House of Commons

Committee of Public Accounts

Local auditor reporting on local government in England

Eleventh Report of Session 2021–22

Report, together with formal minutes relating to the report

Ordered by the House of Commons to be printed 8 July 2021

HC 171
Published on 14 July 2021
by authority of the House of Commons

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Summary

Without urgent action from government, the audit system for local authorities in England may soon reach breaking point. With approximately £100 billion of local government spending requiring audit each year, the Ministry of Housing, Communities & Local Government (the Department) has become increasingly complacent in its oversight of a local audit market now entirely reliant upon only eight firms, two of which are responsible for up to 70% of local authority audits. This has not been helped by the growing complexity of local authority accounts, with audit firms now asked to carry out more work in each audit, comply with new regulatory demands and adapt to the new multifaceted landscape in which local authorities operate, while also struggling to hire and retain experienced auditors. Such problems have been evident since 2018, but the COVID-19 pandemic has heightened them with less than half of local authorities completing their audits on time in 2019–20, while more than half of the audits examined by the Financial Reporting Council (FRC) needed improvement. If local authorities are to effectively recover from the pandemic, it is critical that citizens have the necessary assurances that their finances are in order and being managed in the correct manner.

The government-commissioned Redmond review of local government accounts and audits reported in September 2020. On 19 May 2021, the Department issued an update on its response to Redmond's recommendations and its now preferred option for a system leader. The need for system leadership for local public audit, identified by Redmond, is pressing. But the government's announced option that the future Auditing, Reporting and Governance Authority (ARGA) will become the new system leader, will take time to establish. The Authority will not be set up until 2023, at the earliest, and will require legislation. Until then, it remains unknown whether this option will be able to fully address the current failings in the market for auditing local authorities. In the meantime, the Department has much more to do to provide credible details on the practical and concrete steps it intends to take to address the urgent problems that cannot wait for ARGA. We will track progress closely for assurance that when the new system leader arrangements are operating, the local audit market will still be in place.

Introduction

In 2019-20, the 487 local authorities, local police and local fire bodies in England were responsible for approximately £100 billion of net revenue spending. Local authorities are responsible for delivering many of the public services which local taxpayers rely on every day. The Local Audit and Accountability Act 2014 (the 2014 Act) set out the local audit arrangements from 1 April 2015 that apply to local authorities. Multiple organisations play a part in the local audit system, including: the Ministry of Housing, Communities & Local Government (the Department); the National Audit Office (NAO); Public Sector Audit Appointments Ltd (PSAA); the accountancy institutes: the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Institute for Chartered Accountants of England and Wales (ICAEW); the Financial Reporting Council (FRC); and audit firms. The Department has oversight of local authorities and is responsible for maintaining a set of statutory codes and rules for local authorities. The NAO maintains a code of audit practice for audits of local authorities and issues guidance to auditors. PSAA is responsible for securing arrangements for the independent appointment of auditors on behalf of local authorities which opt into its services and for setting audit fees. The external auditors audit the financial statements of local authorities and conclude on whether an authority has made proper arrangements for securing value for money. The FRC monitors and reports on the quality of these audits. The Department for Business, Energy and Industrial Strategy (BEIS) will become the sponsor department for the new Auditing, Reporting and Governance Authority (ARGA), once it is established, but the Department will hold Accounting Officer responsibility for the local government role of ARGA.

Conclusions and recommendations

1. **The marked decline in the timeliness of external audit undermines accountability and hampers effective decision-making.** Only 45% of local authorities published audited accounts on time for 2019–20, despite the Department having extended the deadline from 31 July 2020 to 30 November 2020, due to the COVID-19 pandemic. This compares with 57% of local authorities which published their audited accounts on time for 2018–19 and 87% in 2017–18. The Department says it will set an extended deadline of end September for the next two years. Late audit completion can delay timely management action to address financial or performance issues identified; affect a local authority's annual budget setting and decision-making processes; and impact on the production and audit of other public sector accounts, such as departmental accounts and the Whole of Government Accounts. The audits of local authorities are not of consistently good quality; more than half the audits the FRC examined in 2020 needed more than limited improvement. Delays and quality issues undermine the value and purpose of audit, reducing the assurance to taxpayers and elected representatives.

   Recommendation: ***As a matter of urgency, the Department should write to us by September 2021 with a detailed plan and timetable for getting local audit timeliness back on track.***

2. **There is a pressing risk of market collapse due to an over reliance on a small number of audit firms and significant barriers to entry.** Only eight audit firms have the specialist knowledge and accreditation needed to audit local authorities. Currently, the market is dominated by just two firms, which carry out around 70% of local authority audits. The current contracts for auditing local authorities cover the period up to the 2022–23 financial year but PSAA says it can unilaterally extend these contracts for two years, if needed. Existing audit firms have little financial incentive to stay in the market and there are serious and pervasive challenges to increasing audit capacity further. Audit firms that have left the market no longer have the necessary specialist teams in place. New audit firms face considerable barriers in the time and costs involved in gaining entry to the market, such as developing a sufficient sized team of staff with the specialist skills, led by key audit partners, as part of gaining accreditation. The Department and PSAA are considering how to overcome these barriers, for example, through small packages of audit work, and through consortia where an accredited firm works with an unaccredited firm to enable future entry to the market. In the meantime, any one firm deciding to exit from the market would create a fundamental capacity gap and harm accountability.

