ICAEW
REPRESENTATION 111/21

LOCAL GOVERNMENT FINANCE SYSTEM: OVERVIEW AND CHALLENGES

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ICAEW welcomes the opportunity to comment on the inquiry by the Committee of Public Accounts (PAC) into the local government finance system published on 21 October 2021, a copy of which is available at this link.

The government needs to address the issues in local reporting and audit as a priority:

- The government's response so far has not recognised the urgency of the crisis in local authority reporting and audit.
- The government should act to remove barriers to entry and increase the attractiveness of the local audit market ahead of the early 2022 procurement round for the next 5-year auditor appointment period.
- ICAEW welcomes government plans to establish a system leader but we are concerned that the Audit, Reporting and Governance Authority (ARGA) will not be able to give local audit the focus it requires.
- The Redmond Review conclusion that local authority accounts are considered "impenetrable" has not received sufficient attention.

A clearer articulation is needed of what local authority financial reporting and audit are for and why they matter:

- More understandable and higher quality reports and financial statements would improve decision making, strengthen financial management within local authorities, and enhance accountability to councillors, residents, and other stakeholders.
- Local audit is vital as it gives taxpayers confidence as to whether public money has or has not been used appropriately.
- The system leader has a key role in promoting the value of local reporting and audit.
- A parliamentary inquiry into the form and utility of local authority reporting could act as a catalyst to reforming local authority financial reporting so that annual reports are better used as tools to improve accountability and strategic decision making.

Local authority finance teams and audit committees need strengthening:

- For local authorities to deliver the government's policy priorities on decarbonisation and levelling up, it is vital that they have sufficient financial capability and capacity to manage public money effectively.
- A key cause of audit delays is the poor quality of working papers, draft accounts or evidence provided to auditors by some local authorities.
- The government can support local authority finance teams by allowing them to focus on the most important areas by simplifying funding.

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- Weak governance has been a key contributing factor to recent high-profile failures in local government.
- The government should legislate for independent members on local authority audit committees.

Many local authorities continue to be in a difficult financial situation:

- There needs to be a clear strategy for addressing the low level of reserves in many local authorities to prevent further section 114 'bankruptcy' notices and ensure sufficient capacity to respond to future crises.
- The spending power of local authorities fell by 29% between 2009-10 and 2019-20, meaning many turned to commercial investments in an attempt to raise the revenue needed to fund essential services.
- Once the cost of implementing the social care reforms is excluded, local authorities received a 1.8% average annual increase in their core spending power over the spending review period compared to 3.3% for the average department.
- Despite a three-year spending review settlement, there remains significant financial uncertainty for individual local authorities.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 157,800 chartered accountant members in over 147 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

As a regulator of the accountancy and audit profession, ICAEW is currently the largest Recognised Supervisory Body (RSB) for local audit in England. We have nine firms and over 90 KAPs registered under the Local Audit and Accountability Act 2014.

ICAEW's Public Sector team supports members working in and with the public sector to deliver public priorities and sustainable public finances, including over 8,000 in ICAEW's Public Sector Community. ICAEW engages with policy makers, public servants and others to promote the need for effective financial management, audit and assurance, financial reporting and governance and ethics across the public sector to ensure public money is spent wisely.

INTRODUCTION

1. We are responding to PAC's inquiry 'Local government finance system: overview and challenges' published on 21 October 2021.
2. Our comments are solely intended to support PAC with its inquiry and in its questioning of officials and others providing evidence.
3. ICAEW is a body whose mission is to promote the public interest and whose members are accountable under a code of ethics. In that context we seek to and want to play a constructive role in supporting the Government and Parliament. We would welcome the opportunity to meet with senior members of the committee to discuss the points we have raised in more detail.
4. Our evidence builds on the submission we provided to the Committee to support its inquiry into the timeliness of local auditor reporting on local government in England.
5. The Ministry of Housing, Communities and Local Government has been renamed the Department for Levelling Up, Housing and Communities (DLUHC). We have referred to the Department as DLUHC throughout.
6. ICAEW has worked closely with DLUHC and other key stakeholders to develop proposals in response to Sir Tony Redmond's independent review into the oversight of local audit and the transparency of local authority financial reporting. ICAEW is represented on DLUHC's Local Authority Audit Monitoring Board and the newly formed DLUHC-chaired Liaison Committee. In addition, it is a member of the "auditor capacity and capability" working group and sub-groups set up by DLUHC that are considering changes to the Key Audit Partner (KAP) guidance and proposals for additional training.
7. Our commentary echoes the submissions we have made in response to various consultations related to local government finances and audit:
   - Our response to the DLUHC technical consultation on the local audit framework welcomed the creation of a systems leader but expressed concerns about ARGA's capacity. We also called for more action to make the local audit market attractive, remove barriers to entry, improve the quality of local authority reporting and strengthen local authority governance.
   - ICAEW's response to the Department of Business, Energy and Industrial Strategy (BEIS)'s white paper on restoring trust in audit and corporate governance called for ARGA to be established as soon as possible and highlighted that there was a need to consider the public sector implications of the BEIS reforms.
   - Our letter to HM Treasury (HMT) published alongside ICAEW's response to the BEIS-proposed reforms highlighted these public sector implications and called for urgent action to address capacity issues in the local audit market.
   - Our response to Public Sector Audit Appointments Limited (PSAA)'s market engagement survey ahead of the procurement for the next appointed period supported PSAA's objectives but raised concerns about the practicality of some proposals. We continue to engage closely with PSAA on the procurement proposals.
   - Our letter to the Chief Secretary to the Treasury ahead of the 2021 Spending Review called on the government to use the review to establish a firm financial platform that enables local government to deliver on the government's priorities.
   - ICAEW Chief Executive Michael Izza's letter to the Chancellor ahead of the 2021 Budget calling for long-term funding for local authorities, strengthened financial management, and reforms to local audit to empower local councils to transform their areas.

