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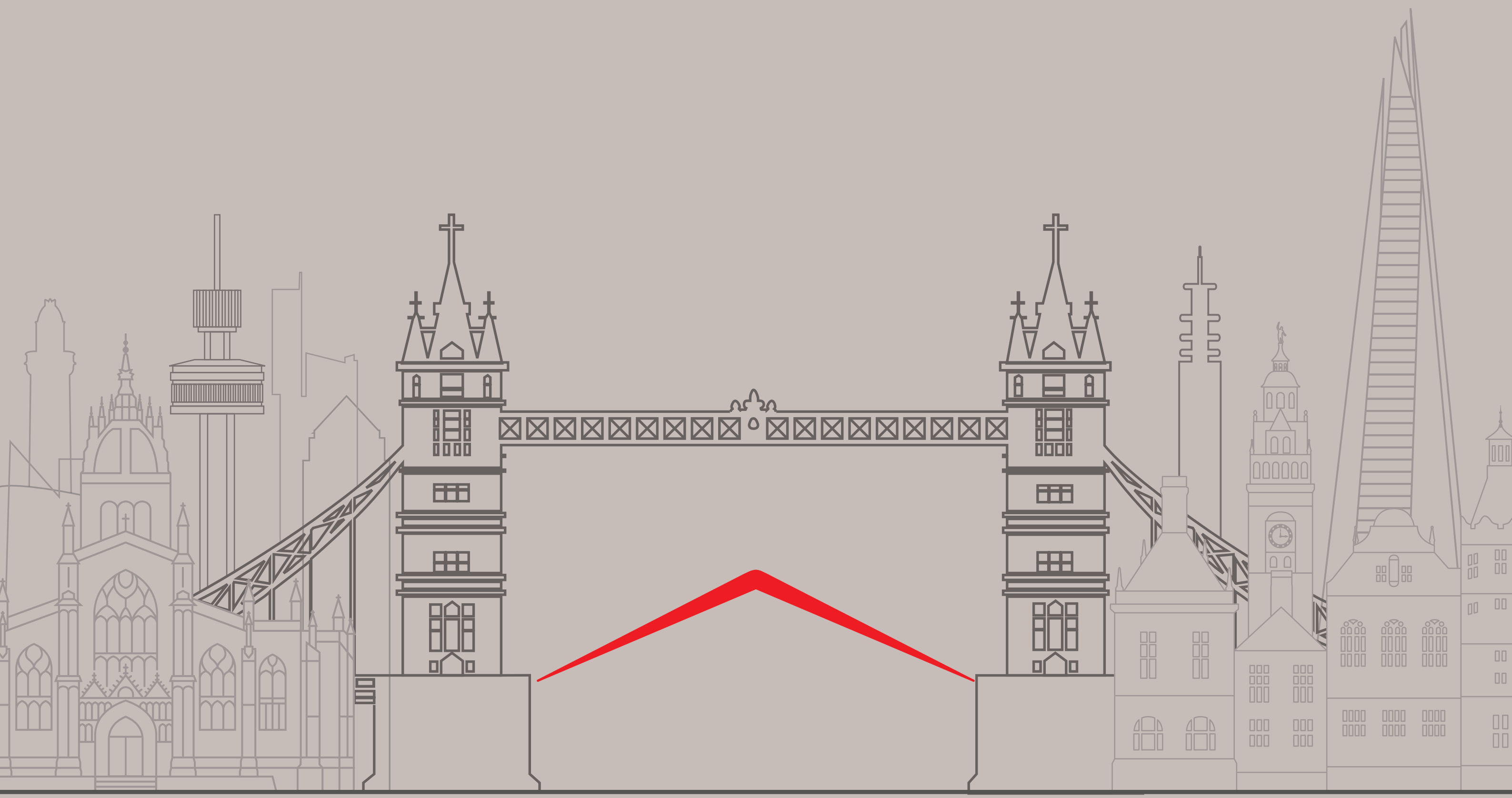


Local public audit: expectations gap

A SPECIAL REPORT

Contents

Executive summary

Public sector spending represents a large part of the gross domestic product of all countries and is therefore a major part of the growth and development of any economy. Local public bodies are responsible (under statute, powers delegated by central government or locally elected) for the provision of public services and for spending and receiving public money. Officials that work within these local public bodies are responsible and accountable for ensuring that public business is conducted in accordance with the law and that proper standards are maintained for the use of public money.

The public needs assurance that when they pay their taxes, the money spent by local public bodies will be spent properly, that there will be transparency and accountability in how that money is spent and how services are delivered. The integrity of financial statements and how government bodies spend public money is therefore important in building trust and confidence in the public sector.

One way that the public builds this trust is knowing that there is an external audit carried out of each local public body and that the audit opinion provides assurance that the information in the financial statements presents fairly or shows a true and fair view of how that money has been raised and spent.

The role of auditors is therefore important. However, this role is often misunderstood and different stakeholders have differing expectations of what an audit is and what the auditors should do, which often creates an **audit expectations gap**. The findings in this paper will feed into a wider debate on the role of the auditor and the audit expectations gap in the private sector. While private sector auditors are under scrutiny, local public auditors have similar issues to address, albeit with wider responsibilities and powers in relation to public money.

This expectations gap is the difference between what an auditor actually does (and is required to do by legislation and auditing standards) and what stakeholders and commentators think that the auditors' obligations might be and what they might do.

There have been many studies covering this topic, in the private and public sector, within the UK and internationally. Invariably they recommend greater education and communication between auditors and stakeholders on the auditors' responsibilities, rather than any substantial changes in the role and remit of audit. Often this is about correcting the misunderstanding about what auditors can and can't do to help to minimise the expectations gap. This debate also requires management, audit committees and stakeholders to play their part.

This paper is aimed at those who rely on the output of local public audit. It attempts to clarify what an audit actually is and what the auditors' and directors' responsibilities are in relation to the financial statements. It concentrates largely on local public bodies in England (in particular local authorities and health bodies) for which ICAEW also has a regulatory role.[1] It is, however, worth noting that local audit arrangements vary around the UK and are not always consistent with each other.