   Recommendation: ***The Department should write to us by September 2021 explaining what contingencies it has in place should any more audit firms leave the market at the end of their contracts in 2023.***

3. **The commercial attractiveness to audit firms of auditing local authorities has declined.** Audit firms bid for the current contracts to audit local authorities in 2017, but the work involved has increased significantly in response to well-publicised problems in the corporate sector. Fees now bear little relation to the costs audit firms incur to carry out the work. Audit firms point to the increased work required to audit pension and property valuations, and to meet increased regulatory expectations for

local audit. Local authorities say the focus on these areas means less attention is paid to more meaningful areas for their themselves and their residents, such as their financial resilience, outturn against their budget, and performance outcomes. The Department is consulting on changes to the regulations that set the fees, to enable fees to be set closer to when the audit work is carried out, and so that fees can reflect any increase in audit work required. In the meantime, the Department is consulting on how to allocate an additional £15 million to help audit firms respond to the pressures in the current year.

Recommendation: ***The Department should ensure that PSAA's next procurement exercise, due to begin in 2021, supports a new fee regime for local government audit, which is appropriately funded, and which brings fees into line with the costs of the work.***

4. **The rapidly diminishing pool of suitably qualified and experienced staff increases the risks to the timely completion of quality audits.** There are serious shortfalls in the number of specialists which audit firms rely on to carry out audits of local authorities. To maintain accreditation, audit firms' key audit partners must have at least three years' oversight experience of auditing local authorities. Worryingly, most key audit partners are over 50 years old and audit firms are likely to find it difficult to replace experienced staff when they retire. The audit firms consider there is a missing generation of auditors with specialist experience of auditing local authorities. A lack of career prospects is a further challenge which audit firms face in recruiting trainees and ensuring they have a sufficient future supply of experienced staff to carry out audits of local authorities. This is not solely a problem for the audit firms and the Department is working with the accountancy institutes and the FRC on encouraging people into the sector, making the key audit partner accreditation process smoother, and improving skills development, but this will all take time.

Recommendation: ***The Department should work with the FRC and the accountancy institutions to implement accelerated training and accreditation to increase the supply of qualified auditors quickly, and to build attractive career paths in local audit.***

5. **We are not convinced that the recently announced new local audit arrangements will meet the pressing need for effective system leadership now.** In May 2021, the Department announced that the system leader for local government audit will be the new Audit, Reporting and Governance Authority (ARGA), the new regulator replacing the FRC. However, ARGA will not be set up until 2023, at the earliest, and doing so will require legislation. Contrary to the Redmond review recommendations, ARGA will not be responsible for procurement, which will remain with PSAA, due to the Department's concerns about potential conflicts of interest. The Department will have Accounting Officer responsibilities for just the local audit element of ARGA, while BEIS will be the sponsor department overall. There is a crisis in local government audit and a need for urgent action to tackle the increasing delays, audit quality and market fragility. The Department recognises the importance of stronger system leadership during the transition to ARGA, but we are not reassured that its proposed liaison committee, bringing together all the responsible bodies, will be

enough to meet the pressing need for system leadership now. It remains to be seen whether ARGA will then be able to meet fully the ongoing priorities for effective system leadership.

Recommendation: ***The Department should write to us by September 2021 and outline:***

- ***how it will address the need for strong system leadership now, while ARGA is being set up and established; and***
- ***how it will work with BEIS to set up ARGA, the accountability and governance arrangements, and how its performance will be monitored and evaluated.***

6. **Unless local authority accounts are useful, relevant and understandable they will not aid accountability.** Changes in auditing standards, such as on auditing pensions and grant distribution, have required considerable extra audit time. Some local authorities also have increasingly complex financial arrangements. The more property investments a local authority holds, the more specialist resources the auditor needs to gain accurate estimates of their values. We are concerned that some of the additional audit work now being carried out is disproportionate to the risk to the overall financial stability of the local authority. The accountability of local authorities to stakeholders, such as residents and service users, through audited accounts is a priority. Yet, the accounts of local authorities are impenetrable to many stakeholders. There could be much greater transparency in the financial reporting of local authorities, such as through the inclusion of a simple standard statement, focused on the key issues of most use and relevance to stakeholders, presented in a readily understandable way. The Department is working with others to look at simplifying aspects of the accounts of local authorities. It intends that the new system leader will also look into reducing accounting and audit requirements for areas of less risk to local authorities.

Recommendation: ***The Department should write to us by September 2021 with its detailed plans for agreeing with stakeholders ways to focus local authority accounts and audits on areas of greatest risk and concern to citizens.***

1 Accountability, transparency and quality in local authority audits

1. On the basis of a report by the Comptroller and Auditor General,[1] we took evidence from the Ministry of Housing, Communities & Local Government (the Department); Public Sector Audit Appointments Ltd (PSAA); audit firms EY and Grant Thornton; and from Sir Tony Redmond, author of *Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting* [the Redmond Review].[2] We also received written evidence from a number of individuals and organisations.

