

Audit - the next generation

By Vivienne Russell 1 September 2011, Public Finance

The abolition of the Audit Commission is going to change the shape of public sector audit forever but many questions are still unanswered. PF looks at what the future holds and talks exclusively to the outgoing chair and chief executive

Getting rid of the Audit Commission is proving to be no easy feat. Over the past year, Local Government Secretary Eric Pickles and his lieutenant Grant Shapps have been caught up in wrangles over the costs and savings of the abolition and had to defend themselves in front of a select committee inquiry. At the same time, commission chair Michael O'Higgins has been angrily deflecting a slew of government criticisms over 'frivolous' spending on days at the races and floral arrangements.

A year on from the shock announcement that it would be abolished, the commission has been shorn of many of its 2,000 staff (600 have been made redundant, and a further 200 are on notice) but the audit practice remains, and therein lies the difficulty.

To further the government's localism aims and open up the relatively small public sector audit market, ministers plan to transfer the power to appoint auditors away from the commission to audited bodies themselves. But they cannot do so until the necessary legislation has been passed. In the meantime, local public bodies still require auditing, and one of the big decisions ministers have had to make is what to do with the 900 public auditors working in the commission's in-house practice. This currently carries out 70% of local audits, with the remaining 30% split between five private firms (Deloitte, Grant Thornton, KPMG, PKF and PricewaterhouseCoopers), which are appointed by the commission.

At the end of July it was announced that from 2012/13 the public audits carried out by the commission would be outsourced to private firms and the audit practice staff would transfer, along with their work, to the successful bidders under Transfer of Undertakings – Tupe – regulations. What remained of the commission would evolve into a small, residual body to manage these contracts until the legislation on auditor -appointment had been enacted.

Aside from these practical issues, the debate over the underlying principles of the government's plans is by no means over. Indeed, with Parliament not yet given a chance to debate the issues, some would say it hasn't even begun. A Department for Communities and Local Government consultation on the future of public audit closed at the end of June, and stakeholders await the government's response. But for some, including the commission itself, this failed to even ask the right questions.

In an exclusive, joint interview with Public Finance, Michael O'Higgins and chief executive Eugene Sullivan shared some of their concerns about the future of local public audit.

Chief among these is auditor -independence, a principle the -commission vociferously defends. Its response to the DCLG's consultation warned that removing independent appointment risked undermining public confidence in the stewardship of public money.

O'Higgins expands on this, telling PF: 'I think, as a taxpayer, it's important that my council can't choose who's going to check on whether it's spending correctly. If anything, the arguments from the financial services crisis of recent years point away from organisations, not just councils, being able to appoint their own auditors towards some sort of -independent appointment.'

Sullivan adds: 'It's important to note that Parliament hasn't had the opportunity to debate this, and experience tells us it is an important issue to Parliament.'

CIPFA, too, believes that -independence of audit appointments is one of the fundamental principles of public audit. Ian Carruthers, CIPFA's policy and technical director, says the spending of public money requires a higher degree of accountability 'so you have to have that clear independence from the organisation being audited'. He adds: 'If you're going to move away from appointment by the commission, you need a process that demonstrably ensures audit independence.'

Views among the commission's private sector partners are mixed. For some, allowing local authorities to appoint their own auditors is long overdue. Mike McDonagh, public sector audit partner at KPMG, hails the move a 'good thing'. He points out that many councils are large organisations with sophisticated senior staff. 'It's an anomaly across the audit world that this is a sector that has never appointed its own auditors. If you look at some local authorities, say Birmingham or Leeds, their turnover is into the billions. They are the equivalent of big, private sector organisations. Why can't they appoint their own auditors?'

Sarah Isted, partner in PwC's government and public sector assurance practice, also supports the plan. She says allowing audited bodies to choose their own auditors is in line with ministers' drive towards greater accountability in the public sector. It will build public trust as well as helping audited bodies deliver value for money, she adds.

'In the commercial sector, we see that organisations place greater value on the audit itself and what the audit can provide. With organisations able to select their own auditors and engage with them more than they've been able to do up to now, that will drive value for money.'

Others disagree. 'There is a net benefit to having independent appointment,' says Sarah Howard, partner and head of government audit at Grant Thornton.