Through a series of interviews and discussions with different stakeholders, we attempt to move the debate forward by capturing and offering insight into:

- how the role of local public auditors in England has changed after the 2010 policy changes implemented by the government, which included the abolition of the Audit Commission and the introduction of a new audit and regulatory framework for local public bodies and auditors in England;
- the issues that local public bodies in England are facing in the current economic climate against a backdrop of financial instability, increasing demands for services from an ageing and increasing population, complex structures (both organisational and financial) and weaknesses of effective accountability and governance structures;
- the issues that are of concern in relation to financial sustainability of local public bodies and their auditors; and
- possible solutions to address these issues which will need all parties to work together.

The thoughts expressed in this publication are those of auditors with practical experience who have first-hand experience of the pressures of working in this environment. We also captured views of a few key Chief Financial Officers (CFOs) identified by their sector or regulatory bodies, who are at the receiving end of audit, as well as some key stakeholders who may seek to rely on the auditors' work to gain assurances about the sector.

There was a good level of commonality in the concerns expressed by those interviewed and a number of key themes have emerged.

1. Local government and health bodies are operating in difficult times with pressure to do more with less, to be innovative and to be more commercial, against a backdrop of financial instability. This brings with it concerns about behaviours that may not be in the best interests of the public purse over the longer term.
2. CFOs are concerned that the reports, particularly the VFM arrangements report, provided by auditors, while compliant within the scope of work, are not of sufficient value to those receiving them.
3. Conversely, auditors are concerned that the qualifications identified in their opinions, and issues that they identify and report on, are not taken seriously enough by those charged with governance.
4. The downward pressure on audit fees in local government and health is having unintended consequences, leading to a perception from local public bodies that they are receiving less, however this is not married up with the reduced scope of work that auditors are now carrying out (in comparison to the previous regime).
5. CFOs want more challenge and review of their forward-looking information and judgements, which underpin the financial resilience of the organisation.

[1] ICAEW is a recognised supervisory body under the Local Audit and Accountability Act 2014, with responsibility for registering, licensing and monitoring local public auditors in England.

6. Other stakeholders, such as the Ministry of Housing, Communities and Local Government (MHCLG), that may rely on the results of the auditors' work, do not feel that they are getting sufficient assurance over the effectiveness of service delivery and performance.
7. Increased regulation, tighter eligibility criteria and enhanced independence criteria have been matched by a reduction in audit firms in the market, especially in local government.
8. To truly engage in using their extra powers, local public auditors need to feel that their time and risk exposure is not a limiting factor. The removal of indemnity insurance, and more restrictive processes to recover costs, change the balance away from using their powers fully.

ICAEW has offered a number of solutions in this paper, some of which require radical thinking outside of the 'traditional' audit and financial reporting boxes and require legislators, standard setters and regulatory bodies to put the right frameworks in place to close the expectations gap around the purpose, scope and value of local public audit.

Authors

Sumita Shah
Regulatory Policy
Manager, ICAEW

Paul Dillon-Robinson
Independent
Consultant

Introduction and background

The audit expectations gap is the difference between what an auditor actually does (and is required to do by legislation and auditing standards) and what stakeholders and commentators think that the auditors' obligations might be and what they might do. The debate about audit is at the forefront of the audit profession, with stakeholders wanting more from auditors. Previous debate on this topic has recommended greater education and communication between auditors and stakeholders on the auditors' responsibilities, rather than any substantial changes in the role and remit of audit. Often this has been about correcting the misunderstanding about what auditors can and cannot do to help to minimise the expectations gap. In this paper, we outline some alternative solutions. These require those charged with governance (eg, management, boards, and audit committees) and other stakeholders to play their part in also challenging the status quo and thinking outside the box.

While ICAEW has a wider role for a number of regulated areas, in this paper, we concentrate largely on local public bodies in England (in particular local authorities and health bodies) for which ICAEW also has a regulatory role.[2] However, it is worth noting that local audit arrangements vary across the UK and are not consistent with each other. In various places within this paper, we comment on those inconsistencies.

Before we explore the audit expectations gap, we need to highlight first what an audit is and what the auditing standards require auditors to do. Appendix A outlines the wider definition and role of external audit. It also highlights directors' responsibilities in relation to the financial statements.

In this section, we highlight the changes in the local public audit framework in England and the wider scope of local public audit.

THE FRAMEWORK FOR AUDIT OF LOCAL PUBLIC BODIES

For many years, the selection, appointment and monitoring of most[3] local government and health bodies[4] in England was carried out by the Audit Commission, which also undertook audits through its own in-house teams of auditors. The appointment process, for work that was outsourced to accountancy firms, was centralised and carried out through bulk procurement and framework contracts.

From 1 April 2016, the framework for the audit of health and local government bodies in England changed under the Local Audit and Accountability Act 2014 (the LAAA). It abolished the Audit Commission and established new arrangements for the appointment, direction and regulation of external auditors of local public bodies in England. The new

[2] ICAEW is a recognised supervisory body under the Local Audit and Accountability Act 2014, with responsibility for registering, licensing and monitoring local public auditors in England.

[3] NHS Foundation Trusts were already appointing their own auditors.

[4] In this paper, we concentrate mainly on principal bodies, although at times, we do comment on other types of bodies to provide comparison.

arrangements are more fragmented than the previous regime, bringing in a number of organisations to manage the overall regulatory framework. The new arrangements are also inconsistent with the audit arrangements for local public bodies in the rest of the UK. The auditors carrying out audits of local public bodies in the rest of the UK are not required to be licensed or registered and indeed are not subject to formal monitoring, although they do voluntarily contract out the monitoring of their auditors' work. There is, therefore, a greater burden placed on local public auditors in England.

The scope of the external auditors' work had previously, under the Audit Commission Act, included more detailed work under the Use of Resources and Comprehensive Performance Assessments themes which were carried out in support of the Audit Commission's inspection powers. This gave auditors more exposure to the organisation under a set of reviews that were additional to the statutory audit, but within their overall appointment.