KEY POINTS

The local audit market is in crisis

8. The PAC report in July warned that "without urgent action" the local audit system "may soon reach breaking point". That point has now surely arrived as 91% of local authorities were unable to publish audited 2020-21 accounts by the statutory deadline of 30 September 2021.

This compares to 55% of local authorities missing the deadline for audited 2019-20 accounts in the previous year

9. Whilst the delays in the past two years can partly be attributed to the disruption and additional audit risk caused by the COVID-19 pandemic, the pandemic has only exacerbated an existing issue with capacity in the market. The percentage of audits completed before the deadline dropped from 97% in 2015-16 to only 57% in 2018-19. There are only nine firms registered to perform local audits and two firms currently conduct over 70% of local authority audits.
10. The issues with capacity in the local authority audit market have a knock-on effect on the audit of NHS bodies as they are audited by the same audit teams. The deadline for NHS audits is even tighter, placing pressure on these teams to work intensively over a short period of time.
11. This is one of the many factors that make the local audit market unattractive to both new entrants and for suitably skilled staff to work in public sector teams in registered firms. Other factors include the high reputational risks, increasing regulatory requirements and the relatively high inherent audit risk of local authorities compared to similar sized companies. This arises from under resourced local authority finance teams, fraud risks from grant expenditure, increasingly complex transactions and investments, and the increasing prospect of the council’s Section 151 Officer being forced to issue a Section 114 Notice.
12. Despite the level of risk, audit fees remain substantially lower than in other sectors. We highlighted this in our response to the DLUHC consultation where we used the example that the fee for the audit of Manchester City Council for 2019-20 was £159,000, compared to £500,000 for Premier Foods, a FTSE 250 company. Both bodies are classified as public interest entities but Manchester City Council generated over double the level of revenue in 2019-20 and had 70% more recorded assets.

The government response so far has not recognised the urgency of the situation

13. DLUHC provided local authorities with £15m additional support to pay for 2020-21 audits and our response to the consultation called for this to be made permanent to ensure that local authorities are able to pay fees that are adequately priced for high quality audits. However, the Spending Review only committed £34.5m over 3 years to specifically strengthen “local delivery and transparency”. The Spending Review states that this funding will be used to strengthen “the sector’s procurement and commercial capacity, establish the Audit Reporting and Governance Authority as the new local audit systems leader, and help local councils meet new transparency requirements”. This is a 23% annual cut compared to the additional support provided in 2020-21 and will be used for a much broader range of essential measures, and thus represents a significant reduction in the annual funding available for local authorities specifically for audit fees.
14. In addition to cutting funding, the government has not introduced any measures that will reduce the significant barriers to entry ahead of PSAA carrying out the procurement for the next appointing period for five years from April 2023. Because of their statutory obligation to appoint an auditor to every public body that opts into their scheme, PSAA intend to complete the procurement by August 2022 and the deadline for the submission selection questionnaires is March 2022.
15. We welcome proposals in the DLUHC consultation around training, a technical advice service and reforms to the KAP eligibility criteria. However, these reforms are unlikely to come into force in time for individuals working at potential new entrant firms to become KAPs so as to pass the initial selection questionnaire. Therefore, there is a risk that these reforms do not have the intended positive impact as firms may not consider it worth the substantial investment if they cannot secure significant local authority audit work until April 2028.
16. The government needs to introduce measures that will have a much more immediate impact in increasing the number of KAPs including amending legislation to permit those with equivalent overseas qualifications to become KAPs and to ensure that the rules do not deny those who work primarily on local audit the opportunity to become KAPs because they have insufficient company audit experience. Furthermore, the government should consider whether there are audits which should be brought outside the scope of KAP requirements, such as audits of local

authority pension funds, where experience of auditing company pension funds is of more relevance than experience of auditing local authorities.

