, resignation / removal of auditors and auditor liability.
- The future of public interest reports / disclosures is also covered.

2.4 The consultation document also includes a number of questions the responses to which will help shape the audit framework. The council's response has been prepared by the Director of Finance in consultation with the Chairman of the Audit Committee to be returned by the deadline date of 30<sup>th</sup> June. The response is attached as appendix A for the Committee to consider. Draft legislation is expected to be published in the autumn.

2.5 The Audit Commission is working closely with the DCLG on options to externalise the work of the in-house audit practice and will start preparatory work for the potential outsourcing with effect from 2012/13 audits. This includes designing a procurement process that allows a range of firms to bid, including the possibility of an in-house bid. However it is not yet clear how this process will affect the proposals set

out in this consultation; it is possible that it may delay their implementation if a 'central' procurement process takes place as proposed.

### **3. OPTIONS FOR CONSIDERATION**

3.1 The Committee is asked to note the consultation paper and the prepared by the Director of Finance and Chairman of the Audit Committee to the questions raised in the document.

### **4. ANALYSIS OF OPTIONS**

4.1 Members are updated on important changes to governance arrangements which will impact on their role as set out in the terms of reference for the Committee.

### **5. RESOURCE IMPLICATIONS (FINANCIAL, STAFFING, PROPERTY, IT)**

5.1 There are no additional resources implications

### **6. OTHER IMPLICATIONS (STATUTORY, ENVIRONMENTAL, DIVERSITY, SECTION 17 - CRIME AND DISORDER, RISK AND OTHER)**

6.1 External Audit and inspection duties are statutory requirements under the provisions of the Audit Commission Act 1998, the Code of Audit Practice and the Local Government Act 1999. The Chief Financial Officer has a statutory duty under the provisions of the Local Government Act 1972 to ensure the proper administration of the council's financial affairs. The council also has a duty under the Local Government Act 1999 to make arrangements to secure continuous improvement in the way in which its functions are exercised, having regard to a combination of economy, efficiency and effectiveness. The Accounts and Audit (England) Regulations 2011 set out financial reporting and internal audit requirements.

### **7. OUTCOMES OF CONSULTATION**

7.1 A response to the consultation questions has been prepared by the Director of Finance in consultation with the Chairman of the Audit Committee.

## 8. RECOMMENDATION

- 8.1 The Audit Committee is asked to:
- (i) note the consultation paper
  - (ii) approve the response to the consultation
  - (iii) authorise the Director of Finance to submit a response to the DCLG on behalf of the Committee.

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**Background Papers used in the preparation of this report**  
**Communities and Local Government – Future of Public Audit – consultation**

## DCLG Consultation Document - The Future of Local Public Audit

North Lincolnshire welcomes the opportunity to comment on proposals to change audit arrangements for public authorities and trust our response will assist in the development of these.

Whilst we support the principle of a cheaper external audit regime that maintains high standards we have two main concerns about the proposals as they stand. Firstly the guiding principles underpinning the proposals are identified as:

- Localism
- Transparency
- Reducing cost
- High audit standards.

However the scope for local discretion is unclear and seemingly contrary to the guiding principle of localism. An important consideration is whether the guidance issued will be mandatory or presents best practice guidance for authorities to use their discretion in developing a new audit regime that best meets their local circumstances.

The second area of concern is the extent of increased independent membership on audit committees. The consultation promotes majority independent membership including the key positions of chairman and vice chairman. This removes the opportunity for Members to directly influence and promote high standards of governance as elected leaders of the council. It could create the possibility of conflict between those members and the authority. Members of the Audit Committee have an important role and desire to maintain high standards of governance and 'put things right' wherever necessary. Audit Committees Members have been able to provide independent challenge to the executive or cabinet and this is not necessarily exclusive of being an elected Member of the council. (Please refer to Q12)

The response to the questions in the paper is as follows;

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?

Answer - Yes, although the risk of different providers adopting varying approaches to and interpretations of accounting and auditing standards will need to be managed with the removal of the Audit Commission providing national guidance and expertise. The scope of public audit should include governance and cannot effectively be audited or challenged by key positions divorced from a public body such as a local authority.

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

Answer - It would appear to be logical.

3. Do you think that the National Audit Office would be best placed to produce the Code of Audit Practice and the supporting guidance?

