ICAEW
REPRESENTATION 69/21

15 July 2021

Michael Sunderland
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HM Treasury
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Dear Michael,

PUBLIC SECTOR IMPLICATIONS OF BEIS WHITE PAPER ON RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE

One of the major points in ICAEW Representation 63/21 in response to the Department of Business, Energy and Industrial Strategy (BEIS) consultation on the White Paper on restoring trust in audit and corporate governance is that, whilst the focus is of the consultation is understandably on large private sector companies, there is a need to consider the implications for the public sector.

As the Ministry of Housing, Communities and Local Government (MHCLG) brings forward proposals in response to Sir Tony Redmond's independent review into the oversight of local audit and the transparency of local authority financial reporting, we recommend that BEIS, HM Treasury and MHCLG work together to conduct a separate review, consultation and impact assessment exploring how the principles covered in this White Paper could apply in the public sector.

This letter is designed to provide ICAEW's initial views to support this review. It supplements ICAEW Representation 63/21 by setting out how the proposed reforms can, where adapted appropriately, also strengthen public sector audit, reporting and governance. It also highlights elements of the proposals that could have a direct impact on the public sector.

There is significant public interest in ensuring that audit and corporate reporting are functioning effectively for public sector bodies so it is important the government seizes this opportunity to strengthen it. Taxpayers need assurance that public bodies are spending money effectively and safeguarding public assets. Elected representatives require assurance that bodies are spending in line with their intentions. The public is particularly impacted by the consequences of weaknesses in governance, internal controls or where financial sustainability leads to unnecessarily high costs for the public purse and eventually results in cuts to public services or tax increases.

Key recommendations

- **BEIS, HM Treasury and MHCLG should conduct a separate review to consider how the principles covered in this White Paper could apply in the public sector.**
- **Public sector bodies, including government-owned companies and local authorities, should be excluded from the scope of the Public Interest Entity (PIE) criteria.**
- **Many of proposals in the White Paper would be valuable in the public sector including the increased focus on fraud and resilience and the new audit and assurance policy.**
- **Urgent action is needed to strengthen capacity in the local audit market including sustainable funding that takes account of new requirements placed on auditors.**

Users of the accounts

Before reforms are introduced in the public sector, more work is needed on establishing who are the primary users of public sector accounts and what reporting they require. This should acknowledge that more financial information, other than the accounts, is available to these stakeholders than would be the case for the private sector such as, for example, through published transparency returns.

Most public sector bodies do not have shareholders and where they do these tend to be either the Secretary of State or the local authority. As a result, the motivations of these shareholders are different from regular shareholders, since policy objectives or legal restrictions will prevent them from potentially looking to sell their holdings or seek a listing on a regulated market.

Users of public sector accounts include:

- the public who want to know how their taxpayers' money has been spent;
- the bodies themselves, which use them to inform budgeting;
- other public sector bodies, which use them for monitoring and oversight; and
- elected representatives, who use them to make decisions.

ICAEW agrees with Sir Tony Redmond's concerns about the accessibility and understandability of local authority accounts as well as widespread concerns about the timeliness of reporting and audit.

More consideration is needed over who will play the "role of shareholder" envisaged in the White Paper in the public sector. For example, the proposals to give shareholders a formal opportunity to engage with audit planning has the potential to undermine the independence of the National Audit Office (NAO) if this power is given to Secretaries of State, where they are the sole shareholder of a government-owned company. One option would be for this power to be given to parliamentary select committees, but this would involve them playing a much more active role in the audit than they have in the past.

SPECIFIC POINTS

Public interest entity definition (Chapter 1)

ICAEW Representation 63/21 expresses concerns that the proposals for extending the Public Interest Entity (PIE) definition captures far too many entities as PIEs, and risks overwhelming the system. In that response, we set out our opposition to including public sector bodies within the definition and we reinforce that message here.

ICAEW member firms have fed back to us that they would welcome clarity from the government over whether it intends that public sector bodies fall within the scope of the revised PIE definition. They are concerned that the increased requirements that are associated with PIE audits are of little benefit for public sector bodies and risk further straining the already stretched capacity of the audit market.

Many local authorities and central government departments would meet either of the proposed thresholds, but it would not be possible for them to comply in full with the current PIE requirements around, for example, transparent audit tendering. This is due to the statutory role of the Auditor Generals of the four nations as the auditors of central and devolved government and the way in which local audits are allocated in lots by Public Sector Audit Appointments (PSAA).

As we note in ICAEW Representation 63/21, a small number of public sector companies like Network Rail and NHS Property Services meet one or both of these thresholds but some large central government-owned companies funded by grant-in-aid or capital funding or that hold substantial assets or liabilities do not. An example is HS2 Ltd, which only generated £109k income alongside the £3bn capital contribution it received from the Department for Transport and had an average of 1,415 employees in 2019-20. Given HS2 already has assets of £6bn and intends to spend more than £40bn building a critical piece of national infrastructure, the government should clarify whether it intends for grant funding to be treated as revenue for the purposes of PIE classification.

Many of the proposals are not relevant for these government owned companies because of the differences between private and public sector companies. For example, government-owned companies often cannot pay dividends under their founding legislation or framework agreement with their sponsor Department so it would not be a useful exercise for government-owned companies to invest resources in calculating and reporting the known distributable reserves.

Our view is that central and local government-owned companies should be explicitly excluded from the PIE definition and that the government should use the separate exercise, which ICAEW is recommending, to consider which elements of the proposals would be useful in the public sector. This also provides the opportunity to end the current anomaly where some small public sector organisations are considered PIEs because they hold listed debt but where the risk compared to other similar public sector bodies does not justify the additional regulatory burden. This includes local authorities with legacy war bonds.