'Although we would encourage a greater say for local government in auditor appointment and what the scope of the audit looks like, fundamentally we would support an independent appointment.

'There are benefits to local authorities. It's a more efficient procurement process and it gives them maximum protection in terms of knowing that the appointment is independent.'

Doubts about the loss of independent appointment are also expressed by partners at Deloitte and PKF. Nigel Johnson, lead public sector audit partner at Deloitte, says: 'We are concerned that, in extreme cases – and examples exist over the past ten or 15 years – auditors have found themselves in a difficult position, doing work that is critical of members or officers... There is a risk that if you are appointed and being paid by that body without anybody standing behind you then pressure is brought to bear not to pursue that matter.'

For Richard Bint, audit partner at PKF, the appointment of auditors by the commission 'works quite well'. There is a need for robust independence, he says, so that 'you don't have the auditors appointed by the leader of the council, or the chief executive, almost on their own, and even more importantly, that those people on their own are not able to sack their auditors', he says.

Both McDonagh and Isted make the point that other public sector organisations, such as housing associations, universities and NHS foundation trusts, already appoint their own auditors. They ask why this shouldn't apply to councils and other local bodies that come under the commission's regime. But put this point to O'Higgins and he responds that there hasn't been a single Public Interest Report issued against a foundation trust since the bodies were created. 'You can draw your own conclusions from that,' he says.

He adds that anyway the DCLG is -proposing that auditors are appointed not by councils but by their audit committees. These would be chaired and dominated by unelected people, -independent of the authority itself. 'You've got to find, in over 400 local authorities, enough people, living locally, who can be members of those audit committees and who will in effect be taking decisions that at the moment councillors believe they're going to be taking. I suspect that as the realisation of the implications of this begins to percolate that there will be some further iterations to try and find an acceptable solution.'

There is certainly little local -government support for the idea of independent audit committee chairs and members. It wants democratically accountable councillors to be in the vanguard.

Dennis Skinner, head of leadership and productivity at the Local Government Group, says: 'We think the proposal runs counter to the whole localism approach. Councils already often have audit committees chaired by opposition councillors. Allowing councils to use their own audit committees, making sure

the process of appointment is open and transparent we believe is sufficient, rather than setting up a committee chaired by someone independent of the council and with a majority of members independent of the council. We think that councils should have much more say in the [auditor] appointment process.'

At Grant Thornton, Howard -questions whether appointment by a largely - unelected audit committee is really any more local than having the commission take the decision. Deloitte's Johnson also wonders whether there are 'enough people out there good enough and interested enough to take on those independent audit -committee roles'.

Without a central body managing the appointments process there are also concerns about what will happen to fees, particularly for smaller authorities in remote areas, which are less attractive to audit firms. The current process allows the -commission to manage the distribution of work, ensuring a fair spread of urban and rural authorities and regular rotation of firms and even teams within firms.

O'Higgins says: 'At the moment, if we want to put someone into a remote area we can give them several contracts so it's worth them having a presence in the Southwest or the Northeast. But doing an individual contract in one of the more remote areas would make it quite a lot more expensive, so you may not see an average increase or decrease in fees, but quite variable changes.'

CIPFA agrees that fee variation is a real risk. 'Any move away from a Post Office pricing approach is going to mean there are winners and losers,' says Carruthers. 'The larger, more prestigious authorities will be the ones that are going to benefit, whereas the smaller ones, particularly if they're geographically far flung, may well have more problems.'

At KPMG, McDonagh is confident that audit fees for the vast majority of authorities will fall. 'You will get the anomaly where you have an authority in a geographically distant part of the UK that will make it a little bit more expensive to service, but I think fees will come down for the core cities, metropolitan authorities, London boroughs and also the district councils.'

Nor is he fazed by the prospect of pitching to potentially hundreds of new clients. 'It's no different to what we do all the time... Yes, there's a cost associated with it, but it's a cost of business for us. We see no downside in going out to the market and competing.'

PwC's Isted notes that firms pass on a proportion of their fee to the commission to fund its national programmes but in the future 'they wouldn't have to do that anymore', she says. 'If there were additional costs [to firms] in terms of bidding, I suspect it would be cheaper overall.'

