



**REDMOND REVIEW OF LOCAL AUTHORITY
REPORTING AND EXTERNAL AUDIT**

10 DECEMBER 2019

Leicestershire County Council's Response

The Council welcomes the opportunity to respond to Sir Tony Redmond's review of local authority financial reporting and external audit. The Council's response follows:

Definitions

1. Who, in your opinion, are the primary users of/main audience for local authority accounts?

The main users of local authority accounts are:

- Government - MHCLG oversight role and other government departments,
- Local Authority – Members, CFO and other finance officers
- Local Media
- Residents of the authority - should also be considered the main audience for local authority accounts. However, the complexity and quantity of financial information provided currently acts as a barrier to most residents being able to understand the information provided.

2. Who are the other users of local authority accounts? Are any of these other users of accounts particularly important?

- Local Businesses – trading with the County Council
- Banks – provision of banking facilities
- Other Local Authorities – benchmarking and comparisons
- Other local stakeholders – suppliers, insurers, partnerships

3. What level of financial literacy/familiarity with accounts and audit is it reasonable to expect the primary users of accounts to have and what implications does this have for the information presented in accounts and/or the information that should be subject to external audit?

This would often be a lot lower than users of private sector companies, where market analysts and investors are looking for detailed financial indicators. This should be taken into account by regulatory bodies such as CIPFA and the NAO when looking to interpret financial standards that are often created with private sector companies in mind. A potential solution could be separating the preparation into two parts;

- A high-level summary for residents - with clear indications showing how funding received has been used, services delivered etc.

- A second part that contains the detailed record for analysts - e.g. government departments.

The introduction of the Narrative Statement has been a good step in this direction.

4. Does the external audit process cover the right things given the interests of the primary users of the accounts/is the scope of the opinions wide enough?

External audit's focus is upon whether the accounts are technically correct and consistent with standards and regulations. The current process does cover the areas that would be of interest to users, ensuring that the authority has vital controls in place and is financially resilient. However, these are both areas that would benefit from strengthening. The question does arise as to whether the auditors have a role in ensuring that the accounts are clear enough for users to understand. This could be by recommending changes in individual authorities or through discussions with MHCLG, CIPFA or the NAO.

Expectation Gap

5. Is the going concern opinion meaningful when assessing local authority resilience? If not, what should replace it?

The Council believes the going concern opinion is not particularly meaningful for local authorities, due to the statutory nature of the services provided. By identifying items such as level of reserves and the levels of cash, auditors can seek assurance on the resilience of Councils, but regardless of this resilience some services must still be provided. As income reduces there should be some assessment on whether the level of services is sustainable.

6. In your opinion, what should an external audit of a set of local authority financial statements cover?

An external audit should cover the main statements, supporting notes as well as any supplementary areas such as group accounts. This should involve testing of controls, testing of substance and compliance with regulations. The audit should cover all aspects of the annual accounts, including financial figures in the narrative report. If key standardised metrics are identified that are seen as key indicators of an authority's financial health they should also be audited for the benefit of users and to ensure consistency across the sector.

7. In your opinion, what should the scope of the external auditor's value for money opinion be?

The scope should be anything that would possibly impact the council's financial resilience and that would indicate whether the authorities' resources were being used effectively. As there are currently no specific audit standards around VFM, it is difficult for auditors to be consistent, but there are a number of areas that should be covered. This includes a thorough examination of the budget setting and monitoring process, and a survey of any inspections, statutory reviews, etc. There should be scrutiny of the decisions made by the council in using resources throughout the year, an examination of any major partnerships the authority has entered into and a review of any commercial financial investments, e.g. property, units trusts etc). It should be established that the council understands its financial risks. The audit should also consider the management of key demand led areas and a review of the financial sustainability of services, and if not the plans to address this. The CIPFA financial resilience index could be used to support this review.

- 8. What is your view on the scope of an external audit engagement as described in Chapters 1 and 2 of this Call for Views? If it is different from your expectations, does this have implications for the reliance you place on external audit work?**

Please refer to the response to Questions 6 and 7.

