

Written evidence submitted by the Department for Levelling Up, Housing and Communities [FRA 024]

Introduction

The department welcomes the opportunity to contribute evidence to the Levelling Up, Housing and Communities (LUHC) Committee's inquiry into Financial Reporting and Audit in Local Authorities.

Transparency and accountability are vital to our systems of local democracy. A key component to ensure that local authorities remain accountable to the citizens that rely on their services is the publication of audited financial statements. An effective system of financial reporting and audit, carried out in a timely manner and of a high quality, can aid trust between local authority and taxpayer, whilst also providing an important and necessary oversight tool both for individual local authorities and more broadly, the department.

The department is acutely aware of challenges to the local audit sector in recent years and its impact on the effectiveness of the system of financial reporting and audit. To address these challenges, a programme of work is being undertaken which is outlined below. Whilst the department is hopeful that the reforms underway will help to strengthen the present system, we do acknowledge that further action will be required and are currently exploring all available options to deliver an effective local audit system that is best able to serve the needs of all users of accounts and local audit.

The value of accounts

Accurate and timely accounts are vital to ensuring that local authorities can trust their financial information and can make spending decisions for the next financial year based on these figures. They serve an important role in ensuring local authorities remain transparent and accountable to local taxpayers, who can use them to understand how their money is being spent, and have legal rights to inspect, ask questions and challenge items in the accounts.

Furthermore, local authority financial reporting and audit has been and continues to be an important part of the department's overall approach to oversight and assurance on local government. Action by auditors has been instrumental in identifying and highlighting some cases of governance and financial failure. There are statutory interventions in five councils following evidence of Best Value failure and non-statutory interventions in three councils (and the Secretary of State has proposed to move one of the non-statutory interventions to a statutory footing). Some of these interventions have resulted from the use of auditor powers, such as issuing a report in the public interest. Since 2016, Public Interest Reports have been issued seven times. Auditors have also shown they can use their powers to expose issues by for example issuing, or threatening to issue, Statutory Recommendations, writing to a council's audit committee, or writing to senior officers requesting that concerns are raised at the council's audit committee.

The challenges faced by the sector

The vast majority of councils are well run and deliver services effectively and provide value for money for their residents. The 2023/24 Local Government Finance Settlement makes available up to £59.7 billion for local government in England, an increase in Core Spending Power of up to £5.1 billion or 9.4% in cash terms on 2022/23. Alongside this the government has published a policy statement which provides certainty on aspects of the Local

Government Finance Settlement for 2024/25. This will allow councils to plan ahead with more confidence over the rest of the spending review period. However, as noted above, some councils have exhibited poor financial management and, in these instances, an effective system of financial reporting and audit is a vital resource.

In June 2019, the government asked Sir Tony Redmond to conduct an independent review into the effectiveness of local audit and the transparency of local authority financial reporting. This was commissioned, in part, due to escalating delays in the completion of local audits. These delays, which have continued to afflict the sector in recent years, impact the value and effectiveness of local audit.

In his findings, published in September 2020, Sir Tony highlighted the complexity of the challenges in the local audit sector and the need for a whole system approach to ensure an effective response. The review also highlighted that within the private market there were insufficient auditors with specific local audit skills, with many leaving the profession following the privatisation of the market. Furthermore, a lack of qualified public sector auditors and audit personnel was contributing to capacity constraints in the local government sector and in turn delays audits being completed on time. Currently there are under 100 Key Audit Partners (KAP) in England undertaking local authority work (KAPs are responsible for signing completed local audits within a registered local audit firm), of which around a quarter work for firms not currently active in the local authority audit market. A further concern that was noted was regarding the quality of accounts and that some had remarked that they were impenetrable to the public.

His review made a number of recommendations as to how the local audit system could be improved, and accountability and transparency enhanced. Our response, which emphasised the significant value of financial reporting and audit and the need to ensure it remains relevant to present circumstances, accepted (in full or partially) the vast majority of Sir Tony's recommendations and we have since worked to implement these, alongside other considerations.

Actions taken to strengthen the financial reporting and audit system

The department has taken a range of actions to strengthen financial reporting and audit. Some of these actions were taken in direct response to recommendations made by Sir Tony. But the programme of work has widened since we published our response to his review in December 2020 and thus many actions have gone beyond those that were committed to in our response.

The department has provided £60 million to local authorities to strengthen their financial reporting and manage any new burdens arising from Sir Tony's review, and this will also enable local authorities to build capacity and capability in their finance teams. Work on financial capability has also been incorporated as part of the broader sector support programme funded through a £18m grant to the Local Government Association's (LGA) Improvement and Development Agency. The 23/24 sector support programme is currently being negotiated with the LGA.

The department has also worked closely with the Chartered Institute of Public Finance and Accountancy (CIPFA). In April 2022, in response to a number of Sir Tony's recommendations relating to audit committees, they produced strengthened guidance and training on audit committees aimed at local authorities and other local bodies - supported by the LGA, Public Sector Audit Appointments Ltd (PSAA) and others – and endorsed by this department.