2. In 2019-20, the 487 local authorities, local police and local fire bodies in England were responsible for approximately £100 billion of net revenue spending. Local authorities are responsible for delivering many of the public services which local taxpayers rely on every day. Local authorities are required to prepare and publish financial statements setting out their financial performance and to account for how they have used their resources in the year. The Local Audit and Accountability Act 2014 (the 2014 Act) set out the local audit arrangements from 1 April 2015 that apply to local authorities. Multiple organisations play a part in the local audit system, including: the Ministry of Housing, Communities & Local Government (the Department); the National Audit Office (NAO); Public Sector Audit Appointments Ltd (PSAA); the accountancy institutes: the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Institute for Chartered Accountants of England and Wales (ICAEW); the Financial Reporting Council (FRC); and audit firms.[3]

3. The Department has oversight of local authorities and is responsible for maintaining a set of statutory codes and rules for local authorities. The NAO maintains a code of audit practice for audits of local authorities and issues guidance to auditors. PSAA is responsible for securing arrangements for the independent appointment of auditors on behalf of local authorities which opt into its services and for setting audit fees. The external auditors audit the financial statements of local authorities and conclude on whether an authority has made proper arrangements for securing value for money. The FRC monitors and reports on the quality of these audits. The Department for Business, Energy and Industrial Strategy (BEIS) will become the sponsor department for the new Auditing, Reporting and Governance Authority (ARGA), once it is established, but the Department will hold Accounting Officer responsibility for the local government role of ARGA.[4]

The deterioration in timeliness and quality of local authority audits

4. The Accounts and Audit Regulations 2015 specify a date by which a local authority should publish its accounts. The auditor needs to provide its opinion on the local authority's financial statements in time to enable the authority to include it in its published financial statements.[5] The original deadline for local authorities to publish their 2019–20 accounts was 31 July 2020. The Department put the deadline back to 30 November 2020, under the

1 C&AG's Report, *Timeliness of local auditor reporting on local government in England, 2020*, Session 2019–21, HC 1243, 16 March 2021

2 Sir Tony Redmond, *Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting*, September 2020

3 C&AG's Report, paras 1, 1.3, 1.5, Figure 1

4 C&AG's Report, Figure 1 and para 1.4

5 C&AG's Report, para 1.8

Accounts and Audit (Coronavirus) (Amendment) Regulations 2020, to reflect the burden on local authorities and audit firms of the COVID-19 pandemic. By the extended deadline of 30 November 2020, only 45% of local authorities had published their 2019–20 accounts.[6] This compared with 57% of local authorities which published their audited accounts on time in 2018–19 and 87% in 2017–18.[7]

5. We asked the Department what impact delays to audit delivery were having. The Department emphasised the importance of timeliness in auditing local authorities and the serious risks that arise from any delays as management action to address any failings is subsequently delayed. The Department also highlighted that delays in auditing local authorities had wider repercussions, including on audits of some government department accounts and the production of the Whole of Government Accounts.[8] For example, the 2019–20 audits of the Care Quality Commission and of the Department for Environment, Food & Rural Affairs, were delayed due to issues with the audit of the Local Government Pension Schemes.[9] The Department considered that a local authority was in a stronger position to complete its budget setting process each Autumn if its auditors had already completed their audit of the previous year's accounts, as the audited accounts often formed the underlying basis for the budget setting process. The Department felt that audited accounts provided confidence, assurance and transparency for the budget setting process. It noted that there had been recent cases where an audit had revealed information that affected the value of a local authority's reserves and which had knock-on effects on future budgets.[10]

6. The London Borough of Hackney was concerned that in May 2021 it was still awaiting the audit opinion from the audit of its 2019–20 accounts, and that this had been the first time in many years this had occurred. The borough told us it considered the delay brought it reputational issues and also affected the assurance that those charged with governance expected from its financial statements for 2019–20.[11] Durham University considered it was essential that audited financial information was published on a timely basis, emphasising that the information formed the basis for decision makers about how funding was allocated and where it went, for citizens to evaluate the way that local services were run, and for stakeholders to scrutinise financial performance.[12]

7. We asked the Department to explain the causes of delays to audit firms' audits of local authorities, given these had begun before the impact of COVID-19. The Department indicated that there was no single cause for the delays in completing audits of local authorities from 2018–19 onwards, and that a variety of factors had been responsible.[13] Staff in the finance function of local authorities and audit staff had been required to perform additional work in response to increasing requirements from regulators. The Financial Reporting Council (FRC) had increased its expectations of audits following high profile corporate failures, such as Carillion. As a result, audit firms had faced a significant increase in work in completing local authority audits, such as on asset and

6 C&AG's Report, Figure 2 and para 9
7 C&AG's Report, Figure 3
8 Q 15 evidence session of 20 May 2021
9 C&AG's report, para 2.9
10 Q 17 evidence session of 20 May 2021
11 London Borough of Hackney submission paras 5 and 6
12 Centre of Public Accountability, Durham University submission, page 1
13 Q 13 evidence session of 20 May 2021

pension valuations, and audit staff had also been reliant on receiving timely responses from valuers.[14] The Department considered that these changes were factors in delaying audit completions.[15]

8. The deadline for local authorities to publish their accounts has changed over time, being 30 September up to 2017; 31 July for 2018 and 2019; and for 2020 the original 31 July deadline was extended to 30 November.[16] Grant Thornton felt that the deadline of 31 July each year was no longer sustainable due to the complexity of local authority financial statements and the amount and nature of work that auditors were required to do. Grant Thornton considered that the earliest date each year to which auditors could complete audits of local authorities, to the right quality standards, was 30 September.[17] The London Borough of Hackney also told us that earlier audit deadlines were not achievable, particularly for larger, complex, authorities.[18]

