Levelling Up Committee inquiry on local audit

To: Chair of the Levelling Up, Housing and Communities Committee

Cc: Clerk of the Levelling Up, Housing and Communities Committee

Email: luhccom@parliament.uk

Date: 22 June 2023

Dear Sirs

ICAS comments on the inquiry on local audit

We note that the above inquiry's request for written submissions has closed but we were not on the circulation list and were unaware of the inquiry in time to submit a response. Please accept our apologies for the lateness of this submission.

This is an important area for parliamentary review and as the topic is of public interest and relevance to our members, we have some points to share which we hope will be useful to the inquiry.

Although we understand that the prime focus of the inquiry is English local audit, and ICAS does not hold Recognised Supervisory Body (RSB) status for Local Audit in England (since 2021), we note that some of the content of the inquiry has wider UK relevance and as over half of our membership is in England, the topic is of interest. We suggest that the following key points may be relevant for the Committee's consideration.

Comparative practice

Cross-jurisdictional practice may offer useful comparisons and contribute a broader range of evidence – the accounts and audit backlogs experienced in English local audit are not as severe in Scotland and Wales. Governance arrangements vary and other jurisdictions still rely on a central audit body so are well placed to comment on what works well.

The audit and financial reporting arrangements has UK-wide relevance. We have outlined our key points below.

Financial reporting

Fundamentally, producing audited financial statements for local authorities (LAs) is important not only for public stewardship duties, accounting for the raising and spending of public money, but also for accountability as local authorities are democratically accountable to their local communities to deliver public services, raise local taxes and charge fees.

Compliance with IFRS is important as LAs consolidate into the Whole of Government Accounts (WGA). There may be potential to help mitigate the backlog of publishing audited local authority accounts through streamlining of the accounts disclosures. We suggest that the existing framework can be adapted to be more proportionate for different sizes of authorities. FRS 101 is a reduced disclosure framework and would align better with IFRS, better supporting consolidation than FRS 102 for smaller authorities.

Whilst work has been undertaken to try to increase understanding of the users of local authority accounts, we believe that a pragmatic approach would be to assume that most readers have a general understanding of accounts. This is hindered by the sector specialisms which are partly driven by the legislation and only fully understood by a small proportion of specialists. This is inconsistent with the principle of transparency and need to be locally democratically accountable.

There is potential for streamlining local authority accounts which would benefit preparers, auditors and users of the accounts. A key obstacle is the statutory framework which drives divergence from international standards, increasing specialisation and reducing understandability. The legislation should be revised to separate the funding and financial reporting duties (see Annex A for further information). This connection pre-dates the implementation of IFRS and is an anachronism.

The impact is that to manage the existing dual purpose of the accounts, a separate and complex statement particular to local authorities is produced (movement in reserves) to make material adjustments to the balances (sometimes in £millions). This also affects the commentary on the council's financial position by the Director of Finance which comments on the lower adjusted (statutory) position not the higher, true cost of providing services as per the accounting based I&E which is the norm for other sectors.

This results in obfuscation of the true cost of services and financial position. We believe it would be more meaningful for the Finance Director to comment on the true cost of services, which would be the focus if the statutory drivers for conflating accounts with the council tax position are removed.

A long-term action to amend the legislation to remove statutory adjustments is needed to enable a step change in local authority accounts (for improved streamlining and understanding).

Annual report

There is currently no legislative requirement for local authorities to produce an annual report. We believe this would help to achieve greater consistency and consolidate key messages from the various performance information which many authorities produce. It would also help local authorities communicate their achievements and challenges to the local communities; explain how services are being resourced and any financial constraints.

A high-level picture of the finances and performance (both narrative and quantitative) would also be easier for a wider range of readers to understand. As an additional document, this would need to be balanced against reducing content within the existing accounts and streamlining existing performance publications/ reports. Greater use of online links for the detail would help to focus the published narrative and financial reports on the key messages.

Audit

In the context of severe delays, we caution against messages that audit is dispensable. Exempting audit is not the answer. A pragmatic option for auditors may be to have a hard deadline, qualify and move on. The consensus from our members is that audit firms have a contract and priority should be given to fulfilling it. If information from the local authority is insufficient, then a hard deadline is needed to allow the process to move on and minimise untimely and out of date balances.