SCOPE OF AUDIT FOR LOCAL PUBLIC BODIES

Public audit across the UK is wider in scope than the private sector, with additional opinions or conclusions required in relation to regularity and value for money (VFM) arrangements. The LAAA sets out the wider scope of audit for local government and health bodies in England. The LAAA made the Comptroller and Auditor General (C&AG) responsible for the preparation and maintenance of the Code of Audit Practice (the Code), which prescribes the framework within which local auditors carry out their statutory responsibilities. The C&AG can also provide further supplementary guidance in the form of Auditor Guidance Notes (AGNs).

For audits of local public bodies in England, local auditors must provide an opinion on the truth and fairness of the financial statements of a local public body (in the same way as for private companies), but in addition, local public auditors are also required to:

- provide an opinion on the regularity (where required for some bodies) of public expenditure;
- provide an opinion on whether the local public body has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources (VFM conclusion);
- for some bodies, where circumstances arise:
  - consider issuing a report in the public interest;
  - consider whether to make a written recommendation to the audited body (copying to the Secretary of State);
  - consider the questions and objections raised by local electors in relation to the accounts of local government bodies;
  - apply to the court for a declaration that an item of account is contrary to law; and
  - consider whether to issue an advisory notice or to make an application for judicial review.

VALUE FOR MONEY ARRANGEMENTS

The conclusion on the VFM arrangements is probably the most significant additional report provided by local public auditors. Other than the main audit opinion on the statement of accounts, this is the only other report that is provided on all local public bodies.

Legislation and the Code requires auditors 'to be satisfied whether, in all material respects, audited bodies have proper arrangements in place to secure value for money in their use of resources', and sets out the associated reporting requirements. Auditors will use their professional judgement in how they apply the Code, reflecting the circumstances of individual local public bodies, and will have regard to guidance issued by the C&AG.

The NAO's AGN 03[5] for the VFM arrangements conclusion lays out the considerations that the auditor should be following. It states that when auditors identify particular risks as part of their VFM opinion work assessment, the auditor is expected to address these through their work plan.

In relation to the **value for money opinion**, AGN 03 states:

8. The Code (along with the LAAA itself) implies that 'reasonable assurance' is required, as the auditor needs to be satisfied that there are proper arrangements in place, regardless of the form of reporting applicable to different sectors. Paragraph 3.14 of the Code states: 'The auditor's work should be designed to provide the auditor with sufficient assurance to enable them to report as appropriate to:

- audited bodies other than health service bodies – providing a conclusion that in all significant respects, the audited body has (or has not) put in place proper arrangements to secure value for money through economic, efficient and effective use of its resources for the relevant period; or
- health service bodies, including NHS foundation trusts – reporting by exception if the auditor concludes that they are not satisfied that the audited body has in place proper arrangements to secure value for money in the use of its resources for the relevant period.'

[5] AGN 03 Auditors' Work on VFM Arrangements Issued 10 November 2017

What's the problem?

The pressure on NHS and local government bodies, operating within finite resources and financial restraints, brings an increased risk to their financial sustainability as they seek to balance delivery of their statutory services, while also exploring innovative and commercial solutions.

The trend of delegating and devolving powers to a local level, allowing local decision-making based on needs of the local community, is in principle a positive development. However, combined with restricted funding it may also pressure local decision makers to favour short-term solvency over longer-term value.

Through a series of interviews and discussions, local public auditors, CFOs and other stakeholders identified a number of issues that they perceived may cause significant risk, especially in the current economic environment for local public bodies. Several themes started to emerge.

SHORT-TERM SOLVENCY VERSUS LONGER-TERM VALUE

LOCAL GOVERNMENT

Examples of risks and pressures identified by auditors include the following.

Financial pressures

- Increasing demands for the services that bodies are statutorily required to deliver, from both a growing and ageing population as well as developments in services.
- Changes in the nature of funding (for example, local government is now more reliant on council tax receipts than Revenue Support Grant, which has resulted in a greater focus on the use of reserves in the short to medium term to provide room for the change).
- Reductions in funding from central government leading to more reliance on reserves, with some local public bodies only having reserves to last for a few years.
- Changes to delivery models, including greater working across boundaries and ongoing reforms and reorganisations (bringing new models and approaches), which often lack clear accountability and governance frameworks.
- A push for more innovative solutions and commercial approaches.
- Entering into complex financial instruments (causing the financial statements of those authorities to be qualified).
- Increasing risks relating to long-term borrowing and the impact of the future debt burden.

Oversight and governance pressures

- Local authorities cannot by law set deficit budgets and must manage their expenditure within the reduced available funding.
- Financial reporting has, over the last few years, become increasingly lengthy and more complex, with new requirements being put into place by government and international standards.

Quotes from local auditors on public services:

'Austerity is having an impact on public services, particularly in local government, as it reduces capacity and support for senior management, at a time when matters are becoming more complex and technical. At the same time there is a desire to innovate, but local bodies do not have the resources (quantitatively or qualitatively) to exploit this.'

'In the NHS there is a trade-off where you get good finances but not good patient care. You need to get to some balance, but this is not sustainable in the short term. One of our clients also points out the first line of call should be to the regulator and then to the auditor – but the regulator did not seem to understand the limits on the auditors.'

- Local government accounts have an array of specific reporting requirements, which do not exist in the financial statements of other public sector or indeed private sector bodies.
- Local government financial statements are not consolidated into MHCLG accounts and do not have any central oversight or scrutiny by MHCLG.
- Local government bodies do not necessarily have investment committees with suitably qualified and experienced members challenging the business case for, and risks of, different borrowing types.

