

Speaking notes for C&AG presentation to PSAA Quality Forum

Overview:

- my role – and that of the National Audit Office on my behalf – what I do, but also what I don't do;
- the broader context of the financial sustainability of many local authorities;
- what's different about local audit and why quality matters;
- whether local auditors are having the impact that they should have – which in my view is the ultimate test of their effectiveness and so quality; and
- how the local audit market has been developing and potential threats to quality that are flashing warning lights to me and which all of us interested in audit quality should, in my view, be focusing on.

1) First a quick word about **my role** in relation to the audits of local public bodies ...

- Neither I nor the National Audit Office audits any individual local bodies. Local bodies are audited either by one of the firms appointed by Public Sector Audit Appointments or by a firm that they themselves have appointed on the advice of their auditor panel.
- My role is to develop and issue a Code of Audit Practice that auditors must follow. I also issue guidance to local auditors in support of the Code. In this way, I determine the standards and other requirements that local auditors must meet.
- But, neither I nor the NAO is responsible for monitoring the quality of the work done by local auditors. This is done by the Financial Reporting Council (the FRC's Audit Quality Review team), which monitors the quality of major audits. The Institute of Chartered Accountants in England and Wales (ICAEW) looks at the rest.
- Because I don't monitor the quality of auditors' work directly, my staff liaise closely with the audit regulators to understand what they are seeing on how well the firms are complying with the requirements I set out in the Code and in my guidance.
- Therefore, I am very interested in the quality of the work of local auditors. I am also very interested in potential threats to the quality of auditors' work – a theme to which I'll come back.
- In addition to my responsibility for the Code and guidance to local auditors, I have powers to carry out national studies across local government. These studies help me to examine, and report to Parliament, how government departments overseeing funding of local services are meeting their responsibilities. My studies across local government have highlighted the severe challenges and stresses faced by the sector which have increased not only the risks to local bodies but also to auditors.

- Audit quality is always important but concerns about the financial sustainability of the sector make it even more important.

2) So, by way of context to our debate today let's look at the **financial sustainability of local government**. My recently published report on this showed:

- Government funding for local authorities has fallen by nearly 50% in real terms from 2010-11 to 2017-18, with nearly a 30% real-terms reduction in so-called 'spending power' (government funding and council tax).
- At the same time local authorities have had to deal with growth in demand for key services, as well as absorbing other cost pressures.
- Demand has increased for homelessness services and adult and children's social care. From 2010-11 to 2016-17 the number of households assessed as homeless and entitled to temporary accommodation under the statutory homeless duty increased by over a third; the number of looked-after children grew by 11%; and the estimated number of people in need of care aged 65 and over increased by 14%.
- Local authorities have also faced other cost pressures, such as higher national insurance contributions, the apprenticeship levy and the National Living Wage.
- Given the scale of the challenges, local authorities have shifted from reducing spending on services to looking for other savings and sources of income, including in some cases looking for new revenue streams such as commercial trading profits.
- While authorities have protected spending on service areas such as adult and children's social care where they have significant statutory responsibilities, the amount they spend on areas that are more discretionary has fallen sharply.
- Overall, local authorities now spend less on services, and their spending is more concentrated on social care. Since 2010-11, spending on services has fallen by 19% in real terms. Social care now accounts for 54% of service spend, compared with 45% in 2010-11.
- Financial resilience varies between authorities, with some having substantially lower reserves than others. Levels of total reserves in social care authorities as a whole are higher now than in 2010-11. However, there is variation in individual authorities' ability to build up their reserves and differences in the rate at which they have begun to draw them down.
- Just under 11% of single-tier and county councils would have the equivalent of less than three years' worth of total reserves (earmarked and unallocated combined) if they continued to use their reserves at the rate they did in 2016-17.

These are clearly significant challenges for local authorities. But they are also issues that I would expect auditors to be thinking about very carefully. For example, auditors need to consider the implications for their work when faced by local bodies dealing with:

- reductions in funding and the consequential reshaping of services;
- difficult and often controversial decisions to set and deliver balanced budgets;

- the need to agree new priorities, transform organisations and manage change at a pace that can be very challenging;
- reduced capacity and capability, including in finance teams, making it harder to maintain good governance and effective financial management; or
- pressure to be more financially self-sufficient, sometimes pursuing riskier commercial opportunities in the hope of creating new revenue streams without necessarily having the skills or market knowledge to understand the long term uncertainties and risks that may arise from this.

Against this backdrop, there is an understandable expectation that local auditors – as office holders exercising important public functions – need to be alert to these risks and respond appropriately.