We agree that audit focus should be more aligned with the risks and note that the FRC quality inspection can be heavy and disproportionate. This can drive greater audit time on areas of the accounts than needed from a risk assessment perspective. An example is pensions which appears lower risk within a single local authority as it is part of a national pension scheme. Greater flexibility is needed to promote efficient and effective use of audit resources.

Responsibilities of accounts preparers and finance teams

Responsibility for an adequate internal control framework and preparing a set of quality accounts and working papers lies with the Finance Director (or equivalent). In cases where financial reporting or quality standards have not been met, significant problems arise, concerns about significant control failures are reported etc. there needs to be clear consequences related to those charged with the responsibility. Some concerns have been raised that where standards have not been met, there is insufficient remedial action or consequences to drive improvements.

Comparatively, we note that in Scotland, although no sanctions exist, some effective controls and deterrents are available, including:

a. Audit Scotland will publish Section 22 reports if they have concerns.
b. The Accounts Commission is appointed by the Scottish Parliament but is an independent body. They have a role to challenge and hold local authorities to account and can investigate if concerns are raised, publishing their findings and conclusions in a report as a matter of public interest.
c. Audit reporting:
    - Auditors submit the Annual Audit Report to Audit Scotland which includes a section on the quality of working papers, governance and accounts. If these are poor, it is raised in the Annual Audit Report and published.
    - Audit Scotland may also raise this in their overview report and report to the Accounts Commission.

A fragmented landscape

There is no clear system leader to provide an overview of the public sector financial reporting and audit landscape in England, from the initial standard setting stage to preparation and publication of audited accounts. This risks creating gaps and weakening scrutiny. For example, the NAO focuses on audit guidance but may be unlikely to intervene on governance matters. The PSAA focuses on audit appointments only, CIPFA LASAAC prepares the Code and FRAB has a high-level overview which is above the level of detailed scrutiny it may apply for WGA. There is no overview of local government accounts and performance as exists at Audit Scotland and their mechanisms for raising concerns.

The Audit Commission provided both an overview and market for public sector auditors which could attract recruits seeking a varied audit career and provide auditors of last resort. Arguably, the scale of late financial statements may have been identified and actioned earlier if a central audit body still existed. We suggest that an independent review of closing the Audit Commission would be useful to understand the impact of this decision, to review gaps, needs, costs and benefit of an Audit Commission type body. This can be informed by comparisons with other jurisdictions. A potential benefit could be to provide greater resilience for audit services. A replacement body would likely have different powers and responsibilities from the original. It is recognised that in the current context, staffing is likely to be challenging but the decision would need to take long-term perspective.

We hope this is helpful to your inquiry.

Please do not hesitate to contact us if you have any questions.

Yours sincerely

Alice Telfer

Head of Business Policy and Public Sector

Email: atelfer@icas.com

or if out of office: schisnall@icas.com

ANNEX A

Further explanation of statutory mitigations

The root cause of much of the accounting specialisms in local authority accounts is the Local Government Finance Act 1992 (Section 93) which requires local authorities when setting a budget to take into account *"any means by which those expenses may otherwise be met or provided for"* (paragraph 4). This includes ‘reserves brought forward’. As a result, the accounts contain both the IFRS-compliant numbers and the carried forward Reserves balance which is required under statute to be taken into account for the council tax calculation (and housing rent setting). This carried forward balance used in the council tax calculation is known as the General Fund.

Various statutory adjustments are made to the figures appearing in the IFRS accounts to transfer components to an Unusable Reserves balance to leave the identifiable General Fund. This dual purpose means that certain costs which one would expect to see in an Income and Expenditure Account such as depreciation and certain anticipated pensions costs, are removed using a series of statutory accounting adjustments so that they do not affect the bottom line, which is used to show the council tax funding requirement. The adjustments are recorded in the reserves statement and referred to as "adjustments between the accounting and funding basis".

There are multiple adjustments which have accumulated over time which increases the financial impact on the accounts.