HEALTH

The NHS in England is made up of approximately 250 trusts and more than 200 clinical commissioning groups. It is generally considered to be operating at, or near to, full capacity, with a very significant factor being the increased consumption of healthcare by an ageing population. This has resulted in considerable financial pressure and some trusts and commentators have claimed that parts of the NHS are close to breaking point. Even with the many reforms that have taken place in recent years – on average it has been reformed every four to five years in the last 25 years – there are still concerns that NHS structures are not fit for the current needs of the population. The rapid pace of reform is also a drain on management time and resources and adds to the pressure of already strained organisations.

Health bodies operate in a different governance environment to local government. They are monitored and their accounts are consolidated into the Department of Health and Social Care (DHSC)'s accounts which are, in turn, consolidated into the whole of government accounts. There is, therefore, an element of central oversight and scrutiny of health bodies, in addition to that provided by the whole of government accounts process. In particular, NHS England (NHSE) leads the health service in England, setting out the priorities and direction of the NHS. NHSE is also more likely to take direct intervention in local health bodies.

NHS Improvement is responsible for overseeing foundation and NHS trusts, as well as independent providers that provide NHS-funded care. The Care Quality Commission (CQC) is an independent regulator that registers health and adult social care service providers in England and inspects whether standards are being met.

The overall financial health of the NHS for 2017/18 led to a number of material uncertainties being expressed in relation to going concern for many of the bodies. Auditors also reported, under relevant legislation, where they believed that the body or an officer of the body:

- was about to make, or had made, a decision which involved, or would involve, the incurring of expenditure which was unlawful; or
- was about to take, or had taken, a course of action which, if pursued to its conclusion, would be unlawful and likely to cause a loss or deficiency;

the auditor should make a referral to the Secretary of State (for NHS trusts)/NHS Improvement (for NHS foundation trusts).

Forty NHS trusts were subject to such referrals in 2017/18. In all cases they related to a failure by the trust to meet the statutory breakeven duty target. The underlying issues in trust finances are disclosed in the consolidated accounts presented on the NHS Improvement's website.[6]

Quotes from CFOs on the financial statements:

'In local government, there is a need to contrast their organisations with those in the corporate sector, where the assurance is on the accounts because there is a clear profit focus. Local government is completely different, because of the myriad of demands. Local government accounts try to do all things and therefore become impenetrable. They are drawn up under IFRS and then reversals made to get to council tax-based figures. Both of these are, however, distant from the management accounts that are used to run the business.'

'There is a need to ask what value is added/saved by going over the accounts in the level of detail that they currently are? The end product, which is long and complicated and impenetrable, doesn't really help anyone. Government/regulators tend to focus on budget/control totals.'

[6] https://improvement.nhs.uk/documents/3018/Consolidated_provider_accounts_201718_web.pdf

The high level of reports of material uncertainties by auditors is evidence of significant financial pressure in the NHS. This gives rise to serious concerns about whether the level of health service output is sustainable within the current level of resources and delivery model. In this context the role of the auditor in providing independent oversight about questions of financial sustainability becomes especially important.

LIMITED USEFULNESS OF AUDITORS' REPORTS

In the previous section, we outlined the different reports that local public auditors provide to local public bodies under the LAAA. One aspect that is noted is the inconsistency in the reporting frameworks between local government and health. This, in itself, can create confusion about the information provided.

Out of the various reports that auditors provide, the report on VFM arrangements received the most comments from management and auditors. While auditors are delivering a compliant audit within the scope outlined above, both auditors and management believe that the work on value for money arrangements generally only highlights issues that management and governing bodies are already aware of. CFOs were of the view that these reports do not go into sufficient detail to challenge management to identify and remedy the underlying problems.

While local authorities produce a narrative VFM statement as part of the statutory accounts (rather than an annual report) the accounts are long, very detailed and complex, with specific reporting requirements that do not exist in other parts of the public sector. Many NHS bodies now also include quality metrics which, while subject to an independent assurance engagement carried out in accordance with international standards, are not perceived to provide sufficient detail about the underlying activities.

With local government audits, the focus and therefore the main 'audit expectation gap' rests with the VFM arrangements conclusion. This is the nearest equivalent to the private sector's going concern statement and is increasingly being qualified by auditors. There is concern that the report is insufficiently detailed to alert stakeholders to issues in relation to the financial sustainability of the organisation at an early enough stage.

A criticism by CFOs is that qualified opinions are merely restating what is known, and that, in their view, an effective opinion would be where the auditor highlights, in advance, concerns about financial resilience and financial sustainability which may not have been appreciated by the governing body, in terms of scope or potential severity.

In turn, the challenge for auditors is in meeting CFOs' expectations to review the forward-looking assumptions and material uncertainties that underlie management's forward planning, and having the information and insight to challenge overly optimistic (or unrealistic) assumptions. This does not fit within the scope of the traditional audit engagement and core competencies of an audit team and would require a change in policy and auditing standards and a reassessment of auditors' liability.

Quote from CFOs on the value for money work:

'The VFM conclusion is helpful, but it is more about the system/ arrangements in place rather than the actual effectiveness of value for money.'

'The pressure on the public sector is to achieve value for money, by whatever means. This needs conversations with auditors across the years.'

OTHER POWERS AND DUTIES

While there has been an increase in qualified VFM arrangements conclusions, auditors have not issued many public interest reports (PIR). The last PIR, for a principal local government body, was issued on 22 June 2016 to Derby City Council, and there have been none for the NHS in recent years. Auditors have, however, used some of their other powers, for instance Northamptonshire County Council was issued with an advisory notice on 20 February 2018 and again in July 2018, after two successive years of adverse VFM arrangements conclusion. However the general criticism in relation to this reporting power has been that the advisory notice was only issued after the local public body itself issued its own Section 114 notice.[7]

For many auditors, issuing a PIR can be expensive. Auditors highlighted that the issues that are raised for PIR consideration are usually already in the public domain and will already have been discussed extensively at a local level. PIRs have most impact where there is disagreement or denial by the local public body. Both local public auditors and management believe that the auditors' other powers, such as statutory recommendations, are more effective tools in raising and alerting stakeholders about issues of concern.

Quotes from an auditor on the powers of auditors:

'In the NHS, there are no public interest reports, because any hint of one leads to [health regulatory bodies] intervention to prevent it.'