3) **What's different about local public audit and why does quality matter?**

- The stakes are high. We've seen how the financial sustainability pressures I have highlighted have impacted on local authorities. For Northamptonshire County Council, as presently constituted, it will most likely be terminal. There are real impacts on local services and how these are delivered, with significant implications for local people.
- So, the audit of bodies spending public money is not just another professional service – it must serve the public interest.
- Parliament has made it a statutory function that forms part of the overall arrangements by which those spending taxpayers' money are properly held to account for their stewardship of the funds entrusted to them. Special accountabilities attach to the use of public money and the conduct of public business.
- Nor is public audit simply analogous to the audits of companies – auditors of local public bodies report not only on the annual accounts but also their arrangements for securing value for money in the use of resources, including their financial sustainability. Auditors of local government bodies also have responsibilities arising from the rights of electors and local people to scrutinise local spending decisions.
- This means that the audit of a public body is wider in scope than private sector audit.
- And, crucially, public auditors must always keep in mind that they carry out their work on behalf of the public. This takes us to the heart of why quality in local public audit is so important.

What does quality in local audit look like?

- I take it as read that the statutory local public auditor must carry out their responsibilities in accordance with the law and with the Code of Audit Practice, which I am responsible for developing and which is itself secondary legislation approved by Parliament.
- The Code also requires auditors to meet relevant professional auditing and ethical standards issued by the Financial Reporting Council, and to have regard to the guidance that I issue in support of the Code.

But, to meet their legal and professional obligations, local public auditors must:

- maintain a healthy, professional scepticism. They need to have an enquiring mind and not accept what's presented to them at face value;
- carry out their work with integrity, objectivity and independence;
- be, and be seen to be, impartial. This means not doing other work for an audited body if that work would impair independence, or might reasonably be perceived as doing so;
- be based on a thorough understanding of those challenges and risks faced by local authorities which impact most on auditors' responsibilities;
- take a constructive approach to their work and engagement with the audited body. For example, the auditor should share and discuss their plan at an early stage with the audited body, and findings and recommendations should be relevant and timely; and
- report without fear or favour, in a timely, appropriate and effective way. Auditor reporting that has an impact is key.

4) **Local auditors' impact**

I am clear that the ultimate test of the effectiveness, and so quality, of local audit is what difference it makes.

And local auditors can only make a difference if their communications and reporting hit the mark, and, where necessary, are acted upon.

Let's go back to the example of Northamptonshire County Council. The severe financial challenges that have now come to a head didn't just appear overnight. There has been a recent history of developing problems:

- The local auditor repeatedly raised red flags which should have prompted serious consideration and action. For two years in a row the local auditor gave what's known as an 'adverse' conclusion on the council's arrangements to secure value for money because of the concerns about financial sustainability and significant shortcomings in the council's response to the problems it has been facing.
- The continuing lack of progress then led the council's treasurer to impose strict spending controls by issuing a section 114 report.
- When the council was set on a course to approve a budget that would not have dealt adequately with the financial problems faced by the council, and which the auditor believed would be unlawful, the auditor then had to escalate matters further by issuing an Advisory Notice, effectively requiring the council to reconsider its budget. It then did so, approving changes to the budget.

You might say that all this shows that the system works – repeated warnings ignored, but then leading to an escalation of statutory reporting by the treasurer and the auditor. The appointment of a Best Value Inspector, in part justified by the concerns raised by the auditor, finally leading to action – albeit drastic action. And, to an extent you'd be right.

But, why didn't the council itself act earlier, and why were the auditor's concerns not acted upon? In the words of the Best Value Inspector:

*'... for two successive years the ... external auditor ... recorded an adverse opinion on NCC's arrangements for value for money. ... **Neither of these reports seemed to trouble NCC.** Initially, the judgment for 2015/16 was reported to the Audit Committee as is normal,*

*but did not result in an officer report setting out a reaction. The minutes of the Audit Committee were reported to full Council and the externally appointed Chair of the Committee spoke to the minutes but **no action appeared to follow, scrutiny did not pick this up nor did Cabinet consider the matter.***

Of course, this raises questions not only about the impact of the auditor's reporting but also the governance of the council and the role of its audit committee. If independent public audit is to have the impact that it needs, it has to be taken seriously by those charged with governance. Any adverse report by an auditor would be a very serious matter in the private sector.

And, qualified auditor conclusions on vfm arrangements are becoming less rare than they used to be.

Across local government:

- For 2016-17, there have been over 30 qualified vfm arrangements conclusions (approximately 7%). Four were 'adverse' conclusions (Avon Fire and Rescue, Birmingham City Council, Bristol City Council and Northamptonshire County Council)

And, looking at the health sector,

- For the same year, over half of NHS trusts received qualified vfm arrangements conclusions from their auditors.
- Most reflected concerns about financial sustainability.

Auditors tell us that little action is being taken as result of qualifications or concerns raised with those charged with governance, which suggests the indifference at Northamptonshire County Council described by the inspector may not be unique to that council.

So what needs to happen to ensure that local auditors' reporting has the impact that it should have?

- auditors have to report clearly, effectively and on a timely basis; but also
- those charged with governance (including audit committees) need to take note and act on audit reports – I think others may say more about the role of audit committees today; and
- there is a key role here for CIPFA and others, including perhaps the Local Government Association, to provide guidance and support to local government audit committee members to help them be as effective as possible in their role.