9. We pressed the Department on when we would see improvements in the timeliness of local authorities publishing their audited accounts. The Department felt that it would not be possible to bring timeliness back on track in one audit cycle in 2021, given the impact of Covid-19. It explained that it had adjusted the deadline for local authorities to publish their accounts to 30 September for 2021 and 2022. It would then review what the appropriate deadline should be. It expected to have better visibility of the completion of local authority audits by 2022, and that we would see progress in timeliness in the audit cycles for 2021 and 2022.[19] The Local Government Association noted that the move of the audit deadline to 30 September for the next two years was a positive one.[20]

10. High-quality audits of local authority financial statements are important to assure taxpayers, stakeholders, and users of the accounts, that local authority accounts have been properly prepared, and to maintain trust in audited accounts.[21] The FRC is the independent body responsible for monitoring the quality of major local authority audits. The Institute of Chartered Accountants in England & Wales (ICAEW) monitors the quality of other local audits.[22] In October 2020, the FRC raised concerns over the quality of local audit. It found that just 40% of audits required no more than limited improvement, down from 64% in 2018–19.[23]

11. The Department said it considered itself to be the steward of the system for auditing local authorities and acknowledged that it was important to maintain the quality of audits of local authorities.[24] Audit firm EY told us that it safeguarded quality before deadlines.[25] It explained that it would not provide an opinion on its audit of local authority to an "arbitrary deadline" or without sufficient evidence, at the appropriate quality, to support it.[26] Audit firm Grant Thornton felt it had come under pressure to complete its audits

14 C&AG's Report, para 2.16
15 Q 13 evidence session of 20 May 2021
16 C&AG's Report, Figure 2
17 Qq 4, 26 evidence session of 17 May 2021
18 London Borough of Hackney submission, para 4
19 Q 41 evidence session of 20 May 2021
20 Local Government Association submission, page 2
21 C&AG's Report, para 1.2
22 C&AG's Report, para 2.25
23 C&AG's Report, para 2.28
24 Q8 evidence session of 20 May 2021
25 Q 14 evidence session of 17 May 2021
26 Qq 2, 7, 31 evidence session of 17 May 2021

to time, but,as with EY, it emphasised it felt it was more important to deliver the audit opinion to the right quality and only issue the audit opinion when it was ready, than to meet deadlines. Grant Thornton believed that this was the right thing to do, as otherwise it would not be giving the right level of assurance to local authorities on their financial statements and on their financial sustainability.[27] The Local Government Association also recognised that the extra work demands on auditors in auditing local authorities had led auditors to de-prioritise deadlines.[28]

The need for greater transparency in local authority accounts

12. Sir Tony Redmond emphasised the need for much greater transparency in the financial reporting of local authorities, to turn accounts that were impenetrable to the public into simpler information that the public wanted to know about. His review had recommended that the Chartered Institute of Public Finance and Accountancy (CIPFA) examine whether the accounts could be simplified, but he did not feel that this could be fully achieved within the framework of statutory accounts. Sir Tony considered that a simple standardised statement would help the public to understand a local authority's financial position and how it had performed.[29] He proposed a further way to bring greater transparency to the public would be for a local authority's auditor to present a report to its council members each Autumn. He explained that the report to the council meeting would be in the public domain, and provide an opportunity to cover the issues of interest to the public.[30] Sir Tony acknowledged that the desire for greater transparency had to be balanced against any sensitivity of the information, in deciding what could be disclosed.[31]

13. Durham University highlighted that local authority accounts were an important means of democratic accountability, and could cover issues of financial sustainability, financial and service resilience and equity, and that work was needed to resolve questions of what local electors should be getting from accounts and the functions that accounts should be performing. The University agreed with Sir Tony's proposals for bringing performance and financial information together and the need to make the data accessible to users of the accounts.[32] The ICAEW also pointed out that financial statements were critical to decision making and a key tool in ensuring local authorities were accountable to councillors and residents, but they were not understandable or sufficiently transparent.[33]

14. The audit firms EY and Grant Thornton told us that some local authorities had increasingly complex financial arrangements, for example in their borrowings, investments and financial instruments.[34] EY explained that the more investment properties a local authority held, the more difficult it had become to arrive at valuations for the properties. EY added that the valuation of assets supporting pension funds and of investment properties required significant input from its specialist real-estate valuation teams to ensure that valuations were appropriately reported.[35] The audit firms pointed out that, at the same

27 Q 9 evidence session of 17 May 2021
28 Local Government Association submission, page 1
29 Q 59 evidence session of 17 May 2021
30 Q 60 evidence session of 17 May 2021
31 Q 62 evidence session of 17 May 2021
32 Centre of Public Accountability, Durham University submission, page 3
33 Institute for Chartered Accountants in England and Wales submission, pages 1, 3, 4
34 Qq 3, 19 evidence session of 17 May 2021
35 Q 38 evidence session of 17 May 2021

time, the FRC had challenged auditors to improve the work they do in auditing these complex arrangements, and held the audit firms to account for the quality of their audit work.[36]

15. Sir Tony Redmond told us that local authorities considered that audits give too much attention to the valuations relating to pension funds and property. He added that local authorities believed the work that auditors had to carry out on valuations was excessive, as they argued that these valuations did not have an impact on their financial resilience and overall financial stability.[37] Sir Tony confirmed that he agreed with local authorities. He considered that some areas of audits to which the auditors gave much attention were not proportionate to the risk to the overall financial stability and resilience of local authorities.[38] The Local Government Association also pointed to the additional work that audit firms are required to do as a result of the requirements of the FRC, and that many believed this work was not a high priority in the governance of local authorities.[39]