'Very few advisory notices have been issued as this is a difficult process.'

RESTRICTED ROLE OF QUESTIONS AND OBJECTIONS

An interested person or journalist is able to inspect a local authority's accounts and related documents.[8] A local government elector living in the area to which the accounts relate can also:

- ask questions about the accounts; and
- object to them on the basis that, in their view:
  - there is an item in the accounts that is unlawful;
  - there are issues relevant to the authority's arrangements for securing value for money or that are referred to in an authority's annual governance statement; or
  - there are matters of wider concern arising from the authority's finances.

Quote from an auditor on the questions and objections powers of auditors:

'My concern is that members of the public have a misunderstanding about what auditors do, more particularly about what auditors 'can' do and about the level of redress that is available to auditors (electors expect more redress action, as well as to be more informed about what has happened).'

A local government elector must tell the local public auditor, in writing, if they object to an item in the accounts and if they think that the item is unlawful. If they are suggesting that a public interest report should be made, then they must provide evidence to support their objection. A disagreement with the local public body on how it has accounted for, or used, monies does not necessarily make an item unlawful; sufficient evidence needs to be provided for any such assertion.

Local auditors will then consider the objection and evidence, what they need to do about the objection and, if there is a valid objection, they will consider the most appropriate and effective means of reporting.

There is sometimes a misunderstanding by local government electors that just because they raise a question and/or objection, the local public auditor will take action. Often there is a lack of understanding that auditors have discretion in the use of their powers.

What adds to the expectations gap is the perceived lack of transparency about the decisions taken by local public auditors, although in reality, auditors do not have to provide detailed reports to an objector about the investigations carried out. Part of the issue is a lack of understanding of what falls within the audit remit and what does not. There is a lack of understanding of the rigidity that comes with who can and cannot object and the period within which they can do so.

[7] Section 114 of the Local Government Finance Act 1988 gives powers to the CFO, in consultation with the council's monitoring officer, to report to the authority's members if there is, or is likely to be, an unbalanced budget. A full council meeting must then take place within 21 days to consider the notice with no new agreements being entered into.

[8] More information can be found in the NAO's guidance: *Local authority accounts: A guide to your rights*

Even when auditors do make a decision to carry out further work and issue qualified opinions and value for money conclusions, or public interest reports, advisory notices and statutory recommendations, they do not have the powers to enforce the required remedial action. Those powers and duties rest with management and those charged with governance.

AUDIT QUALIFICATIONS NOT ALWAYS ACTED ON BY THOSE CHARGED WITH GOVERNANCE

At a conference in 2018, Sir Amyas Morse, Comptroller and Auditor General of the NAO, said:

> 'if independent public audit is to have the impact that it needs, it has to be taken seriously by those charged with governance.'[9]

Local public auditors are required by international auditing standards to communicate audit matters to those charged with governance. It is the responsibility of each local public body to have in place appropriate corporate governance arrangements which enable those charged with governance to have an understanding of all significant issues that have arisen from the audit process. For local government and health bodies, these differ depending on which part of the sector the body is in (local authorities' arrangements are, for example, different to those of police bodies).

The role of those charged with governance (variously management, governing boards and audit committees), as addressees of the audit opinion is an important one. Their role should be to see a qualified audit opinion, and the findings of other reports and management letters, as a significant event that requires immediate and comprehensive action. Those charged with governance should be leading on resolving issues through remedial action, with non-executives and members pressing for delivery of those remedial actions. In reality, the strength and effectiveness of these structures varies, however, if the message from audits is not being heeded, then the impetus for improvement or remedial action gets restricted.

Stakeholders want early identification of concerns so that the impact on services is lessened, both in severity and the time spent under threat, with remedial actions implemented with due priority. But there are concerns from auditors that the qualifications they make within their opinions or management letters are not taken seriously, either at a local level or more widely. There is a concern that a failure, by management and/or those charged with governance, to take the findings of audit reports and opinions more seriously may be indicative of a lessening influence, or respect, that auditors have traditionally been accorded.

Quotes from auditors:

'One of the problems is that nothing seems to really happen if there is a qualification.'

'The tools that the auditor has have somehow lost their impact, such as the ability to qualify or report by exception. Last year we qualified half of the accounts that we audited on going concern and there were no consequences, mainly because everyone (including NHS Improvement) was aware of it. If we qualify on value for money arrangements, very often this is also known to the regulator.'

AUDIT COMMITTEES NOT CONSISTENTLY EFFECTIVE

The purpose of an audit committee is to provide those charged with governance assurance over the internal controls, risk management, and the financial management processes of the local public body. It is therefore a critical part of the governance of a local public body, but their maturity and level of effectiveness in the sector is very mixed.

Local government struggles to recruit external members for their audit committees, and where it does find them, they do not always have the required competencies and independence.

[9] Sir Amyas Morse, Comptroller and Auditor General, speaking to the PSAA Quality Forum, 18 April 2018

Local authorities are not legally required to have an audit committee. Unusually, the membership of the audit committee will generally include elected members. While this provides separation from the executive, it can restrict debate and objective scrutiny. Where there is greater political involvement, rather than non-executive directors, it can result in varying arrangements and lack of skills to participate in the traditional work of an audit committee.

A best-practice approach would establish an audit committee whose members have the appropriate skills to discharge its responsibilities. Where members of the committee have conflicts of interest or are not able to contribute in a non-partisan manner, or turn over rapidly, the effectiveness of oversight will inevitably be undermined.

For example, in police authorities, the Home Office Financial Management Code of Practice makes the establishment of the joint audit committee mandatory, including the requirement for all members to be independent.

The NHS corporate governance structures are different, particularly in NHS Foundation Trusts, however there is limited uniformity in approach across the health sector. Every health body is required to have an audit committee that reports to its governing body (or Board or Council of Governors). The formal requirements to have an audit committee are set out in different documents, depending on the organisation.[10] NHS audit committees comprise independent, objective non-executive directors (NEDs) or lay members who are appointed by the organisation's governing body and need to satisfy the governing body's definition of 'independence'.