Answer – It would seem the NAO is best placed to carry out this role however there would need to be appropriate consultation with bodies to whom the guidance applies and organisations such as CIPFA & the LGA, to ensure local government expertise is taken into account.

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?

Answer – Yes although the role of NAO setting the standards and FRC deciding who meet them would need to be clarified. Also CIPFA members should have recognition as the public sector accounting body in becoming auditors of local authorities.

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

Answer – As registrar the FRC would need additional resources and expertise the cost of which should not be passed on to councils, NAO may already have comparable expertise. Given the differences between private and public organisations there may be merit in ensuring that the register of local public auditors is separate from the register of company 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?

Answer – Proper criteria regarding the level of experience and qualification of staff to perform this work would need to be set. The onus would be on audit firms to demonstrate they are appropriately staffed. Given the complexity and importance of the final accounts councils are unlikely to take the risk of engaging firms without appropriate experience. One way of enabling new firms to enter the market would be to have an initial probationary period for new entrants and perhaps being restricted to audits of smaller authorities initially.

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?

Answer – Appropriate qualifications, relevant direct experience of previous good performance and maintenance of effective client relationships are important.

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?

Answer – No comment

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?

Answer - The audit regime should be proportionate to the size and activity (and direct public interest in) the entity.

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

Answer - It is important arrangements, and therefore (additional) costs are kept proportionate to the size of the bodies.

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?

Answer – The final proposal may need to incorporate a framework arrangements of approved providers from which an auditor can be procured. This would reduce potential disadvantage based on size of authority or geographical distance.

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

Answer – There is need for clarification on the CLG's definition of 'independent' member of an audit committee. In the private sector, audit committee members are independent of the executive but part of the audited body as appointed board members. This provides for appropriate independence of the audit committee within the public sector. The assumption that an Audit Committee will have members entirely independent of the council is therefore not necessary, or appropriate. It could create the possibility of conflict between those members and the authority. .

We agree the approach that the appointment of the auditor should ultimately be by the Council as a whole. The Secretary of State should only intervene to be able to appoint an auditor if an authority failed to make an appointment, or there was a breakdown in the relationship between the authority and auditor, which could not be resolved without external intervention. Although these circumstances will be rare they need to be provided for.

We recognise that there may be merits in having "independent" members, though are less convinced that these should necessarily be in the majority, or that it should be mandatory for authorities to follow a particular model. It would be better to let the "localism" principle operate here and allow authorities to determine structures locally. An audit committee of members of the authority is able to take a governance view (apart from political group views, as members are often able to do in relation to planning or regulatory matters).

Therefore, there should be more discretion in relation to independent members and the local freedom to apply other criteria, for example independent members' political group or business associations.

However the 'structure of audit committee' as set out on P26 of the consultation paper envisages a very prescriptive structure, without allowing consideration of other models. Moreover, without giving guidance for a 'best practice' number of committee members, the recommendation regarding the number and qualifications of independent and elected members would tend towards a number of members which would result in an unwieldy and operationally ineffective committee.

If such a structure is to be imposed, then it should function in a regulatory capacity only, with operational functions being carried out by an Audit (Operations) Sub-committee consisting of 6 members – 5 elected (3 from the controlling group and 2 from the opposition) and 1 independent member, the Chairman and Vice-chairman being elected members independent of the executive.

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?

Answer – The advice of the Chief Finance Officer is important in determining criteria for such appointments. It should be recognised that wider skills than financial expertise are required given the span of audit committee responsibilities.

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

Answer - In some cases it could be. If the inclusion of independent members is mandated then authorities will need to be permitted to meet reasonable expenses and provide remuneration on a similar basis to councillors allowances if they wish. The chairman and vice chairman would also need to be appropriately remunerated. This additional cost needs to be considered in the context of reducing the overall cost local public audit.

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?

Answer - Option 1 is all that is necessary to specify in legislation. In the spirit of localism public bodies should be allowed to make their own arrangements. There should be a statutory obligation on the audit committee to take account of such advice as the S151 officer may wish to offer it in performing its functions (with requirements to clearly record the rationale for significant departures from advice). Best practice advice would also be available from professional bodies such as CIPFA.

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?