16. The Department agreed with Sir Tony's assessment that local authorities' audited accounts were hard reading, and with his proposal for a summary statement in plain English. The Department had asked CIPFA to look at simplifying local authority accounts.[40] This included examining the issues behind the growth in the length of statutory accounts and the scope to simplify the code of accounting practice. The Department also wanted the new system leader to look at whether it could reduce some of the accounting and audit requirements for local authorities, where they related to areas of less risk.[41]

The Department's new arrangements for local government audits

17. In May 2021, the Department announced its updated response to recommendations in Sir Tony Redmond's review, from September 2020. We challenged the Department on whether the new arrangements would have any real effect on the efficiency of local government auditing. In the response, the Department expressed its view that the Audit, Reporting and Governance Authority (ARGA), the new regulator being established to replace the FRC, would be best placed to take on the local audit system leader role.[42] The system leader would be a single body aiming to resolve the fragmented structure of public sector audit, which is dispersed around different bodies, and with no one body looking for systemic problems, co-ordinating different parties, or monitoring and acting on emerging risks.[43] The Department believed the proposals it had announced would tackle the weaknesses in the market for auditing local authorities and the fragmented nature of the different responsibilities of the bodies involved.[44] We questioned whether ARGA would really have the degree of independence needed to look at the specifics of local

36 Qq 3, 8 evidence session of 17 May 2021
37 Q 46 evidence session of 17 May 2021
38 Q 47 evidence session of 17 May 2021
39 Local Government Association submission, page 1
40 Q 19 evidence session of 20 May 2021
41 Q 47 evidence session of 20 May 2021
42 Ministry of Housing, Communities and Local Government, Local authority financial reporting and external audit: Spring update, 19 May 2021
43 Sir Tony Redmond, Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial reporting, September 2020
44 Q 4 evidence session of 20 May 2021

government audit. The Department indicated that ARGA would establish a unit with local government audit expertise, aimed at ensuring that the specific nature and circumstances of local government were not ignored.[45]

18. Given that ARGA is not going to be set up until 2023 at the earliest, we pressed the Department on what would happen in the interim. The Department acknowledged that it would take time to establish ARGA, and that doing so would require legislation.[46] It accepted the importance of having stronger system leadership during the transition to establishing ARGA. The Department reported that, in the interim, it would chair a liaison committee to bring responsible bodies together. It recognised the need to take actions that would have the greatest impact quickly, and to tackle immediate issues, such as consultation on changes to regulations that set audit fees.[47]

19. The Department had asked PSAA to continue as the appointing body for procuring audit services, unlike the recommendation in Sir Tony's review to create a new body as a system leader, an Office of Local Audit and Regulation, which would have had responsibility for procuring audit services.[48] When we asked why the Department had taken a different approach, it explained that, in its view, including procurement within the system leader would have created a potential conflict of interest and it envisaged there would be a benefit from independence between the procurement process in PSAA, and the oversight of quality in ARGA.[49]

20. The Department confirmed that ARGA would be accountable to the Secretary of State for Business, Energy and Industrial Strategy.[50] The Department explained that it would hold Accounting Officer responsibility for the local government role of ARGA and for all aspects of the local government audit and accountability system, including public interest reports which enable auditors to put into the public domain their concerns and recommendations for action on matters that come to their attention in their work.[51] The Department added that it would need to work within the oversight arrangements for ARGA, to ensure that the interests of local government were properly reflected and represented.[52]

45 Qq 22, 23 evidence session of 20 May 2021
46 Q 6 evidence session of 20 May 2021, Ministry of Housing, Communities and Local Government, Local authority financial reporting and external audit: Spring update, 19 May 2021, paragraph 77
47 Qq 6, 40 evidence session of 20 May 2021
48 Q 21 evidence session of 20 May 2021
49 Q 22 evidence session of 20 May 2021
50 Q 70 evidence session of 20 May 2021
51 Qq 25–27 evidence session of 20 May 2021
52 Q 23 evidence session of 20 May 2021

2 Stabilising the local authority audit market

The crisis in the local authority audit market

21. In September 2020, Sir Tony Redmond reported to the Secretary of State for Housing, Communities and Local Government, that it was clear from his independent review of the effectiveness of local audit and the transparency of local authority financial reporting, that the local audit market was very fragile.[53] The London Borough of Hackney was also concerned that the additional pressure, due to the COVID-19 pandemic, had exposed an already fragile system which was no longer sustainable.[54] The Ministry for Housing, Communities & Local Government (the Department), and Public Sector Audit Appointments Ltd (PSAA), accepted that there were serious and pervasive challenges in the local authority audit market and the Department recognised that it needed to take action to tackle the underlying weaknesses in the market.[55]

22. All parties agreed that the market was not currently competitive, and that one measure needed for the market to become effective was to have more audit firms in the market.[56] Only eight audit firms are accredited to audit local authorities.[57] Of these eight, EY and Grant Thornton together carry out around 70% of local authority audits.[58] Grant Thornton considered that audit firm KPMG's exit in the last contract round in 2017 left the remaining firms in the market with insufficient capacity to take on the additional audits.[59] EY warned that audit firms that had left the market would no longer have the necessary specialist teams in place, if they ever considered re-entering the market.[60]

23. We pressed the Department on what it was doing to encourage a greater number of audit firms to carry out audits of local authorities. The Department agreed that maintaining capacity in the market for auditing local authorities was a serious matter.[61] It reported that it kept a close watch on the audit firms supplying the market for auditing local authorities, to monitor the situation and ensure that audit firms provided the necessary capacity.[62] It added that it was in regular dialogue and meetings with the audit firms.[63] The Department felt that, in taking the actions which Sir Tony Redmond had recommended in his review, this would provide the confidence that the market needed, and to ensure that there was sufficient capacity.[64]

