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Levelling Up, Housing and Communities Committee

Financial Reporting and Audit in Local Authorities: Government Response to the Committee's First Report

First Special Report of Session 2023–24

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Levelling Up, Housing and Communities Committee

The Levelling Up, Housing and Communities Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Levelling Up, Housing and Communities.

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First Special Report

The Levelling Up, Housing and Communities Committee published its First Report *Financial Reporting and Audit in Local Authorities* (HC 59) on 24 November 2023. The Government's response was received on 25 January 2024 and is appended below.

Appendix: Government Resposne

Introduction

The government welcomes the Levelling Up, Housing and Communities Committee's report into Financial Reporting and Audit in Local Authorities. We recognise the vital role played by accurate financial information and effective audit to local authorities' ability to plan, make informed decisions and run their services. Moreover, high-quality and timely financial reporting which has been subject to external audit is essential to maintaining public confidence in transparent and accountable local democracy. The Select Committee hearings were an excellent opportunity to bring together senior stakeholders from across the sector to discuss the current audit system and its challenges.

As the letter from Simon Hoare MP, Minister for Local Government, to the Committee Chair on 09 January 2024 set out, extensive work has taken place with system partners to develop proposals to clear the backlog of outstanding audits of local bodies in England[1]. These proposals include setting an initial backstop date for local authorities and auditors of 30 September 2024 for all outstanding local audits up to and including the financial year 2022–23. The proposals will be subject to consultation in early February, and we will reflect on responses to test and develop the plans.

Clearing the backlog is a key priority, but we recognise the need to ensure that the system is on a more sustainable footing for the long-term. The Committee's report makes many astute recommendations about ways in which the value and effectiveness of local authority financial reporting and audit can be improved, and we will ensure these are taken on board as we consider long-term reforms, including as set out below.

Government Response to Recommendations

Primary issues with local authority accounts and audit

> (Paragraph 47) **Recommendation 1** - The Government must ensure that the purposes of local authority accounts are clearly set out in government policy and accessible to all relevant stakeholders. This should be done before the next accounts production cycle for the year ended 31 March 2024.

> (Paragraph 48) **Recommendation 2** - The Government must also coordinate with key stakeholders in the sector, including the Chartered Institute for Public Finance and Accountancy and the local audit system leader, to

1 Local government bodies in England comprise local authorities, local police bodies, local fire bodies and other bodies (combined authorities, functional bodies, local transport, national parks authorities, pensions authorities and waste disposal authorities).

> ensure that the production, content and format of local authority accounts are aligned with the agreed purposes of local authority accounts; and it must report back to us at least annually on its progress in this area.

We are grateful to the Committee's recommendations on the purposes of local authority accounts and agree that it would be beneficial to clearly set these out in a single place. The purposes the Committee set out are a helpful starting point which will inform system partners' work on long-term reform. Adopting the specific purposes, or a variation on them, that the Committee has proposed, would need to be done in conjunction with the Chartered Institute of Public and Financial Accounting (CIPFA) as the body responsible for the 'Code of Practice on Local Authority Accounting' (the Accounting Code) and with the Financial Reporting Council (FRC) as incoming shadow system leader for local audit in England. We believe CIPFA's Accounting Code is the appropriate vehicle for articulating these purposes but we agree there is merit in the Committee's recommendation for the Department to issue a policy statement clearly setting these purposes out. CIPFA consider changes to the Accounting Code a year ahead of the year any changes would be applied to allow for a period of transition. As such, CIPFA has now consulted on changes ahead of the next version of the Code and therefore will not consult on further long-term changes ahead of the next accounts production cycle. CIPFA will consider the Committee's proposals as part of their work to develop future versions of the Accounting Code which will be consulted on and published ahead of the 2025–26 financial year.