In his review, Sir Tony recommended the introduction of a standardised statement of service information and costs, to be prepared by each authority and to be compared with the budget agreed to support the council tax/precept/levy and presented alongside the statutory accounts. The department accepted this recommendation, noting the value it would bring in providing greater transparency of financial reporting. Whilst this work has been paused to enable a greater focus on the immediate concerns in the local audit sector, the government remains committed to working with CIPFA on its implementation.

Further CIPFA work includes:

- a new performance audit qualification, anticipated to be offered globally and which focuses on developing expert level methodological and analytical skills for the public sector;
- accredited diplomas and certificates on topics such as financial reporting standards, finance skills for public sector managers and counter fraud;
- non-accredited tutor led training on its Leadership Development Programme, CFO Leadership Academy, and its 'introduction to' series including Local Government Finance, Collection Fund Accounting and Treasury Management;
- a wide range of webinars – featuring, for example, webinars on infrastructure assets, latest developments in the local authority accounting Code, the untapped potential of internal audit, PFI exit strategies and updates for police audit committee members;
- e-learning including free to air micro modules covering topics such as Public Sector Audit and Fraud.

We are already laying the groundwork for the Financial Reporting Council (FRC) to begin leading the system in the coming months, ahead of legislation to establish the Audit Reporting and Governance Authority (ARGA). As a step towards transitioning the role of the system leader of local audit in shadow form to the FRC, we have published a Memorandum of Understanding (MoU) agreed between DLUHC and the FRC, setting out the roles and responsibilities the FRC will assume. The MoU sets out in detail how DLUHC and the FRC expect the system leader role to work in practice and is the outcome of extensive liaison between DLUHC and the FRC. We expect full shadow arrangements to start in due course.

Looking ahead to ARGA, our Permanent Secretary will continue to act as Accounting Officer for local audit and maintain responsibility for the core local government accountability framework and the effectiveness of the local audit system framework. DLUHC will also remain responsible for adherence to the Best Value duty, stewardship, local government financial reporting requirements (with CIPFA/LASAAC¹ responsible for preparing the Local Authority Accounting Code) and policy decisions. DLUHC will also continue to retain oversight of local audit procurement once ARGA is established.

The department has acted as interim system leader since July 2021, in which time we have coordinated the following actions:

- we have established a Liaison Committee of key stakeholders which we chair and which comprises members from: the FRC, NAO, His Majesty's Treasury (HMT), Department of Health and Social Care (DHSC), Department for Environment, Food and Rural Affairs (DEFRA), Home Office, LGA, PSAA, CIPFA, and the Institute of Chartered Accountants in England and Wales (ICAEW). This has marked a significant step forward in driving greater cohesion and collaboration within the local audit system.

¹Chartered Institute of Public Finance and Accountancy / Local Authority (Scotland) Accounts Advisory Committee

- laid a Statutory Instrument (December 2022) and worked closely with CIPFA to provide a temporary solution to the issue concerning the audit of local authority infrastructure assets such as roads. These regulations are now in force and we have encouraged any authorities affected by the issue to close outstanding accounts as soon as possible. This is an example of providing flexibility to enable the system to work through a complex technical issue, acknowledging that local authorities may lack the historical information needed to make reliable estimates of the assets' value.
- worked with the PSAA as they developed and delivered their procurement strategy for the current appointing period, which includes stronger incentives in new contracts for timely delivery from 2023/24.

We have also worked closely with other organisations, which has enabled the announcements that:

- the NAO have rolled over amendments to the 2020/21 Auditor Guidance Notes, which require value for money reports to be drafted for every accounting year, to enable external auditors to focus on the audit of the financial statements if necessary.
- HMT have raised the threshold for local authority Whole of Government Accounts (WGA) returns from £500m to £2bn, effective for returns for 2020/21 and 2021/22, This has alleviated pressure on the audit system through reducing the number of local authorities that need to have their WGA returns audited.
- the NAO has agreed to re-lay the Code of Audit Practice 2020 to apply until at least 2027/28. This has provided the certainty requested by audit firms and benefited PSAA's procurement outcome.
- CIPFA has implemented amendments to the 2022/23 and 2023/24 local authority accounting code, in a pragmatic response to delay until the 2024/25 financial year the mandatory implementation of International Financial Reporting Standards (IFRS) 16, which newly requires the recognition of the right-to-use assets and lease liabilities of lessees in the accounts. The deferral should reduce resource pressures in the local audit framework while there are ongoing audit timeliness issues
- following their commitment in the December 2021 timeliness publication to review the reporting regime for valuation of non-investment assets (which includes Plant, Property and Equipment) in local authority accounts, HMT has now published a consultation paper on potential changes to the public sector reporting framework, informed by the findings of their Thematic Review and feedback from the Financial Reporting Advisory Board.
- CIPFA/LASAAC undertaking work to improve the presentation of local authority accounts to inform development of the 2024/25 Accounting Code, so that it is able to present the key messages of the financial statements to council taxpayers and service users.