24. PSAA is the organisation responsible for appointing audit firms to audit those local authorities which have opted into its arrangements, for an initial five-year period to 31

53 Sir Tony Redmond, Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial reporting, September 2020
54 London Borough of Hackney submission, para 3
55 Qq 4, 12 evidence session of 20 May 2021
56 Qq 28, 51 evidence session of 17 May 2021, Qq 5, 42, 46 evidence session of 20 May 2021
57 Q 11 evidence session of 20 May 2021
58 Q 5 evidence session of 20 May 2021; Q 28 evidence session of 17 May 2021
59 Q 28 evidence session of 17 May 2021; C&AG's report para 1.16
60 Q 28 evidence session of 17 May 2021
61 Q 61 evidence session of 20 May 2021
62 Q 58 evidence session of 20 May 2021
63 Q 60 evidence session of 20 May 2021
64 Qq 58–59 evidence session of 20 May 2021

March 2023.[65] It has a legal obligation to ensure that there is sufficient capacity in the market for auditing local authorities, and that local authorities have access to auditors.[66] PSAA recognised that there were many problems in the market for auditing local authorities, and considered that it would take time to sort them out. PSAA wanted to make the market a more attractive one for existing audit firms to stay, and for new firms to enter.[67] It also wanted to have long-term viable contracts with the audit firms. We asked if there would be a fundamental problem if one or more of the large audit firms did not bid in the next contract round, and we sought assurance on whether any contingency was in place if any firms dropped out. PSAA explained that if any audit firms were minded to leave the market after the end of the five-year period, it had a safety net in that it could extend the current contracts for two years, forcing the audit firms to keep auditing local authorities beyond 2023.[68]

25. PSAA recently commissioned research into the market for auditing local authorities which found challenges and barriers to audit firms looking to come into the market. New firms have to invest in their staff over time to build the specialist knowledge and accreditation needed to carry out audits. A member of staff who leads an audit must also gain individual accreditation to become a key audit partner.[69] EY added that key audit partners must have at least three years' experience of oversight of delivering audits within this market.[70] The Institute for Chartered Accountants in England and Wales (ICAEW) also felt that the requirements on key audit partners acted as a barrier to new entrants, even where audit firms did have audit partners with the experience that would make them eligible to apply.[71]

26. For the next procurement round for audits of local authorities from 2023, PSAA is looking at measures to reduce the barriers to entry for new audit firms. One measure proposed is for firms to enter the market while carrying out relatively small packages of audit work. PSAA is also open to consortia, in which an accredited firm would work with an unaccredited firm, to enable it to learn the ropes and gain experience of the unusual aspects of auditing local authorities.[72] PSAA told us that it had consulted audit firms to gain their views on gaining accreditation and entering the market to audit local authorities. This included the option of working in consortia with accredited firms. It was also in contact with firms which had left the market to take soundings from them on returning to the market.[73] PSAA explained that its strategy was to convince audit firms that auditing local authorities was an attractive market in which to work; one which would be worth their while; and worth their investment in training their staff. However, PSAA accepted that audit firms had a choice of audit markets and that it faced a challenge in making the offer attractive enough to audit firms.[74] The Local Government Association also told us that the attractiveness of auditing local authorities had declined for audit firms, as the

65 C&AG's report, Figure 1; Sir Tony Redmond, Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial reporting, September 2020, para 3.2.1
66 Q 59 evidence session of 20 May 2021
67 Q 44 evidence session of 20 May 2021
68 Qq 63–66 evidence session of 20 May 2021
69 Q 11 evidence session of 20 May 2021
70 Q 28 evidence session of 17 May 2021
71 Institute for Chartered Accountants in England and Wales, page 5
72 Q 11 evidence session of 20 May 2021
73 Q 45 evidence session of 20 May 2021
74 Q 46 evidence session of 20 May 2021

demands of the audits had increased.[75] The ICAEW also expressed a view that the market for auditing local authorities was not attractive and that there was a risk that audit firms could withdraw from the market.[76]

The diminishing pool of experienced auditors

27. We challenged the Department on the sustainability of firms auditing £100 billion a year of spending by local government while relying on only a few hundred auditors with the requisite skills. The Department and PSAA recognised the challenge which audit firms faced in having sufficient people to take on all the work required in auditing local authorities.[77] The Department had heard directly from audit firms that a shortage in specialist skills was a factor in their delays to completing audits.[78] PSAA had seen that, within the four largest audit firms, some key audit partners had moved away from auditing local authorities to internal audit consultancy. Such moves had put additional pressures on the numbers available to lead audits of local authorities.[79]

28. PSAA highlighted that the age profile of key audit partners was a factor likely to increase the challenge which audit firms faced, in having sufficient staff.[80] EY confirmed that it was facing a retirement issue for its key audit partners, with most having been in careers in local audit for 30 years or so, and in Grant Thornton the vast majority were aged over 50. EY was aware that when this cohort retired, it faced a risk of too few people coming behind them to take on their roles, and it considered that there was a generation of key audit partners missing.[81] The Local Government Association also told us that among the relatively few accredited audit firms in the market, there were too few key audit partners to ensure the resilience of the system.[82]