The content and format of local authority accounts are produced in accordance with the Accounting Code. The government agrees that the Accounting Code should, in practice, lead to accounts that meet the needs of the user and, following recommendation 1, reflect the stated purposes of the accounts. Our immediate priority is clearing the backlog and, reflecting the importance that any policy statement aligns with CIPFA's Accounting Code, we need to ensure this work is sequenced appropriately. Once the purposes of the accounts are clearly articulated in the Code, and a Departmental policy statement, the Department will work with CIPFA and the FRC to ensure that the requirements and practices set out in the Accounting Code are aligned and consistent with the purposes set out. We will work with CIPFA to report back to the Committee on the progress of this work and, in line with CIPFA's production cycle, will provide the Committee with an update ahead of the consultation process on the Code ahead of the 2025–26 financial year.

> (Paragraph 57) **Recommendation 3** – Through coordination with the Chartered Institute of Public Finance and Accountancy, the Department for Levelling Up, Housing and Communities must make the Accounting Code freely available to all possible users of local authority accounts before the next accounts production cycle for the year ended 31 March 2024. Once this has been achieved, the Department should set out its assessment of what else it can do to encourage the use of the Accounting Code as a central, authoritative, and accessible document that meets the needs of all possible users of local authority accounts.

The Accounting Code is produced by CIPFA, an independent body which sets the principles and practices of accounting required to prepare financial statements which give a true and fair view of the financial position and transactions of a local authority. Chief Financial Officers in local authorities are responsible for ensuring they comply with the Accounting Code and all local bodies receive public funding which can be utilised to support the production and audit of their annual accounts in line with CIPFA's Accounting Code. We accept it may be beneficial to consider what else can be done to encourage the use of the Accounting Code and will consider this alongside CIPFA as it takes steps to reform local authority financial reporting.

The current audit crisis

(Paragraph 74) **Recommendation 4** – The Department must move quickly to clear the audit backlog and implement its proposed actions by the end of the calendar year 2023. Until the actions have been fully implemented, the Department should provide us with updates on its progress every four months. In addition, the Department should ensure that, when auditors qualify or disclaim the audit opinions on delayed audits, the accompanying commentary should be clear whether the local authorities are at fault and whether the audit has given any indication of financial failings or distress at those authorities.

We are working to clear the unprecedented backlog and our consultation on proposals will begin in early February. This has been detailed and complex work, balancing various imperatives across the system. We have engaged with stakeholders across the sector and have developed a proposal that has the agreement of all system partners. We will continue to provide updates to the Committee on progress at key junctures.

Auditors are already required under International Standards on Auditing (UK) to outline the reason for any modified opinions. System partners, including the FRC as the body which develops and maintain auditing standards within the UK, recognise the importance of communicating the reasons behind an issuance of any modified opinion and will be supporting stakeholders in understanding the different types of opinions which can be issued and what they mean. The NAO is responsible for providing guidance to auditors on the way in which auditors report and will shortly be consulting on a revised Code of Audit Practice. Auditors' statutory duty to report on value for money arrangements and their statutory audit powers (such as the power to make statutory recommendations or produce Public Interest Reports where necessary) are an important mechanism for assurance and for identifying areas of concern at an early stage, allowing councils to address them. Under the government's proposals this will remain a high priority. While timeliness has long been a requirement of the Code, and there are already mechanisms by which auditors can flag concerns about financial failings, the forthcoming NAO consultation proposes further measures to make reporting on local bodies' arrangements to secure value for money more timely.

We recognise that the proposal to introduce a backstop will result in a number of disclaimers or qualifications, and we are considering with system partners how best to ensure consistent messaging to explain that these opinions have been issued in the context of a system-wide process to clear the backlog and are not necessarily the fault of local authorities.

We remain committed to exploring how greater measures of transparency concerning audit delays could influence behaviours across the local audit system. While mechanisms such as specifically identifying fault as the Committee propose may (and already do in some respects as outlined above) have a role to play, such approaches need to be carefully considered to avoid unwarranted and unforeseen consequences. Therefore, this area requires additional time and collaboration, with input from all parts of the local audit system for full consideration and we will keep this recommendation under review.