Quote from a CFO on audit committees:

'Audit committee maturity in the sector is mixed. This is not helped by the fact that members change through election, which results in a relatively high turnover. Some committees now include lay members, which does help.'

DECREASED AUDIT FEES

Part of the rationale for the government's decision to abolish the Audit Commission was a desire to reduce the total of local audit fees. This was to be achieved by reducing central overhead costs as well as the amount of additional work required by the Audit Commission. While the LAAA gave local public bodies the autonomy to procure their own auditors, the majority of local government bodies chose to enter into the sector-led body procurement process.

Public Sector Audit Appointments Ltd (PSAA) took on the role of the sector-led body that appoints auditors to the majority of local government bodies. It now has the responsibility for appointing auditors through bulk framework contracts and setting the audit fees for those bodies which have opted in to the framework. As part of its role, PSAA has continued to seek reductions in audit fees for its client local government bodies.

A number of the interviewees considered that changes to financial reporting, as well as to auditing standards and regulations, had not been taken into account when setting fees through five-year procurement contracts. However, while the fees were set by PSAA, the firms bid with the knowledge that statutory accounts have continued to become more complex, lengthy and detailed, requiring more time in their preparation and more time for audit.

In setting fees, therefore, PSAA did take into account the bids that were put in by accountancy firms (in which the firms outlined what they would be able to deliver) in order to win the framework contracts. At the final stage of the procurement

Quote from a CFO on tendering:

'PSAA/local government and the NHS seem to treat audit as a commodity, where a low fee is a good thing and there is no debate or discussion about the 'value' of audit.'

[10] For clinical commissioning groups (CCGs), s14M of the NHS Act 2006 (inserted by s25 of the 2012 Act) and NHS England's Model Constitution Framework (section 6.6.3). For foundation trusts (FTs), Monitor's NHS Foundation Trust Code of Governance. For non-foundation NHS trusts, the NHS Trust Development Authority's Code of Conduct and Accountability.

exercise, a couple of the firms chose not to participate because they considered that the margins were too tight to enable them to carry out a sufficient amount of work within the fee scales.

In local government, CFOs tell us that auditors now spend less time on site which, in their view, affects the 'quality' of the audit. They recognise, however, that the amount of time allocated to the audit is in direct correlation to the decrease in fees over recent years.

When we explored their perception of the quality of audit with interviewees, we learnt that CFOs are not concerned about the work that is actually being carried out in relation to compliance with auditing standards, but rather about the value added activities that auditors used to provide under the previous regime, which they are no longer receiving under the new framework for local audit under the LAAA.

CFOs value the ability to discuss issues with auditors in advance, or use their knowledge of the wider sector, while maintaining independence. With limited time and resources, these discussions no longer take place which leaves CFOs feeling vulnerable. However, it does remain open to CFOs to commission such additional pieces of work from firms that do not carry out the main financial statements audit.

Auditors are of the view that, while they are carrying out enough audit work to meet the requirements of auditing standards, they do not have flexibility within the fee range to spend more time and provide further support to CFOs to discuss wider sector issues. The audit is risk-based and auditors can try to secure fee variations if they identify significant new risks, however, in auditors' experience, securing fee variations is not easy.

The picture in health is less clear: while health bodies still struggle with procurement processes for external auditors, a reduction in fees has also been reported.

FUTURE FINANCIAL RESILIENCE OPINION OUTSIDE OF AUDIT SCOPE

CIPFA BUILDING FINANCIAL RESILIENCE, 2017

Financial resilience describes the ability of local authorities to remain viable, stable and effective in the medium to long term in the face of pressures from growing demand, tightening funding and an increasingly complex and unpredictable financial environment.

The Section 151 officer[11] is legally responsible for signing off a deliverable budget and simply setting targets doesn't meet that test. A culture of constructive challenge in each part of the organisation is essential. Departmental managers and the political leadership need to question constantly not just what is being proposed but how it will be delivered.

Quotes from auditors on tendering:

'In terms of the market, firms have bid, knowing the framework, and therefore have taken into account the risk of undertaking a compliant audit only. Previously, we had fees that allowed for a 'compliant plus audit' which allowed us to include 'add-ons'. Now these need to be charged separately in addition to the basic fee.'

Quotes from other stakeholders on audit fees:

'There has been a squeeze in terms of fees which has meant a strip back on work in other areas, rather than the areas the auditors have to comply with or are mandatory under auditing standards. You will probably find that the boundaries were more blurred in the past than now and therefore auditors did more than the minimum under the old regime.'

[11] Section 151 of the Local Government Act 1972 requires each local authority to appoint an officer to oversee the proper administration of its financial affairs (the S151 officer). Usually the CFO takes on this role.

This is possibly the widest expectation gap for CFOs, where they would like a more detailed review and challenge of their future assumptions. However, while there is a conclusion on the local public body's VFM arrangements, an audit is, on the whole, a backward-looking exercise and based on historic information. The auditor can only provide an opinion on what has already been done. It is not possible, under current international audit, assurance and ethical standards, for auditors to provide an opinion or comment on management's thinking process or of the local public body's strategy or policies.

Although these could be done outside of the main audit engagement, auditors cannot, under current auditing standards, provide opinions on future management plans. The closest they get to commenting on the future is when they are reviewing the going concern assumptions as part of the financial statement audit, through which auditors consider the management plan for the next 12 months. The extent of the expectations gap between CFOs and auditors (who are limited as described above as to what they can perform within prevailing audit and ethical standards) is borne out by the comments in the following box:

Quotes from CFOs on audit scope:

'Audit is now working to a narrower scope – they do a solid audit of the accounts, but I am not really sure how much work they do on the wider work? Certainly the VFM judgement is much lighter and they are not proactive in identifying issues. The obvious ones about financial sustainability are being raised (but are obvious to all) and they are not getting into the areas before the sustainability becomes an issue – because this is a harder piece of work and takes more time/skill.'