- 9. Should the external audit engagement be extended? If so, which additional areas/matters are most important for external auditors to look at? What would be the cost implications of extending the engagement to the areas/matters you consider to be most important be?**

No, the auditors should focus on identifying risk areas and concentrating resources on these areas. For example, relying more on system robustness testing rather than excessive sample testing, thus allowing the focus to be on areas that matter, such as sustainability of services and financial resilience of an authority. Similarly focusing on the most material figures risks missing the most relevant figures when assessing financial health.

Audit and Assurance

- 10. Should the scope of the VFM opinion be expanded to explicitly require assessment of the systems in place to support the preparation of some or all of the reports that statute requires to be presented to full Council? If you do, which reports should be within scope of the external audit VFM engagement? If not, should these be assessed through another form of external engagement? If you believe that the VFM opinion should be extended to cover these reports will there be implications for the timing of audit work or auditor reporting?**

The Council believes that, an examination of the budget setting and monitoring process would inform VFM and financial resilience. While this would be an ideal situation, there could be resource implications, both in costs and auditors having suitable resources with an understanding of LA services (more so than just auditing the accounts).

- 11. Should external auditors be required to engage with Inspectorates looking at aspects of a local authority's service delivery? If you believe that this engagement should happen, how frequent should such engagement be and what would be the end purpose of doing so?**

Yes, auditors should be engaging with inspectorates looking at service delivery. For example, for a service such as Children's Services, auditors would need to be aware of the context the service is working on, such as high levels of demand growth, given any requirements arising from an Ofsted inspection. This needs to be an annual question to authorities about which inspections have taken place, any adverse findings, and what ensuing recommendations or directives have been made. It should then be the auditor's duty to contact these inspectorates to receive independent confirmation of findings and any subsequent improvements.

This should also help to refine the use of inspections in a VfM opinion, for example a negative Ofsted report will not always have significant on-going financial consequences. This would also help in forming an opinion around whether Government departments are aware of the consequences of their actions e.g. the SEND reforms that have created a significant financial issue nationally.

The Governance Framework for the Audit System

12. Does the current procurement process for local authority audit drive the right balance between cost reduction, quality of work, volume of external audit hours and mix of staff undertaking audit engagements?

The Council's auditors are very professional, helpful and supportive and produce a good quality audit. However, we are aware there are a number of problems elsewhere across the sector, with significant delays in reporting the 2018/19 audit opinions, in part due to a shortage of audit staff. This is not a surprise given the significant reductions in the level of fees and the concentration of audit effort into a short period of time. In order to maintain the quality of audits, audit firms are increasingly being forced to seek additional fees for all non-standard work.

Saving money on audit fees is all very well, but if there is an expectation that local authorities will provide a perfect set of accounts, explain local authority accounting processes and regulations and provide multiple items of evidence for trivial amounts, then savings are not really being made. In the current financial climate not many councils will be willing to support an increase in fees. Part of the solution could be to reduce auditor workload by placing more reliance on internal audit work and removing audit work on less important areas so that reporting is focused on the significant areas that matter.

13. How should regulators ensure that audit firms and responsible individuals have the skills, experience and knowledge to deliver high quality financial and VFM audits, whilst ensuring the barriers to entry do not get too high?

The Council's auditors are professional and skilled in local authority accounting processes and service provision. However, it is understandable that this may not always be the case elsewhere. With the increasingly compressed deadlines it is difficult to specialise – a typical auditor would be onsite 4 to 5 weeks plus two weeks at interim. Spreading work throughout the year would help manage workload and allow staff to specialise, for instance, allowing a longer period of time for the main audit and moving the VFM work to the Autumn. Also consider making use of government departmental auditors. Simplifying local authority accounts so that disclosures are more in line with the private sector would also reduce the problem.

14. What metrics should regulators use when assessing whether financial and VFM audits are delivered to an appropriate level of quality?

The Council proposes the following metrics:

- Timely delivery of opinion.
- Timely dealing of any objections.
- Number of items reported as outstanding in audit report at Corporate Governance (Audit) Committee.
- Feedback from Audit Committee
- Self-evaluation and client evaluation feedback.
- Additional costs charged.

15. Do you agree with the Independent Review of the Financial Reporting Council's findings and recommendations; and why do you agree/not agree? If you agree with the recommendations do you think the 'single regulatory body' should be the "successor body to the FRC" or a sector specific entity? If you do not agree with the recommendations are there any other changes you would make to the regulatory framework for local authority audit?