Reporting reforms relevant to the public sector (Chapters 2 and 3)

Many of the proposals in the White Paper could strengthen the quality of reporting in the public sector and increase the usefulness of the annual report and accounts for users. This would address some of the concerns raised by the Redmond Review that there are no specific requirements over local authority narrative reports, which in turn leads to variable quality of such reports.

One of the five steps that ICAEW Representation 63/21 identifies as a key area of focus for reform is reinforcing the core audit with targeted action on fraud and resilience. These are areas of particular interest to users of public sector accounts as failures in these respects can have a major impact on the services that these bodies can deliver to taxpayers.

Just as in the private sector, there is an expectation gap in England between the limited requirements for public sector auditors to conduct work over fraud and the expectations of users. Taxpayers and elected representatives want confidence that public sector bodies are spending public money appropriately and safeguarding public assets. As a result, our view is that the proposed requirements for entities to report on the effectiveness of internal controls and the steps taken to prevent fraud are just as applicable to large public sector organisations as to large private sector companies.

ICAEW Representation 63/21 expresses support for the proposed reform package on fraud and we would support extending the requirements to the public sector with the appropriate adaptations. ICAEW calls for ARGA to maintain the proposed fraud register and it should use its proposed new powers over local audit to maintain a separate one for bodies subject to the Local Audit and Accountability Act 2014.

The changes to the NAO's Local Audit Code and Guidance in England for 2020 to 2021 partly address concerns over the work done by auditors on resilience. The revised code requires auditors to produce a commentary on value for money that covers financial sustainability, while the Auditors General in the devolved administrations already have greater scope to carry out work on financial sustainability.

Nevertheless, a resilience statement tailored to the entity that avoids boilerplate wording could provide further transparency by requiring public sector bodies to demonstrate their active consideration of financial sustainability, including the impact of climate change. It could act as the early warning system of issues in financial sustainability that the Chair of the Public Accounts Committee has recently called for. The requirements for the resilience statement would need to be amended for the public sector context. The most useful information for elected representatives would be over whether the current funding mechanisms are sustainable rather than the body trying to predict whether the same elected representatives will agree for it to continue to receive funding in future.

Audit and Assurance Policy (Chapters 3 and 6)

We would support extending the proposed requirements for entities to publish an audit and assurance policy to large public sector organisations as there is the same lack of understanding over the auditor's scrutiny of information as in the private sector.

We consider that this is particularly important in the public sector where an entity's primary objectives are less likely to be focussed on making a profit but rather on providing public benefit. Indeed, the KPIs for many public sector organisations are predominantly non-financial and it would be helpful for users to understand what assurance has been obtained over these KPIs.

The nature of the policy would need to be tailored to the public sector as some proposed mandatory elements, such as the policies for tendering for external audit, may not be relevant given the roles of the NAO, the devolved audit offices and PSAA.

Careful consideration will need to be given to the capacity of public sector external auditors to accommodate increased requirements that can arise from audit and assurance policies. Local government auditors in particular would struggle to accommodate additional requests given the current capacity constraints in the market. If the government intends for central government bodies to be able to request that the NAO audits their internal controls effectiveness statement, the NAO will require additional resource to carry out this work.

Impact on auditors and audit firms (Chapter 6, 7 and 8)

Public sector audit will be impacted by changes to auditing or financial/non-financial reporting standards that arise from these proposals. Changes to the Companies Act or other legislation on the purpose of audit may not explicitly apply to all public sector audit but public sector auditors may have to adopt the changes to align with firm-wide procedures and best practice. Therefore, as ICAEW Representation 63/21 states, it is essential that the public sector is considered in these changes.

As we state in ICAEW Representation 63/21, we support the suggestion that 'corporate auditing' as a concept should accommodate public sector audit, as the core audit skills are common to those required in the private sector. In order to promote the important role of public sector audit and encourage recruitment and retention of staff auditing this sector, new requirements for PIEs must not decrease the ability of staff to flexibly transfer between public sector and PIE audits.

A quality audit profession must support and include quality public sector audit. The proposed principles of corporate audit set out in the Brydon Review should also apply to public sector audit. We would support auditors reporting graduated audit findings in the public sector as this could strengthen accountability from public sector audit and reduce misunderstandings of the auditors' role.

The issues raised in the White Paper over the highly concentrated audit market for FTSE 350 firms are even more acute for local audit where two firms conduct over 70% of local government audits and there are only eight firms in the market in total. Urgent action is needed to address this issue but the solutions proposed in the White Paper for large companies, such as managed shared audit, would not work in the local audit market.

ICAEW is working with MHCLG and other key bodies on ways to increase capacity in the local audit market and encourage new entrants. We are an active participant in the local audit capacity and capability working group, including by calling for a review of the Key Audit Partner (KAP) eligibility criteria, as our research suggests this is one of the barriers to entry into the market, and helping develop proposals to create a centre of excellence to provide public sector-specific training to potential and existing local auditors.

When considering how the reforms should apply to public sector bodies, the government must consider whether any new requirements could further worsen the capacity and market sustainability issues already outlined. MHCLG have already acknowledged that fees are too low for local authority audits based on the current requirements placed on auditors, as they have pledged an additional £15m for the 2020-21 cycle. New requirements on auditors must be accompanied by long-term funding that allows for the resulting fee increases.

Supervision of the Auditors General (Chapter 11)

More detail is required about what is meant by the proposals in 11.6. While we understand the justification for changing the responsibility for appointing the independent supervisor of the Comptroller & Auditor General from the Secretary of State for BEIS to Parliament, we do not consider that any entity apart from ARGA has the capacity or expertise to oversee the NAO. This section of the consultation does not consider the potential impacts on the other Auditors General so this should be considered by the Government as they consider legislative proposals in this area.

Yours sincerely

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