Answer - We suggest that it would be better to pursue option 1, though guidance provided by either CLG or CIPFA might discuss many or all of the issues set out in option 2. We would be concerned about a much more detailed mandatory role being specified, as that might require additional resources for which budgetary provision does not presently exist. Any mandatory role beyond the appointment one (which itself will require funding) will need to be funded by CLG under the 'new burdens' principle.

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

Answer – The roles and responsibilities should be limited in legislation to option 1 (i.e. to provide advice on the appointment and removal of the external auditor). The wider role of the audit committee should not be specified in legislation as it would remove discretion to meet local circumstances. The broader role of an audit committee could be dealt with through best practice guidance from professional bodies.

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?

Answer - Non statutory guidance would be more helpful than a statutory code of practice. CIPFA would have an important role in producing best practice guidance with assistance from SOLACE.

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

Answer – The level of public involvement is difficult to specify and should not be mandated e.g. consultation may be influenced by the nature of procurement - via a regional or national framework. The arrangements should ensure the public first raise the issue with the section 151 officer and safeguard against for vexatious raising of issues.

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

Answer - No comment.

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?

Answer - Option 2 provides sufficient sanction to ensure that local bodies carry out their statutory responsibilities. In practice we would expect the Secretary of State to ascertain why an appointment had not been made and consider those reasons before using his reserve power.

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?

Answer – Yes both appointment and failure to appoint an auditor.

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

Answer – Secretary of State or NAO.

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

Answer – Yes. Overall this would help safeguard independence. However experience had shown a long relationship with former external auditors with no problems of independence arising.

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?

Answer - Yes.

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?

Answer – Yes. Although annual approval of the appointment by Council could lead to annual contracts and uncertainty for firms.

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?

Answer - Yes.

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?

Answer – Yes – this may be reflected in their charges.

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?

Answer – Options 3 and 4 would involve additional cost to the audit regime therefore should not be mandatory. Option 3 also highlights difficulties auditors may face in reaching a robust conclusion on vfm, regularity and propriety conclusion. And option4 hinges on the production of an annual report which would need to become a mandatory requirement. Overall if we consider the auditor should provide an opinion on the arrangements within the council to achieve vfm then 2 would be the preferred option.

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

Answer - Whilst it may be identified as good practice to produce an annual report it should not be a requirement.

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?

Answer – An annual report should not be a mandatory requirement. A separate report by independent auditors is the best method for reporting on financial resilience.

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

Answer - This would depend on whether the annual report was a mandatory feature and what the nature and implication was of 'limited' or 'reasonable' assurance e.g. cost of audit; whether the audit committee could place reliance on the assurance provided.

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

Answer – If it is a requirement to produce an annual report any guidance produced should be provided by the appropriate professional bodies e.g. CIPFA, SOLACE in conjunction with the NAO. Guidance produced should provide flexibility to meet local circumstances and achieve effective engagement all stakeholders.

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?

Answer - The retention of the ability to report in the public interest is an important safeguard in the public sector audit regime, and needs to be retained. Safeguards need to be put in place to ensure:

- The consistency of approach in issuing public interest reports
- That such reports do not lead to attempts to remove auditors.

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?

Answer - Provided there are sufficient safeguards in place to prevent conflicts of interest with the audit role...

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

Answer – Additional work that could not be provided by less expensive internal audit services could be tendered for separately ensuring competition.

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?

Answer – This role is currently undertaken by regulatory bodies and it is unclear what the implication is of designating an individual as a prescribed person would be. Alternatively the NAO and FRC could be added to the list of prescribed persons. The council's whistle blowers' charter incorporates arrangements for confidential reporting of concerns to an independent body including the local government ombudsman.

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

Answer - Yes.

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?

Answer - Yes, except the accounts and auditors' report should be advertised on the council's website

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?

Answer - Yes, the data gathered by the external auditors belongs to the audited body and any request should be directed to them.

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)?

Answer – This could lead to additional costs and should be not be separately chargeable as part of the audit fees.

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

Answer - No comment.

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?

Answer - This should not be mandatory and some councils may consider this additional burden and unfunded cost.

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?

Answer - This should be agreed locally

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

Answer - No comment

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?

Answer - No comment

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?

Answer - No comment

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?

Answer - No comment

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?

Answer - No comment

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?

Answer - No comment