29. Sir Tony Redmond highlighted that his review found that the lack of career prospects and opportunities produced a real challenge for trainee accountants when considering whether to go into public sector accounting and auditing. He believed that audit firms needed to give more attention to career progression and training schemes for people to encourage them into public sector auditing.[83] Sir Tony thought that the Department, accountancy institutes, and audit firms could be involved in developing a training scheme that encouraged people to pursue a career in public sector audit.[84] ICAEW told us that the struggle that audit firms have in finding sufficient qualified and experienced individuals to deliver local authority audits could, in part, be due to low margins on the audits, which limited the ability to offer higher pay, and in part, be due to less attractive career paths. It added that pressure put on audit staff to work intensely over such a short period of time exacerbated staffing issues.[85]

30. The Department reported that it was working closely with the Financial Reporting Council (FRC), the Chartered Institute of Public Finance and Accountancy (CIPFA) and

75 Local Government Association submission, page 2
76 Institute for Chartered Accountants in England and Wales submission, pages 1, 4
77 Qq 12, 42, 46 evidence session of 20 May 2021
78 Q 43 evidence session of 20 May 2021
79 Q 46 evidence session of 20 May 2021
80 Q 12 evidence session of 20 May 2021
81 Qq 29, 30 evidence session of 17 May 2021
82 Local Government Association submission, page 2
83 Q 53 evidence session of 17 May 2021
84 Q 54 evidence session of 17 May 2021
85 Institute for Chartered Accountants in England and Wales submission, page 4

others to ensure there were enough skilled auditors to meet the needs of the market.[86] It noted that the FRC was leading a working group with stakeholders to look at factors affecting the supply of audit staff, such as entry criteria and skills development. The Department wanted to make the process for auditors to gain key audit partner status as slick as possible to encourage more people, but it also recognised that increasing the supply of people with the necessary skills would be a long-term issue.[87]

31. PSAA noted that the audit firms carried out extensive training programmes for their staff, but that it was important to ensure these programmes covered training on the specific aspects for audits of local authorities.[88] Grant Thornton informed us that it was the largest trainer of students through CIPFA, but that it took a long time to train people from joining the firm to becoming public sector specialists. EY added that the ICAEW was looking urgently at the requirement for people to have at least three years' experience of oversight of delivering audits of local bodies before they could gain accreditation as key audit partners.[89]

The declining commercial attractiveness of auditing local authorities

32. In 2019, the previous Committee reported on the reduction in fees for auditing local authorities.[90] The Department accepted that audit fees had become insufficient to reflect the increased challenges in auditing local authorities.[91] Sir Tony Redmond confirmed that audit fees in real terms had dropped significantly in recent years. He considered that the fall in fees had dissuaded a number of audit firms from bidding in 2017 for the current contracts to audit local authorities.[92] The audit firm EY felt that the connection between the underlying cost of the audit and the fee had been lost, and that the fee regime was no longer fit for purpose.[93]

33. EY and Grant Thornton highlighted that the amount of work which firms were required to carry out in auditing local authorities looked nothing like that required in 2017, for example, in the additional work involved in valuing assets supporting pension funds and of investment properties.[94] Grant Thornton referred to additional work required to reflect changes in auditing standards, in systems regulation, and in following the revised audit code of practice, and considered that these changes were introduced without recognition of the impacts on the costs to auditors. EY also noted that the contracts signed in early 2017 were different to the audits which auditors had to carry out when they started to deliver work against these contracts in 2019.[95] The London Borough of Hackney said that the decline in audit fees had put pressure on audit firms, such as in trying to field a suitable number of experienced auditors, and that this mirrored a deterioration in audit performance over recent years.[96]

86 Q 42 evidence session of 20 May 2021
87 Qq 43–44 evidence session of 20 May 2021
88 Q 55 evidence session of 20 May 2021
89 Q 28 evidence session of 17 May 2021
90 Committee of Public Accounts, Local Government Governance and Accountability, Ninety-Seventh Report of Session 2017–19, HC 2077, May 2019, paragraph 20
91 Q 8 evidence session of 20 May 2021
92 Q 52 evidence session of 17 May 2021
93 Q 19 evidence session of 17 May 2021
94 Qq 19, 38 evidence session of 17 May 2021
95 Q 19 evidence session of 17 May 2021
96 London Borough of Hackney submission, para 7

34. We sought clarity from the Department on whether, if fees went up, it would look to reflect the increase in the settlement for local government. The Department responded that is had put in more money this year for affected bodies, rather than going directly to audit firms.[97] The Department reported that it was taking action to address the decline in audit fees. It was consulting on changes to the regulations that set the fees for auditing local authorities to enable the fees to be set at a closer time to when the audit was done, and so that variations in fees can respond to changes in the audit work required. In the meantime, the Department was consulting on how to allocate an additional one-off £15 million towards the costs of 2021–22 audits.[98] EY told us that the sector welcomed the announcement of the further £15 million, as this would go some way to address the imbalance between the cost of delivering the audits with the specialist skills required, and the fees earned. EY added that it was responding to the Department's consultation with the view that £15 million be shared in an equitable way with the audit firms facing higher costs of auditing local authorities with increased complexity, rather than those auditing simpler bodies.[99]

97 Q 9 evidence session of 20 May 2021
98 Qq 6, 10 evidence session of 20 May 2021; C&AG's report, para 1.16
99 Q 15 evidence session of 17 May 2021

Formal minutes

Thursday 8 July 2021

Virtual meeting

Members present:

Dame Meg Hillier, in the Chair

Dan Carden
Barry Gardiner
Sarah Olney
Nick Smith
James Wild

Draft Report (*Local auditor reporting on local government in England*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 34 read and agreed to.