The private firms are unanimous in welcoming the opening up of the public sector audit market. While some are already clearly stating that they plan to bid

for more work, a lot depends on the shape of the tender and the size of the lots, and, of course, there are the costs of transferring staff to price in.

Johnson remarks: 'We know that some of [the Audit Commission staff's] benefit arrangements are pretty attractive and we probably don't have comparable arrangements. That is a feature that I'm sure will exercise the minds of any potential bidder: what those terms and conditions are and how they can assimilate people on those terms and conditions and end up making a viable bid.'

Bint at PKF says potential pension costs are the biggest issue. 'Not necessarily the regular contributions but the potential open-ended chequebook required for future deficits in the scheme. We'll be looking very carefully to see how the invitation to tender deals with that issue.'

The period immediately following the abolition announcement was characterised by some bitter exchanges between Pickles and the commission over allegations of irresponsible spending, chiefly the use of conference facilities at Newmarket racetrack for technical briefings.

O'Higgins says: 'We sought to distinguish between our agreement that the secretary of state [was] allowed to do as he wished with the structures around him, and our disagreement with some of the inaccurate comments about the incommision and about our staff.'

He and Sullivan agree that, after this difficult start, relations with the DCLG are now 'very good' and both parties are working closely together on -arrangements for a post-commission world.

But even after a year, unanswered questions persist. For Sullivan, winding up the -commission is about more than transferring its audit work to the private sector.

He tells PF that more thought needs to be given to the gap that is created once the commission has gone. 'There are things that we do that are not as obvious to people that will be missed,' he says.

Who, for example, will collate the data from annual audits to give an overview of how authorities are performing? Who will provide assurance to accounting officers in Whitehall departments, to Parliament and to the comptroller and auditor general? Who will intervene in failing authorities and in those with financial resilience problems?

'It needs a lot of careful thought,' says Sullivan.

And what of the wisdom of junking the commission's inspection function and national studies programme at a time of unprecedented council budget cuts?

O'Higgins says the vacuum could be filled by the Local Government Group. 'The issue is always going to be, are there things that they as a membership organisation can't say that we would have been able to say. And what if the areas of bad practice are from authorities that have chosen not to be members of the LGG? What influence can you have on those people?'

O'Higgins reveals that, ahead of the abolition, the commission's board was considering whether to sell or transfer some or all of the audit practice to the private sector. The 30% share of work for private firms, is 'just the way it's panned out', he says. 'There's nothing inviolate about that.'

As chair, O'Higgins was planning to take soundings from the private sector to see what interest there was for taking on a greater proportion of public audit work, but the abolition -announcement stopped this process in its tracks.

The District Audit service, founded in 1844, has a long and distinguished history, but its break-up now looks inevitable, given the government's outsourcing proposals. It's difficult to see how it can survive intact, despite ministers, the commission itself, the staff union and the communities and local government select committee all saying they'd like this to happen. The procurement will need to abide by strict European Union rules.

Senior commission staff have confirmed that they are planning to bid for some of the outsourced work on behalf of an employee-owned successor. But a bid from such a mutual couldn't be favoured over those from rival firms.

Loss of the audit practice is a matter of regret for Sullivan. 'Something as distinctive as what was District Audit and had been around for a long time needs to be modernised maybe [but] I still think it's got a value, and as a public servant working in this regime I would regret its loss.'

Both chair and chief executive confirm that planning for the residual body that will hold and manage the private sector's audit contracts has begun 'but it will be for the DCLG and ministers to decide the shape of it', says O'Higgins.

Sullivan explains: 'We're going to design the small body to be fit for purpose. We don't want it to be just what's left...' – 'after everything else has been chopped!' O'Higgins chips in with some black humour.

And so, a year after the abolition announcement, life at the commission goes on. There is still much to do. Senior managers have to put their minds to the twin challenges of outsourcing millions of pounds worth of professional services and transforming into a smaller and leaner successor body to oversee audit appointments for at least the next three years, perhaps longer.

If this successor body is still working beyond the next general election, and working well, who can say what a new -government might choose to do with it?