> (Paragraph 80) **Recommendation 5** – The Department must introduce backstop dates for publishing audited local authority accounts on an annual basis going forwards. The Department must also ensure that, if an authority and its auditors do not collectively produce audited accounts by the backstop date in a given year, then the Section 151 Officer of the authority (and other responsible individuals such as the auditor's Key Audit Partner) must immediately write to the Secretary of State for Levelling Up, Housing and Communities, to us, and to the authority's council to explain why the audit could not be completed. The relevant recipients of the correspondence from the Section 151 Officer should then pursue any follow-up action as is necessary. The introduction of these backstop dates should be done alongside the Department's implementation of its statement of proposals to clear the backlog, with a suitable annual backstop date chosen by the end of the calendar year.

The proposals to clear the backlog, on which we will be consulting, will include statutory backstop dates for both outstanding historic years and the duration of the next five years to support the recovery. Our immediate priority must remain clearing the backlog, however, the government agrees with the Committee that important questions concerning systemic challenges must be addressed and as part of this we will consider the desirability of backstop dates becoming a permanent feature of the local audit process. In the immediate term, the FRC, in its role as incoming shadow system leader, is developing an escalated reporting framework for identification of bodies at risk of missing the backstop date. We have also already committed in the July 2023 cross-system statement to publish a list of authorities and their auditors that have not published audited accounts on time.

We agree with the Committee that it is important that Section 151 Officers and the auditor's Key Audit Partner should keep their council updated on the work to produce audited accounts by the backstop dates and would expect Section 151 Officers to notify the council leadership of any issues with the audit, including where audits could not be completed. We are confident that there are already mechanisms in place for the Department to be kept updated on the situation and are mindful not to unnecessarily introduce administrative requirements on S151 Officers.

As stated previously, we remain committed to exploring how greater measures of transparency concerning audit delays could influence behaviours across the local audit system, including the mechanisms proposed by the Committee. The government's priority is to continue to work with all local audit stakeholders to clear the backlog of local audit opinions, but we will work with system partners to keep options for introducing incentives and sanctions under review.

> (Paragraph 92) **Recommendation 6** – The Government must reconsider its plan to combine the local audit system leader with the new audit regulator, ARGA. Specifically, the Government must, in coordination with the FRC, which currently has shadow system leader responsibility, introduce legislation to create a new body to manage, oversee and regulate local audit

> in line with the recommendations put forward by the Redmond Review. The new body must be sponsored by, and directly accountable to, the Department for Levelling Up, Housing and Communities. The legislation to establish this body should be introduced as soon as possible in the 2023–24 session of Parliament.

As the Committee will be aware, Sir Tony Redmond's 'Independent review of local authority financial reporting and external audit' recommended the establishment of a new independent regulator for local audit. The aim of this central proposal was to overcome fragmentation in the local audit framework, enabling a coordinated response to challenges arising. As set out in our May 2021 'Local Authority Financial reporting and external audit: Spring Update', it is the government's view that a new arm's length body is not necessary to achieve this objective and that a system leader should instead be appointed from within the current system. This policy has been subject to a public consultation.

The Auditing, Reporting and Governance Authority (ARGA) will be established through primary legislation when parliamentary time allows. Ahead of that, it was stipulated in our July 2021 public consultation 'Local Audit Framework: technical consultation' and the subsequent government response, that a shadow system leader function would start at the FRC, funded by and accountable to the Department. Accordingly, an MoU between the FRC and DLUHC was published in March 2023 setting out the roles and responsibilities the FRC will undertake as shadow system leader and associated governance arrangements. The local audit unit at the FRC, as incoming shadow system leader, has now been staffed and is working with the Department to lead the cross-system package of measures to clear the backlog.

> (Paragraph 94) **Recommendation 7** – The Department must ensure that the local audit system leader is the primary point of contact to which local auditors can escalate matters of concern that they find during an audit of a local authority. Additionally, the local audit system leader must be responsible for collecting and considering audit findings across the sector to identify and coordinate responses to systemic or widespread issues that the auditors have found. Furthermore, the Department must clearly set out which body has these responsibilities until the audit system leader is established in legislation.

Where auditors issue a public interest report (PIR) or statutory recommendations, such as issuing a Section 24 (S24) notice, they are required to send a copy to the Secretary of State for Levelling Up, Housing and Communities. Weaknesses identified by auditors in their work on local government bodies' value for money arrangements are also routinely considered by DLUHC as the Department responsible for stewardship of local government (as issues concerning police or fire authorities would be considered by the Home Office).