But, it's also fair to ask whether there is more that the NAO can do to reinforce the importance of auditor reporting. I think there is. Through our national studies we:

- look across the sector to highlight challenges – my reports on financial sustainability are a good example. But we could look at the broader governance arrangements across the sector; and
- help Parliament to hold central government departments to account. Government departments have *accountability system statements* that say they rely on the work of local auditors. We challenge departments by asking how they make use of the work

and findings of local auditors, how they act in the event of any significant failings that are identified. It is fair to say that there is more that government can and should do to draw on the work of local public audit.

But the NAO itself could also make more of local auditors' findings and reporting to inform our national reporting. That's something I am interested in exploring further.

We will also be developing a new Code of Audit Practice for 2020. That gives us the opportunity to look at how the impact of auditor reporting can be improved so that it prompts appropriate responses and has greater impact.

5) How **the local audit market** has been developing **and potential threats to quality**

- To ensure that you have local auditors with the skills, expertise and resources to have the impact that, in the public interest, they need to have, you need a healthy audit supplier market.
- Historically, there has been a mixed supply including a long period when the former Audit Commission's in-house audit practice operated alongside firms appointed by the Commission. Although some were critical of the dominant position that the Commission itself held it is fair to say that the Commission worked to ensure that local audit work was sufficiently attractive to a range of audit firms, with no single firm dominant, who were then willing to invest in this work.
- However, recent procurement exercises, in the latter days of the Commission and culminating in the most recent exercise by PSAA, have seen developments in the market which could have implications for the future health of the local audit supply market.
- Take audit fees. I am not surprised that many in the sector – and not just the audit profession – have queried how quality, and future investment in local audit, can be maintained at present fee levels. This is one of the reasons why many agree that focusing on local audit quality – as today's event demonstrates – is so important.
- Fees have been coming down significantly:
 - From 2012-13 a 40% reduction
 - From 2015-16 a 25% reduction
 - And from 2018-19 a 23% reduction
- I wouldn't be surprised if these reductions can be explained by a combination of factors including:
 - no longer needing to fund a range of Audit Commission activities,
 - the lower costs of PSAA,
 - the impact on pension costs of transferring staff from the Commission to the firms,
 - economies of scale for firms looking to secure a significant share of the local audit market,
 - audit efficiency gains, and

- the likely lower profit expectations of the firms - partly due to wider market trends and pressures over the last few years.
- While savings in fees are welcome to hard-pressed authorities paying them, we need to think about the longer term implications.
- I can't evaluate this, but the contributions that firms can now achieve from local audit work to their overheads are likely to be small by historical or long term measures.
- This is happening at a time when firms' margins are also being squeezed in private sector auditing – partly due to the impact of mandatory auditor rotations and the pressures to bid low to maintain or secure work. Opportunities to cross-subsidise local audit work from corporate work are likely to be much more constrained now.
- Of course, the firms have bid at these prices to do a quality audit consistent with professional and legal requirements. But low margins have an impact – they make local audit work less attractive, make it harder to draw the best people into this work, and limit investment in improving skills and technology to improve the effectiveness and impact of audit.
- By the way, some might be tempted to say that the problem could be eased by reducing the scope of the work that auditors need to do. But it won't surprise you to know that I do not intend to lower the bar that I set through the Code of Audit Practice. The standards required of local auditors need to be appropriately high to recognise the need for this work to meet the public interest.
- Another indicator of a healthy audit supplier market is that there are a range of suppliers with sufficient market share.
- But we are seeing market concentration:
 - From 2018/19, 70% of audits of local government bodies will be carried out by just two firms – Grant Thornton (40%) and Ernst and Young (30%). The remaining 30% is split between Mazars (18%), BDO (6%) and Deloitte (6%).
 - Previously, the top three in this market were KPMG, GT and EY each with approximately 30%, with other auditors sharing the remaining 10%.
 - Two of the Big 4 firms have left the market. KPMG was unsuccessful in the most recent procurement and PwC did not bid having lost out in the previous procurement too.
- I am not commenting on the quality of the work of individual firms. But if there are firms that are no longer finding local audit work sufficiently attractive, or if there are fewer suppliers, there is a risk that there will be less incentive to develop the audit approach or to invest in the skills needed to deliver the quality that we should expect of local public audit. As I said earlier, this isn't just another professional service but a public function that needs to act effectively in the public interest.
- This should be a key concern for all of us.

Summing up

Thank you for the opportunity to be with you today. I hope I have helped to prompt some debate by sharing my views on:

- why public audit matters;
- the challenges presented to local bodies and their auditors, including those arising from pressures impacting on the financial sustainability of many local authorities;
- the need for local auditors' reporting to have the impact and make a difference, and the role of all of us in supporting this; and
- how the local audit market has been developing and potential threats to quality arising from reductions in fees and market concentration.