17. The government should also explicitly exclude all bodies subject to the Local Audit and Accountability Act from the scope of public interest entity (PIE) requirements. A small number of local authorities are currently classified as PIEs due to historic issues of securities to fund civic building construction or legacy war bonds. The risk compared to other similar public sector bodies does not justify the additional regulatory burden faced by the auditors of these bodies. The reforms offer the chance to remove this anomaly but instead firms are concerned that the government will seek to extend the size criteria reforms proposed for large companies to local authorities.
18. We support establishing a system leader as strong leadership and co-ordination is required to resolve the issues in local audit and reporting. However, we are concerned that ARGA will not be established until 2023 at the earliest and the Department of Business, Energy and Industrial Strategy (BEIS) proposed audit and corporate governance reforms, including the proposed expansion in the number of PIEs, could overwhelm ARGA's capacity to be an effective system leader.
19. We share PAC's concerns that the Liaison Committee may not provide the strong leadership that the local audit system urgently needs. Audit firms are not represented on the Committee, limiting its effectiveness as it does not receive the perspective of some of the key bodies impacted by issues it discusses.
20. DLUHC need to take a much more active role in local audit until the new system leader is established in FRC in shadow form. The new system leader will need to set out a longer-term vision for the local audit market, ensuring that the audits are rewarding for those carrying them out and focus on the areas of highest risk. It needs to be a forward-looking improvement regulator that shares good practice and emphasises that local audit matters as it provides confidence to citizens that public officials are using public money appropriately and can result in improvements in financial management. This could help make the market more attractive to talent in the long term.

The timeliness issues in local authority audits are symptomatic of a wider broken reporting system

21. The government's response so far has focussed almost entirely on audit without adequate consideration of the wider system. Our response to the DLUHC consultation highlighted other weaknesses in the system including:
    - Many local authorities have under-resourced finance teams which means they struggle to produce good quality working papers, sample evidence or draft accounts;
    - Weaknesses in governance including partisan audit committees that lack sufficient expertise; and
    - Unnecessarily long and complicated local authority accounts that make the audit more challenging and mean that the accounts do not provide the intended transparency to citizens or their elected representatives.
22. We stated in our response to the DLUHC consultation that we do not understand why the government proposes that ARGA will play a significant role in corporate reporting for large companies but the proposals do not establish any role for the system leader in local authority financial reporting. Just as in the corporate sector, timely and high-quality audit relies heavily on good quality accounting records and financial statements.
23. The proposed objectives of the system leader are too narrow as they should also be tasked with improving the quality, accessibility and understandability of local authority reporting. We suggested ideas to DLUHC including that the system leader should maintain an easily searchable database of local authority accounts and establish a body to conduct periodic reviews of local authority annual reports and accounts to suggest improvements.
24. The system leader has a key role in promoting the importance of the accounts to local authorities. ICAEW is firmly of the belief that better use of quality financial accounts, especially

active management of the balance sheet, could help prevent many of the high-profile financial management issues arising in local authorities.

25. As local authorities have faced a 29% reduction in their spending power between 2009-10 and 2019-20 and senior finance officers have viewed the accounts as a compliance exercise, local authority leadership have often identified accounts teams as a suitable back-office function to face spending cuts. This has had real consequences for the quality of financial management in local authorities.
26. For example, Grant Thornton's statutory recommendations report for Slough Council highlighted how significant weaknesses in the finance team led to audit delays and, as a consequence of errors in unaudited accounts, the local authority lacked an accurate picture of its financial position. This eventually led to the Section 151 Officer being forced to issue a Section 114 Notice.

There should be a parliamentary inquiry into the purpose of local authority accounts

27. With these significant issues in local authority financial reporting, we are disappointed that the DLUHC consultation did not include substantive proposals to address Sir Tony Redmond's conclusion that local authority accounts are "impenetrable". The Redmond Review's recommendations for a new summary statement and for CIPFA / LASAAC to consider how the accounts can be streamlined need to be implemented as soon as possible.
28. The Public Administration and Constitutional Affairs Committee's (PACAC) 2016-17 inquiry into central government accounts resulted in an influential report Accounting for democracy: making sure Parliament, the people and ministers know how and why public money is spent that established four key purposes of central government financial information. Many of the recommendations were adopted in HM Treasury's Financial Reporting Manual.
29. We believe a similar inquiry by a parliamentary Select Committee into the purpose of local authority accounts could clarify the primary users and identify what information they require. This would support CIPFA / LASAAC with their accounts streamlining by helping to identify the disclosures that could be removed or the notes that are poorly understood.
30. It would also help educate senior local authority officers and elected representatives about the need to invest in their accounts teams and using the accounts as a source for evidence-based decision making. By reinforcing the importance of accounts, it could increase the attractiveness of the local government sector to both accounts preparers and auditors.