'The traditional accounts audit is pretty good, but my biggest concern is over the VFM conclusion. This work is a lot narrower and they don't seem to do much work, other than review reports, budgets and documents. I'm not really sure that they are picking up the concerns that they should be and raising them with members (and authorities, regulators) with sufficient gravity and importance.'

IMPACT OF AUDIT INDEPENDENCE RULES

While local public auditors' duties are wider than their private sector colleagues', with additional and increasing other pressures, the challenge for auditors is in balancing the wider expectations. For example:

- Failures of large organisations such as Carillion have an impact on stakeholders' views of the audit profession, and what they believe they should receive from auditors, which isn't always commensurate with what auditors think they can actually or realistically deliver under the scope of their work.
- The profession (both private sector and public sector audit work) is heavily regulated, with a number of changes introduced in recent years, designed to reduce the amount of other work that firms can carry out with an audit client. The new independence rules do not allow external auditors to take on additional work that could compromise their external audit role (for example, the revised Audit Guidance Note 01 (AGN 01)[12] goes beyond the FRC's ethical standards) regarding what can and cannot be carried out at local public audits. This has seen firms not bid for audits at clients where they are the incumbent due to the non-audit service fee levels (notably on tax and financial recovery work).

[12] AGN 01, General guidance supporting local audit.

OTHER STAKEHOLDERS' EXPECTATIONS NOT ALIGNED WITH AUDIT STANDARDS

Under the previous regime and transitional arrangements, the Audit Commission and PSAA published annual reports which provided a summary of the results of audits. These reports identified and often escalated key issues, either with individual bodies or from themes that emerged across several bodies to central government, permanent secretaries or to parliamentary scrutiny committees. The Audit Commission also published reports on VFM studies about local services which provided assurance to permanent secretaries that the services that they are accountable for were being properly run.

Some stakeholders are of the view that there is no longer visibility of what local government bodies are doing. While local government accounts are sent to government departments, there is a perception that there is now a reliance on local government trade bodies or professional accountancy bodies to identify issues of concern. While MHCLG has powers to intervene and can send inspectors in to carry out special investigations, these powers are rarely used.

Quotes from a government official:

'The department's concern is less about historic reporting and more about the future sustainability of service delivery and performance, and this is what we want from audit.'

'The message on value for money qualifications is getting through, and the department's audit committee has discussed this with the NAO, however there has been no further follow-up on how this needs to be resolved.'

INCREASED AUDITORS' LIABILITY

Auditors now have unlimited liability when carrying out the audit of local public bodies. In the previous regime, under the Audit Commission, indemnity arrangements were in place whereby if auditors used one of their statutory powers to report on a matter of concern, and if they were unable to recover the costs from the client, the cost of that work could be covered through the indemnity held by the Audit Commission.

Under the new regime this is no longer the case and an auditor considering reporting outside of the main audit engagement would need to bill their client separately and expect that the client pays for the work. If they do not get paid, there is no longer any indemnity cover in place to compensate the auditor for the additional work that they had to carry out.

These challenges, coupled with the unlimited liability regime of auditors, make audit firms and regulators nervous of systemic risk.

It is ironic that, while local public auditors have wider powers to report on an organisation than their private sector colleagues (which is one of the different aspects of local public audit), there is a greater level of risk for them in this wider reporting. While it would not be appropriate to indemnify firms for the audit of the financial statements, the complexity of work and the greater challenge involved in the use of these wider powers merits some further consideration of the risk environment within which the local public auditor's role is discharged.

As is the case for the licensing, registration and monitoring aspects, the auditors of local public bodies in England do not benefit from the same liability frameworks as the auditors of local public bodies in the rest of the UK. Indeed, a question worth bearing in mind is whether or not auditors would report differently if the liability regime was the same as for the auditors of local public bodies in the rest of the UK.

Possible solutions

Trust and confidence in public spending can only be enhanced by building a framework of accountability, transparency, governance and ethics. Ultimately the responsibility for government spending rests with the government departments which delegate responsibility for local spending down to local public bodies. It is therefore important for local public bodies to demonstrate to the public that this money has been spent efficiently and effectively. The strength of the arrangements in the UK is that local public audit has a wider scope and local public auditors have wider reporting powers. However, there are potential areas of improvement that need to be considered for the new local public audit regime to be fully effective.

Some of the solutions identified here are, in our view, radical and require all stakeholders to change some of their long-held assumptions and to work together to achieve the required outcomes. It is easy to fall back on old ways of doing something, and indeed to point to legislative, regulatory or international standards which may currently be restrictive but potentially not fit for purpose in the current environment. There are clearly concerns. To overcome these challenges, innovative solutions are needed. We need to consider what changes can be made to break down these barriers to effect change.

Future financial viability of local public bodies
Local public bodies are being asked to deliver more with less and be more innovative and commercial. CFOs are, of course, nervous at taking risks in the current environment and therefore would like more involvement by their auditors. They want auditors to challenge their forward-looking plans and assumptions and comment on the financial resilience of the organisation. However the traditional statutory audit is a backward-looking engagement, reviewing historical information. It is not designed to look forward and currently there are no audit or assurance standards that can adequately cover forward-looking information.

Two solutions, therefore, are:

1) As CFOs want additional advisory work, rather than just the audit, they can separately hire consultants (either accountancy firms not providing the statutory audit or other business advisory organisations with the required competencies) to work alongside them in their financial resilience work and challenge their budget assumptions (indeed, NHSI and NHSE routinely do this where CCGs or trusts are struggling).

2) The wider profession (IFAC, IAASB, accountancy bodies) should consider whether audit, in its current form, is sustainable and fit for purpose. It is clear from the wider debate in relation to private sector audit, that stakeholders want greater assurance, through greater depth of testing, analysis and more detailed reporting of financial matters. It is perhaps, therefore, time to look at the wider scope of audit and whether that needs to change in the future. For example, could there be more value in auditors providing assurance reports on key risk indicators which have a greater future-looking focus, albeit based on historic data?