The preference is for a single regulatory body to keep standards similar across the sector. This body should have a deeper expertise in the local audit world. On a practical level, having a quality review of the hundreds of local authorities would take a substantial amount of resources, and we wouldn't be wanting to take a large amount of local audit expertise out of the audit firms to staff this body. More details would be required before the Council could fully support this recommendation. The point about prioritising a reduction in cost of audit at the expense of audit quality may be true, but as funding is increasingly tight. The first thought should be to reduce non-value adding activity.

Audit Product and Quality

16. Do external audit firms have enough understanding of the local authority regulatory framework to focus audit work on the right areas? How do they/should they demonstrate this? Who should regulate this work?

At a high level, during the planning process, there is an understanding of the CIPFA requirements for local authorities, currently the areas of focus on are the high value areas, such as assets and the pensions liability. This is not necessarily the high-risk areas, e.g. 'negative reserves'. Similarly the audit fieldwork could be better focused where there is still a lot of emphasis on income, expenditure and journal transaction testing. There is not always a full understanding of particular local government concepts such as the Capital Adjustment Account or Collection Fund Accounting. It is worrying if auditors do not understand these concepts.

17. Do auditing standards have a positive impact on the quality of local authority financial audits?

They have impact when they relate specifically to local authorities. When auditors apply standards that are designed for the private sector there is less impact, and this can dilute the usefulness of local authority accounts.

18. Do audit firms allocate sufficient resources to deliver high quality and timely audits? How is consistency and quality maintained in external audit work? To what extent is there consistency in audit teams year on year? What more can be done to ensure consistency between firms?

Please refer to the Council's response to Question 12. Additional comments are guidance will help ensure standardisation while balancing consistency and auditor initiative.

19. To what extent are senior audit staff, particularly the responsible individual signing the audit certificate, visibly involved in audit work? Who do senior audit staff meet with?

The audit director attends the Corporate Governance Committee and with his senior audit manager meets regularly with senior management. Together with the audit manager they are always available for discussions through meetings, emails and telephone call. Most day to day on site work of the audit is done through the audit manager and their team as appropriate.

20. Should external auditors consider financial resilience as a key factor when designing their VFM work programme? If so, what factors do they/should they consider as indicative of a lack of financial resilience?

Yes, they should look at budget position, level of reserves, cash/ debt movements, change in key spend areas, budget flexibility – fixed costs and unavoidable costs etc, evidence of

savings position and transformation programmes. The auditors should evaluate the above, comparing the progress year on year and reported accordingly. This does assume that the auditors have sufficient knowledge of the local authority sector to be able to form an effective opinion on an authority's resilience. For example, will an auditor be able to make a judgement on whether planned MTFS savings are realistic? Compliance with the new Cipfa Financial Management Code will also be an indicator of good financial management.

21. Does the Code of Audit Practice provide enough guidance on how much work needs to be done to support the VFM opinion? If not, what should it cover?

This is very difficult to be covered by guidance as it is quite subjective. Providing the auditors have sufficient experience in the local authority sector and have a detailed understanding of the individual authority then they should be able to meet any challenges from the authority on their opinion.

22. Do auditing standards provide appropriate guidance on quality standards for VFM audits? If not, is guidance needed and should it be included in the Code of Audit Practice or elsewhere?

No, this needs to be expanded to provide guidance to and consistency from auditors.

23. What is the current relationship between external and internal audit? How should that relationship be developed to add most value to local authorities and local residents?

Current external audit standards are clear that an external auditor cannot place reliance on Internal Audit (IA) work. They do however use IA work to form their risk assessments and will query what has been tested in year and if any issues have arisen from testing of controls. This relationship could be developed so that areas covered in year by internal audit are covered with light touch testing by external auditors. Also, there should be engagement throughout the year (e.g. regular internal audit reports forwarded to external auditors, as this can help shape the final audit focus). In addition, it would be helpful if external auditors could discuss certain areas that internal audit could focus on during the year.

24. What should happen when a regulator finds that a local authority audit has not met quality standards? Where should the balance between ensuring effective enforcement action against auditors and maintaining participants in the audit market lie?