Local authorities need investment in their finance teams and governance structures

31. Local government has a key role to play in many of the government's top priorities including fixing the social care crisis, supporting the levelling up agenda, rebuilding the economy following the pandemic and achieving net zero carbon by 2050. To ensure that it is an effective delivery partner, local authorities need to invest in the skills and capacity of their wider finance and commercial teams, in addition to their accounting teams. Central government needs to provide councils with sufficient resources to allow them to make this investment.
32. We are concerned that the Spending Review has not provided local authorities with sufficient funding to make this necessary investment. Despite the headline 9.4% annual real-terms increase in resource expenditure funding for local government announced in the Spending Review, local authority spending power is only projected to increase by 3% in real-terms each year. Research by the Institute of Fiscal Studies found that, once the impact of the government's social care reforms is excluded, the increase in core spending power is only 1.8% each year, which is lower than an average 3.3% increase across central government departments.
33. This means local authorities are likely to continue to engage in commercial investments in an attempt to generate the revenue they require to fund essential services and deliver on government priorities. These investments expose local authorities to greater balance sheet risks making it even more important that they produce accurate financial reports and have strong risk management structures in place.

34. However, current reporting over investments does not provide confidence that many authorities fully understand their financial risks. The 2019-20 annual report and accounts of one local authority provided very little detail about the nature of over £800m of commercial investments nor did it include the risk from holding such significant investments in their strategic risk register. It is examples like this that illustrate why Sir Tony Redmond raised concerns about the variable quality of local authority narrative reporting.
35. We also share Sir Tony Redmond's concerns about the expertise and partisan nature of some local authority audit committees and strongly support his recommendation for all committees to contain at least one independent member. Research by Grant Thornton on public interest reports issued between August 2020 and March 2021 highlights how weaknesses in audit committees were a major contributory factor in the financial management failures at the three councils in question.
36. However, we believe that DLUHC's proposal of requesting that CIPFA produce "strengthened guidance", when CIPFA's guidance already clearly recommends independent members, is inadequate and that the government should make appointing independent members a statutory requirement, as it is already in Wales.

Central government needs to improve how it works with local government

37. In addition to providing more funding to local authorities to allow them to invest in their financial capability, central government needs to work much more effectively to support local authorities deliver policy priorities.
38. A good example of this is the Small Business Grant Fund and Retail, Hospitality and Leisure Support Grant Fund COVID-19 business support schemes. Local authorities were tasked with administering these grants and urged by ministers to pay these grants to businesses 'as quickly as possible' in April 2020. Detailed guidance on assuring these grants, including pre-payment assurance, was however not provided to them until June 2020.
39. A recent National Audit Office (NAO) report on local government and net zero also flagged serious weaknesses in the government's approach to working with local government. This included a lack of clarity of its expectations of local authorities and the lack of a central point of contact. We welcome the commitment in the government's net zero strategy for BEIS to take overall responsibility for co-ordinating local government's response to decarbonisation.
40. One of the most significant findings of the NAO report was that piecemeal funding has hampered the ability of local authorities to act on climate change. This is an issue that is not just limited to net zero as research by the Local Government Association identified 448 different funding streams and grant awards between 2015-16 and 2017-18. This means valuable local authority finance team time and resource will have been wasted understanding the funding available and preparing competitive bids rather than helping to deliver improvements in services.
41. Another consequence of the complicated funding of local authorities is that it contributes to the complexity of local authority accounts. Successive governments have introduced numerous statutory overrides meaning local authority finance teams have to calculate their value to disclose in the Movement in Reserves Statement. Alongside the streamlining of accounts recommended by Sir Tony Redmond, the government should consider whether there is the opportunity to reduce differences between the accounting and funding basis for local authorities.
42. Another unnecessary complexity that has been imposed on local government by central government is the uncertainty over funding. Our letter to the Chief Secretary to the Treasury called on the government to use the Spending Review to provide financial certainty to local authorities, as well as rationalise the number of funding streams.
43. After several years of single year Spending Review settlements, the three-year settlement should provide a degree of certainty. However, individual local authorities are still not in a position to plan effectively because there has been no announcement as yet as to how DLUHC intends to allocate grant funding.

44. The repeated delays to the "Fair Funding Review" have been a particular source of uncertainty and difficult financial positions for some councils. This needs to be implemented as soon as possible because the current methodology involves the government allocating funds based on 2013 population statistics. For areas of the country that have seen significant population and demographic change, this has the potential to cause further financial difficulties if not addressed.