The local audit system leadership function has been established to ensure better integrated working across the system and to ensure a coordinated and coherent response to issues arising; it is not envisaged that the system leader should perform duties set out in the individual codes or accountability mechanisms. The Department has an ongoing interest in being alerted to and understanding the issues raised by auditors in PIRs and S24 notices, but we can explore whether there should be a similar mechanism put in place for ensuring the system leader is kept similarly updated.

On the question of reporting, the MoU setting out the FRC's responsibilities as shadow system leader already includes a responsibility for the system leader to "lead work to report annually, in the public sphere, on local audit: on timeliness, on the findings of local audit, overall trends/patterns emerging from local audits and the state of the local audit market". Access to timely and reliable data from system partners will be vital for the system leader to develop a whole system view of risks and priorities and to reflect these in its reporting on the system.

Producing local authority accounts

> (Paragraph 110) **Recommendation 8** – The Department for Levelling Up, Housing and Communities must immediately initiate a review into existing legislation that places requirements on the contents and format of local authority accounts. The review should refer to the intended purposes and users of the accounts (as we have set out earlier) and determine what legislation is needed to produce accounts to meet those purposes. The Government must then introduce legislation to amend existing legislation to meet that objective.

Local Authorities are required by statute to produce and publish a set of accounts for each financial year. The accounts must be produced in accordance with 'proper practices', which is defined in the Local Government Act 2003 and its Regulations as the 'Code of Practice on Local Authority Accounting in the United Kingdom' as published by CIPFA along with any practices required by legislation. Since 2010, the Code has been based on International Financial Reporting Standards (IFRS).

There are various accounting practices set out in statute for local authority accounts. Generally, legislative provisions are there for one of two main purposes: firstly, to establish the separation of capital and revenue which is a fundamental component of the local authority finance system; secondly, as legislation introduced in response to risks or issues specific to the sector (referred to as "statutory overrides" as they override the normal accounting practices set by the Code). Statutory provisions are only used to set accounting practices when the Department considers that they may be required. We have previously consulted with the sector and key stakeholders, including auditors, FRC and CIPFA, before introducing any such overrides. The government, however, does recognise that this can add complexity to the accounts, and will undertake to review the existing overrides to ensure that their value is not outweighed by the additional complexity they place on local authority accounts.

The Department will also review all relevant legislation that places requirements on the content and format of accounts as per the Committee's recommendation. However, given the work to clear the backlog this will not be the immediate priority and this review will form part of the Department's work to ensure the system is on a more sustainable footing for the long-term.

In the interim, CIPFA is currently assessing whether the reporting requirements could better present the statutory adjustments from accounting standards that are required for council tax setting. This is an area which does add complexity and requires additional explanation. This will be subject to review by the CIPFA Better Reporting Group.

> (Paragraph 111) **Recommendation 9** – The Department should coordinate with the Chartered Institute of Public Finance and Accountancy and the CIPFA/LASAAC Local Authority Code Board to ensure that the Accounting Code does not interpret existing legislation as placing requirements on local authority accounts disclosures that are neither mandated nor intended by the existing legislation.

We agree that it is important the Accounting Code aligns with legislation and the Department will work with CIPFA to review the legislative disclosure requirements alongside the Code. As part of this work, we will also consider if the disclosure requirements are necessary and appropriate, as agreed to above. The CIPFA LASAAC Local Authority Code Board conduct a regular annual review process to consider items for development for the Accounting Code and any changes to the existing Code should be implemented as part of this development process and consultation.

> (Paragraph 117) **Recommendation 10** – The Department, in consultation with the Chartered Institute of Public Finance and Accountancy, must resume the introduction of a standardised statement of service information and costs for local authority accounts as soon as actions to address the audit backlog have been implemented. We expect a standardised statement could be introduced for financial years starting in 2024. At the same time, it must ensure that local authority accounts disclosures outside this statement are streamlined by removing requirements that are now covered by the new statement.

