Professor Pete Murphy and Research Associate **Katarzyna Lakoma** from Nottinghamshire Trent University report on fundamental flaws in the fragmented approach to local audit

Local audit no longer fit for purpose?

The independent review of local audit conducted by Sir Tony Redmond, a former president of CIPFA, has found a complete lack of coherence and public accountability within the existing system, no single body taking responsibility for coordination and regulation of local audit activity, with the situation facing PCCs and FRAs being in many ways similar to those for principal councils.

'For local audit to be wholly effective it must provide a service which is robust, relevant, and timely; it must demonstrate the right balance between price and quality; and be transparent to public scrutiny. The evidence is compelling to suggest that the current audit service does not meet those standards' (Redmond p.72).

The Redmond Review complements and follows the Brydon Review on the quality and effectiveness of the private sector audit, and the Kingman Review of the Financial Reporting Council. It also complements the new Code of Audit Practice issued by the NAO earlier this year, which equally applies to FRAs and PFCCs. All found that fundamental changes were necessary to meet current circumstances.

The review received 156 responses and conducted over 100 interviews. It also generated an unprecedented amount of unanimity on its key issues across respondents and key stakeholders including local authorities, fire services, the audit companies and the regulators. With everyone in the sector – up to and including HMT – having a vested interest in robust public auditing, its implementation is likely to be expedited.

What are the key issues?

Leadership, Coordination, and Regulation of the Audit System

The underlying feature of the existing framework is the absence of a body to coordinate all stages of the audit process. Chapter 2 takes us through the six different entities with statutory responsibilities in the local accounting and audit framework, which is further complicated by differing parts applying to different sectors and inconsistency with the arrangements in Scotland and Wales. None of these bodies have a system leadership role nor the statutory duty to ensure it operates in a coherent or joined-up way. As the Kingman report had previously commented:

'The structure is fragmented and piecemeal. Public sector specialist expertise is now dispersed around different bodies. The structure means also that no one body is looking for systemic problems, and there is no apparent co-ordination between parties to determine and act on emerging risks'.

This is widely recognised as a major weakness by stakeholders and 82 per cent of respondents wanted a single regulatory body. Redmond considered whether any of the exiting bodies should adopt this role but concluded that a new Office of Local Audit and Regulation (OLAR), should be established. He calculates the additional cost at £5m per annum because most functions and employees would be transferred in from exiting bodies under TUPE arrangements.

Financial Resilience and Financial Sustainability

Financial resilience and the concept of resilience generally has become ubiquitous in public discourse, not least by the government in response to the pandemic. However, neither the financial nor the value for money audits of local authorities contain any opinion on either financial sustainability or financial resilience. The public expects and assumes that they do and not surprisingly 91 per cent of respondents (and Redmond himself) think that they should.

By the time Redmond had published, the NAO, CIPFA, the LGA and others had already expedited initiatives to lay the foundations to help operationalise its inclusion in statutory duties. He is, however, careful to differentiate what should be in the financial audit and what should be in the value for money audit and he looks at the approaches in Scotland, Wales and New Zealand.

Redmond picks apart the Gordian knot around audit, being a record of the past, while conceptually sustainability and resilience look to the future. Nevertheless, some of the riskier and expanding areas of local authority activity increasingly fall outside of the audit. The expansion of wholly owned companies, joint ventures, and acquisition of commercial property has increased authorities' risks to their financial resilience (although this is less true of FRAs) with the latter being the subject of a recent NAO report (2020).

Local audit needs to be comprehensive, robust and integrated into the public assurance system, but it is not the whole of public assurance nor for that matter is it a performance management system. Positive and mutually helpful relations should be maintained with clients, providers and other stakeholders, although they must

not be allowed to compromise the independence of the external audit arrangements.

'Many examples of service delivery and financial failures are underpinned by weaknesses in governance and senior leadership… so, it might be a good idea if an auditor or inspector has concerns to see if they are reflected in other areas.'

Public Reporting

Local external audit and reporting is longer, more complex and more technical than in central government or in the private sector. Redmond considered three options for reporting on his new model for auditing financial resilience. He then evaluates the three options before strongly recommending a new short, standardised statement to be compared to the budget and council tax levy to be presented alongside the statutory accounts. For good measure he provides a draft of the statement for both local authorities and FRAs in an appendix. This would allow the current movement in reserves and expenditure and funding analysis, together with supporting disclosures, to be discontinued.

One of the underpinning principles of the current financial audit is the 'going concern assumption.' The going concern assumption means that readers of a set of accounts are entitled to assume a business will continue in the future, unless there is evidence to the contrary. Public service bodies are presumed to be a going concern unless there is a clear parliamentary intention to discontinue an organisation service. Eighty seven per cent of respondents to Redmond thought the going concern assumption is meaningless in a local authority context, many citing the example of Northamptonshire County Council, which was deemed to be a going concern, even after the auditors had issued an advisory note on its undeliverable budget.

This nonsense Redmond wants to replace with a substantial test of an authority's financial resilience and sustainability. He acknowledges that expanding the scope of the audit will involve marginal costs but these need to be balanced against the benefits to all stakeholders and would be a 'genuine demonstration of public accountability.' Finally, he recommends shifting the annual reporting date to September to allow all of this to be manageable in practice.

Procurement and Audit Fees

The local audit market is not operating effectively, and procurement and the level of fees are a clear part of the deterioration evident since 2010 but exacerbated since the 2014 Local Accountability and Audit Act. Since 2015, fees paid by local authorities have dropped by 42.5 per cent and relative to fees in central government and the private sector. You would expect the audit companies to be unhappy, but 88 per cent of local authority respondents also thought the procurement process did not drive the right balance between cost reduction, quality of work, volume of external auditors and mix of staff undertaking the work.

It has proved a huge false economy. Audit completion has slowed down, audit quality has deteriorated, fee variations have increased, and there has been a serious loss of qualified staff. Less qualified staff are having to be employed and potential new accountants are finding other more lucrative branches of the profession.

Audit staff and audit examiners have less knowledge of local authorities and staff are spending too much time on less useful parts of the audit, such as fixed assets and pension valuations. Individual authorities cannot challenge their individual charges, despite this being an explicit function of the appointing person. PSAA, which performed this role for the majority of local authorities and FRAs up to 2018 (under a Memorandum of Understanding with MHCLG), claimed it did not have the expertise or resources for active contract management and simply did not fulfil its obligation. When the MoU came up for renewal in 2018, MHCLG negligently allowed this obligation to lapse.

Conclusion

Robust local audit is a fundamental building block for policy development, service delivery and for the assurance of the public that taxpayers' money is well spent. It forms a fundamental part of any performance management system, but it is not the whole system. Redmond is at pains to say he is not recreating the Audit Commission, and he is not. Prior to 2015, local audit was only one of the four roles the Audit Commission performed. It was the District Audit Service that performed the role recommended for OLAR.

District Audit was established as part of HMT in 1844 and became the Audit Commission's in-house audit practice in 1983, when the Commission was established. As part of the closure of the Commission, all local authority audits were outsourced from the 2012-13 financial year, with most staff transferring to the private sector accountancy firms, who took on responsibility for local audits.

Some of the changes Redmond recommends will require primary legislation. However, the fundamental importance of the audit to effective government, the origins of the system, and the universal view that it is not meeting anybody's interests, suggest that changes might not be too long in coming.

References

1. Kingman, J. (2018). Independent review of the Financial Reporting Council. London: HMSO.
2. NAO (2020) Local Authority Investment in Commercial Property. London: NAO.
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