Or could there be more use of integrated reporting with a focus on non-financial indicators?

Audit reports
Those at the receiving end of the audit reports and those who use and/or rely on the audit reports, need to receive briefings or training to enhance their understanding of the roles and responsibilities of local public auditors specifically in relation to the VFM arrangements conclusion, and also in relation to the ethical standards, to understand what auditors can and, more importantly, cannot do.

Currently as drafted, audit reports are only intended for use by the bodies that are being audited. Auditors should consider whether they are providing sufficient information in their audit reports to be of value to local public bodies or whether there is more information that they could provide. Reports on a body's VFM arrangements in particular have been identified as lacking in information about key risks that auditors have identified and the work that the local public body has carried out to satisfy itself that adequate arrangements are in place (or not).

Those charged with governance
Those charged with governance should receive training on how to deal with audit reports and qualifications to demonstrate that they are taking the audit qualifications seriously.

Audit committees
There are different and complex governance arrangements in the different sectors that comprise local public bodies. MHCLG should be mandating that audit committees have a majority of independent members, as is the case in health and the private sector. The elected nature of local government means that, currently, the necessary skills cannot be guaranteed and therefore there is doubt about whether sufficiently robust challenge will be provided.

Audit fees and future procurement of local auditors in local government
We are aware that there is a review being carried out on PSAA's recent procurement processes in preparation for future procurements. We urge their reviewers to consider carefully the issues highlighted in this paper and consider how and whether the future procurement exercise can stimulate more interest in the local public audit market.

Other stakeholders' additional assurance requirements
Government departments that require assurances on public spending, that fall outside of the current scope of audit, should engage separately with independent accountants or consultants through third party engagements. Departments should identify clearly the information they require, working with the third party assurance providers (or their professional bodies) to discuss and agree a suitable framework that clearly specifies the purpose and scope of work and form of report. This would need all parties to understand the requirements of international assurance standards before setting additional assurance requirements.

Liability of auditors for local public bodies in England
While we do not seek to indemnify for the standard audit of the financial statements, ICAEW's view is that there needs to be consistency in the liability arrangements across the UK. Parliament should consider implementing the same liability framework for local public bodies in England and give the local public auditors the same liability regime (similar to that enjoyed by auditors of all other local public bodies in the UK). In the meantime, indemnity arrangements should be put into place by MHCLG to cover the costs of auditors' work in their use of their wider powers, in case they are unable to recover costs from the clients.

Appendix A: What is an audit?

The objective of an audit is to form an independent opinion on the financial statements of the audited entity. The opinion includes reporting on whether the financial statements show a true and fair view, and have been properly prepared in accordance with relevant accounting standards.

The audit involves performing procedures on the numbers disclosed in the financial statements. These procedures are designed to identify material misstatements and regularly involve testing a sample of transactions and balances.

Traditionally, audit is a backward-looking exercise, looking at historical information, usually a few months after the end of the financial year. Different sectors have different timings for reporting deadlines.

> International Standard of Auditing (ISA) 200[12] states: 'The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework … that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.
> An audit in accordance with ISAs (UK) is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. ISAs (UK) require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance.
> It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.'

AUDITORS' RESPONSIBILITIES FOR THE AUDIT OF THE FINANCIAL STATEMENTS

Auditors' objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes their opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material

[12] International Standard on Auditing (UK) 200 (Revised June 2016) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)

misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs (UK), auditors exercise professional judgement and maintain professional scepticism[13] throughout the audit. They also do the following.

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for their opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the body's ability to continue as a going concern. If auditors conclude that a material uncertainty exists, they are required to draw attention in their auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify their opinion. Their conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the organisation to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Auditors also communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that they identify during their audit. In local public audit, this also includes the VFM arrangements responsibilities.

DIRECTORS' RESPONSIBILITIES FOR THE FINANCIAL STATEMENTS

The directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the organisation's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

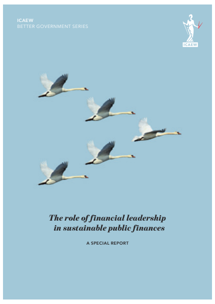
[13] *Scepticism: the Practitioners Take*, ICAEW, June 2018

The Better Government Series

ICAEW supports greater transparency and accountability in public sector finance and provides policy recommendations to ensure taxpayers' money is managed wisely. Our *Better Government Series* is a series of thought leadership, policy insights, toolkits and best practice special reports on topical public sector financial management issues.

Procurement: Tendering for local audit

This special report has been written to support local public bodies when they are in the process of tendering for external audit services under the Local Audit and Accountability Act 2014. The independence of the selection and appointment process is a central theme that runs through this guidance. Ultimately the Auditor Panel's objective is to identify the firm that is best able to meet the needs of the local public body in undertaking the external audit. This guidance highlights key factors that will contribute to an effective appointment process and outcome.



The role of financial leadership in sustainable public finances

In this publication, we explore the role that finance leaders can and should play in managing sustainable public finances. We explore the drivers for strong financial leadership and the skills and competences that, in our view, a strong finance leader should have. Senior leaders, from around the world, provide their thoughts on the importance of strong finance leaders in the public sector.

The UK Central Government Public Financial Management System

While the UK system is transparent, the relationship between the government, acting on behalf of the Crown and Parliament is complex, with a number of parties involved in the overall process by which public expenditure is approved, managed and accounted for. This document aims to provide a simple and clear explanation of how the system works – in one short and accessible document.

Managing the public balance sheet

This Policy Insight aims to help public officials understand what is in their balance sheets. The value of the information about different sorts of assets and liabilities and how some governments around the world are using it to support more effective policy-making. In particular, it is written, to help government ask the right questions to make the most of their financial information.

These publications and others in the series can be found here icaew.com/publicfinances

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ICAEW
Chartered Accountants' Hall
Moorgate Place
London
EC2R 6EA
UK

T +44 (0)20 7920 8100
E contactus@icaew.com
icaew.com/publicfinances