We remain committed to the prospect of a standardised statement. However, introducing this now would add a new requirement onto auditors and accounts preparers at a time when the immediate priority must remain clearing the backlog before we can then turn to issues of long-term reform.

In the meantime, CIPFA is keen to ensure that the focus should be on developing better performance reporting so that the accounts and statements that accompany them are able to convey the key messages to the user. Through its updated strategic workplan, CIPFA LASAAC will focus on an overview of performance and summary financial information note. Following this work CIPFA LASAAC will then make any final decisions on any proposed changes to the Code, including determining the best mechanisms to report performance and summary financial information. This could become the precursor to the standardised statement of information and costs.

> (Paragraph 120) **Recommendation 11** – Local authority accounts are currently required by legislation to include Pension Fund statements, but this has made the accounts longer, more complicated, and less useful to users. The Government should introduce legislation to decouple local authority accounts from these Pension Fund statements, which should be published as separate documents.

We will consider the Committee's recommendation as part of the review of legislation we have committed to undertake in response to Recommendation 8. There are 86 authorities, mainly county councils and London boroughs, which are responsible for individual Local Government Pension Scheme (LGPS) funds. Under s20(3) of the Local Audit and

Accountability Act 2014 the annual statement of accounts for these authorities includes the pension fund account and the authority's local auditor must give a separate opinion on the part of the statement that relates to the accounts of the pension fund. We recognise that these requirements make the main accounts longer and more complicated and will consider the case for separation of the two sets of accounts.

> (Paragraph 129) **Recommendation 12** – The Department should work with the organisation that prepares the Audit Code (currently the National Audit Office, eventually the system leader) to ensure that local auditors' opinions over value for money include an actual assessment of value for money achieved, not merely whether appropriate arrangements exist. Such assessments of value for money achieved should cover specific services, projects or programmes, not necessarily to the activity of the entire local authority. These services, projects or programmes would be determined by, for example, local councillors or the auditors. This would allow a greater focus on areas of risk and provide actual assurance over the performance of the authority in key areas.

We do not support this recommendation. It is for local democratically elected leaders to ensure value for money for their communities and to put in place sufficiently robust processes (such as overview and scrutiny committees) to achieve that. Moreover, to ensure consistent application of such work that the Committee describes, would require a significant increase in resources and expertise. Auditors are not currently equipped to be able to comment on the value for money achieved by specific services, projects or programmes. At a time when there is significant pressure on the local audit system it would not be helpful in achieving the priority of clearing the backlog of outstanding audits to introduce a significant extra requirement on auditors.

Separately, the work of the new Office for Local Government (Oflog) will enable citizens, local government, central government, and civil society to be better informed about the performance of local authorities. The information that is published will help citizens and civil society to hold their local authority to account and also help local authorities to identify where and how they might need to improve.

> (Paragraph 131) **Recommendation 13** – The Department should work with the organisation that prepares the Audit Code (currently the National Audit Office, eventually the system leader) to assess the potential benefits (for example, to timescales and resourcing) of decoupling value for money work from financial audit work, and report the findings of the assessment to us for further consideration before the end of this Parliament.

We agree with the Committee that there are potential benefits in decoupling this work. We plan to consult on this and will continue to work with the NAO and the FRC to consider the merits of this. We will report back to the Committee in the time frame requested.

> (Paragraph 135) **Recommendation 14** – The Department should work with the organisation that prepares the Audit Code (which is currently the National Audit Office but will be the system leader) to introduce new guidance for the auditors of local authorities in order to encourage them to make more proactive use of their existing powers to flag potential issues

> earlier in the audit process, both to managers internal to the authority and publicly by issuing Public Interest Reports. The Department should assess the effect of the guidance 12 months after it has been introduced and share that assessment with us.

The government agrees with the Committee as to the importance of auditors using their existing powers and this will continue to remain a high priority under the proposals to clear the backlog. In communications to the sector, we have consistently encouraged greater use of these powers to flag concerns in line with the requirements of the Code of Audit Practice and existing guidance. We will work with the NAO and FRC to consider the merits of new guidance to further reinforce those expectations.