To tackle the capacity challenges within the local audit market, we have led system wide work with a number of partners to enhance routes into local audit and develop the skills of local auditors. For external auditors this includes the following:

- the FRC revising the KAP guidance (*Guidance for Recognised Supervisory Bodies on the approval of Key Audit Partners for Local Audit*) which was published in June 2022 and has reduced the barriers to entry of potential KAPs.
- the FRC secured endorsement on the scope of a local audit workforce strategy from the Liaison Committee on 24 January 2023. Data gathering and analysis have now commenced and it is anticipated that a finalised strategy, developed in collaboration with audit firms and wider stakeholders, will be prepared by Autumn 2023.

- the proposal for a Local Audit Qualification is aimed to address the shortage of senior auditors in local audit. We expect to launch procurement shortly.

Finally, PSAA's recent appointment of auditors for 2023/24-2027/28 has been a positive outcome in supporting the development of a more sustainable market, despite extremely challenging market conditions. PSAA awarded contracts for 99.5% of the audit work that was detailed in the tender, which, after accounting for recent and scheduled local government reorganisations, means sufficient auditor capacity has been achieved to meet the needs of the sector.

Two new audit firms (Azets and Bishop Fleming) entered local audit for the first time in the 2023/24-2027/28 appointing period, and we are already seeing the return of KPMG. This is a positive reflection on PSAA's procurement strategy, which included smaller 'development lots' to attract new entrants, an increased number of lots to prevent any one supplier dominating the market, and an increase in audit seen.

Actions taken to strengthen the department's oversight role

Actions taken by auditors are an important part of the assurance system and sit alongside a wider range of oversight tools for local authorities and government. The department has acted to strengthen and improve our oversight of overall risk in the sector and our approach to responding to failures in local leadership or financial management, where they occur.

For example, the department has recently introduced Best Value Notices to set clear expectations and support authorities on their improvement journeys. Where the government becomes aware of early indications of Best Value failure in an authority, the department will consider issuing a Best Value Notice to obtain assurance of progress.

We have also significantly increased the level of scrutiny and assurance for those local authorities that experience financial difficulties. Since 2020 we have required that authorities seeking support through the Exceptional Financial Support process are subject to detailed independent reviews of their financial position. Where those reviews have highlighted wider weaknesses or financial risk, the department has acted swiftly to intervene (for example through the appointment of Commissioners in Slough). The department recently appointed a CIPFA led consortium to enable us to act quickly and carry out similar reviews where government has significant concerns. We are increasingly using reviews to better understand how local authorities are operating within the local government accountability framework.

As set out in the department's published Accounting Officer System Statement, we monitor the financial health and governance of local authorities on a regular basis using a wide range of data and through extensive direct engagement with councils. At a local level, councils are responsible for their own financial management and for setting a balanced budget. Within legislation, there is provision for a Section 151 Officer to take action, through issuing a Section 114 notice, where it is not possible to set or maintain a balanced budget. We have been clear that local authorities are encouraged to engage with the department if they are facing significant financial difficulties. CIPFA have also reflected this position in their updated guidance on Section 114 notices.

In addition to increasing the level of scrutiny and assurance for those local authorities that experience financial difficulties, the department, working with HMT and in consultation with CIPFA, has also taken forward a range of actions to strengthen the capital framework to prevent risky practices with borrowing and investment. This includes improving the data

collected to monitor risks, timely engagement with authorities where we have concerns and work to strengthen compliance with minimum revenue provision.

To ensure that we have the appropriate powers to address risky practices directly, the Levelling Up and Regeneration Bill contains new powers to allow direct intercession where authorities are exposed to excessive risk from capital practices and to mandate remedial actions where needed. Ahead of these powers coming into force, we have engaged with a small number of local authorities that are outliers in their level of borrowing.

Furthermore, the department is establishing the Office for Local Government (Oflog) to improve transparency on outcomes and delivery of key services; and foster accountability through the provision of meaningful comparative data on the performance of local authorities. In doing so, Oflog will shine a light on local authority performance – highlighting excellence and supporting our understanding of failures.

In March 2023, we wrote to local authorities and audit firms to note the critical importance of CEOs, CFOs and finance teams within local government, and auditors and KAPs in audit firms, in the delivery of timely, high-quality financial reporting and audit. This letter emphasised the responsibility of these individuals to ensure the highest standards to ensure the system operates effectively.

Next steps

The programme of work outlined above has brought, and will continue to bring, marked change to the financial reporting and audit system, which will ensure it is of the greatest value to all users of accounts. However, we do recognise that further action may be required. We are therefore committed to considering any recommendations or conclusions the committee brings forward.

April 2023