Summary agreed to.

Introduction agreed to.

Conclusions and recommendations agreed to.

Resolved, That the Report be the Eleventh of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Monday 12 July at 1:45pm

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Monday 17 May 2021

Janet Dawson, UK Government and Public Services Assurance Leader, Ernst and Young; **Mark Stocks**, Head of Public Sector Assurance, Grant Thornton; **Fiona Baldwin**, Head of Audit, Grant Thornton Q1–42

Sir Tony Redmond, Author Independent Review into the Oversight of Local Audit and the Transparency of Local Authority Financial Reporting, Chartered Institute of Public Finance and Accountancy (CIPFA) Q43–67

Thursday 20 May 2021

Jeremy Pocklington CB, Permanent Secretary, Ministry of Housing, Communities and Local Government; **Catherine Frances**, Director General, Local Government and Public Services, Ministry of Housing, Communities and Local Government; **Tony Crawley**, Chief Executive, Public Sector Audit Appointments Ltd Q1–70

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

TLA numbers are generated by the evidence processing system and so may not be complete.

1 Laurence, Professor Ferry (Professor, Durham University Business School); and Midgley, Dr Henry (Assistant Professor of Accounting, Durham University Business School) (TLA0001)

2 Local Government Association (LGA) (TLA0003)

3 Rowson, Mr Andrew (TLA0005)

4 Mason, Mr Michael John (TLA0006)

5 London Borough of Hackney (TLA0007)

6 ICAEW (TLA0008)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website.

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1st	Low emission cars	HC 186
2nd	BBC strategic financial management	HC 187
3rd	COVID-19: Support for children's education	HC 240
4th	COVID-19: Local government finance	HC 239
5th	COVID-19: Government Support for Charities	HC 250
6th	Public Sector Pensions	HC 289
7th	Adult Social Care Markets	HC 252
8th	COVID 19: Culture Recovery Fund	HC 340
9th	Fraud and Error	HC 253
10th	Overview of the English rail system	HC 171
1st Special Report	Fifth Annual Report of the Chair of the Committee of Public Accounts	HC 222

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1st	Support for children with special educational needs and disabilities	HC 85
2nd	Defence Nuclear Infrastructure	HC 86
3rd	High Speed 2: Spring 2020 Update	HC 84
4th	EU Exit: Get ready for Brexit Campaign	HC 131
5th	University technical colleges	HC 87
6th	Excess votes 2018–19	HC 243
7th	Gambling regulation: problem gambling and protecting vulnerable people	HC 134
8th	NHS capital expenditure and financial management	HC 344
9th	Water supply and demand management	HC 378
10th	Defence capability and the Equipment Plan	HC 247
11th	Local authority investment in commercial property	HC 312
12th	Management of tax reliefs	HC 379
13th	Whole of Government Response to COVID-19	HC 404

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14th	Readying the NHS and social care for the COVID-19 peak	HC 405
15th	Improving the prison estate	HC 244
16th	Progress in remediating dangerous cladding	HC 406
17th	Immigration enforcement	HC 407
18th	NHS nursing workforce	HC 408
19th	Restoration and renewal of the Palace of Westminster	HC 549
20th	Tackling the tax gap	HC 650
21st	Government support for UK exporters	HC 679
22nd	Digital transformation in the NHS	HC 680
23rd	Delivering carrier strike	HC 684
24th	Selecting towns for the Towns Fund	HC 651
25th	Asylum accommodation and support transformation programme	HC 683
26th	Department of Work and Pensions Accounts 2019–20	HC 681
27th	Covid-19: Supply of ventilators	HC 685
28th	The Nuclear Decommissioning Authority's management of the Magnox contract	HC 653
29th	Whitehall preparations for EU Exit	HC 682
30th	The production and distribution of cash	HC 654
31st	Starter Homes	HC 88
32nd	Specialist Skills in the civil service	HC 686
33rd	Covid-19: Bounce Back Loan Scheme	HC 687
34th	Covid-19: Support for jobs	HC 920
35th	Improving Broadband	HC 688
36th	HMRC performance 2019–20	HC 690
37th	Whole of Government Accounts 2018–19	HC 655
38th	Managing colleges' financial sustainability	HC 692
39th	Lessons from major projects and programmes	HC 694
40th	Achieving government's long-term environmental goals	HC 927
41st	COVID 19: the free school meals voucher scheme	HC 689
42nd	COVID-19: Government procurement and supply of Personal Protective Equipment	HC 928
43rd	COVID-19: Planning for a vaccine Part 1	HC 930
44th	Excess Votes 2019–20	HC 1205
45th	Managing flood risk	HC 931
46th	Achieving Net Zero	HC 935
47th	COVID-19: Test, track and trace (part 1)	HC 932

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48th	Digital Services at the Border	HC 936
49th	COVID-19: housing people sleeping rough	HC 934
50th	Defence Equipment Plan 2020–2030	HC 693
51st	Managing the expiry of PFI contracts	HC 1114
52nd	Key challenges facing the Ministry of Justice	HC 1190
53rd	Covid 19: supporting the vulnerable during lockdown	HC 938
54th	Improving single living accommodation for service personnel	HC 940
55th	Environmental tax measures	HC 937
56th	Industrial Strategy Challenge Fund	HC 941