Auditors should be held responsible for not meeting quality standards, just as local authorities are held responsible for not meeting reporting and VFM standards. Various sanctions should be available to the regulator from recommendations to removal from audit. As well as the balance of maintaining participants in the audit market, there will also be a need to ensure that increased enforcement does not make audit firms more risk averse and bureaucratic, damaging the relationship between auditor and local authority.

Auditor Reporting

25. Do you think that the format of the VFM audit opinion provides useful information? If not what would you like it to cover?

No, the VFM opinion should focus on financial resilience. VFM in local authorities is covered under other statutory processes such as scrutiny committees. For example, the inclusion of poor Ofsted reports creates confusion, these should be a flag for further investigation, but not a means in itself to qualify on VFM. Changes to the NAO Code should improve the format of the VFM opinion in 20/21.

- 26. Do you think the VFM opinion should be qualified solely because a local authority has received an inadequate Ofsted opinion or a similar opinion from another inspectorate?**

No, it should focus on the financial implications. Auditors need to look at other inspectorate reports in context, examining any subsequent improvements that have been made. If a local authority is constantly qualified because it is waiting for a new Ofsted inspection, despite measurable improvements, then the effect of the VFM qualified opinion loses its impact.

- 27. Do you think that the VFM opinion is presented at the right point in a local authority's annual financial management and budgeting cycle? If not when do you think it would be most useful?**

No, it should be flexible and can be helpful in managing auditor and LA staff workload. The ideal time would be Autumn/Winter so improvements are part of the budget setting process.

- 28. Where auditors have identified significant issues, audit certificates and reports have often been delayed? Why do you think this is and can changes be made to the framework to encourage earlier reporting of significant issues?**

This has not been an issue for the County Council. Prioritising high risk and high value areas in the planning stages (ideally mid-year) and testing of these either during an interim audit or early in the final audit is key.

- 29. In your view, what sorts of issues should Public Interest Reports be used to highlight?**

Public Interest Reports should be issued if the local authority has been found to have acted illegally, fraudulently or has not managed its finances adequately.

- 30. Statistics demonstrate that very few Public Interest Reports and Statutory Recommendations have been issued. Why do you think this is? Does it indicate an issue with the framework or common behaviours? If you think this is an issue, what can be done to incentivise more frequent and timely reporting of significant issues?**

The Council has no experience of this. Elsewhere it could be that major issues are not arising that require Public Interest Reports or Statutory Recommendations. Unless many issues suddenly appear, it would seem that authorities are working within statutory regulations.

- 31. Does a publication summarising the results of local authority audits add value? If so, who should publish it and what information would they need to have access to perform this function effectively?**

This has been done in a limited way by the PSAA, which published statistics on the number of local authorities that met the deadline having an audited set of accounts. It would be more appropriate if this was done by a regulatory body or the Ministry of Housing, Communities and Local Government (MHCLG). There is not much else that is quantifiable, other than cost, so could report on performance (e.g. number of complaints, disputes).

The Framework for Responding to Audit Findings

- 32. To whom should external auditors present audit reports and findings; is it the audit committee, to full committee or another committee? If findings are not presented to full council or equivalent what information (if any) should full council or equivalent receive?**

Under the County Council's Constitution, such non-executive functions have been delegated to the Corporate Governance Committee. However, if the Committee considered a matter to be serious it could refer that matter to the Council's Cabinet, Constitution Committee, or full Council as it considered appropriate.

33. In your authority, what is the membership of the audit committee (number of members, how many are independent etc.) and which officers typically attend?

The Council has a Corporate Governance (Audit) Committee which is made up of 9 councillors, 6 Conservative, 2 Liberal Democrats, 1 Labour and no Independents. Officers in attendance are the Section 151 Officer, Assistant Director (Strategic Finance and Property), the Monitoring Officer, and the Head of Internal Audit Service. The external audit Director will also attend.

34. How should local authorities track implementation of recommendations made by internal audit, external audit and relevant statutory inspectorates? What should the external auditors do if recommendations are not being implemented?

The Corporate Governance Committee are informed of key recommendations, progress in implementing them and any delays and this works well. Progress or lack of progress should be reported by external auditors at the Corporate Governance Committee.

35. Should there be a role for an external body in tracking action taken in response to modified audit opinions and/or statutory recommendations and public interest reports? If so should that responsibility sit with MHCLG, the sector specific oversight body recommended by the Independent Review of the Financial Reporting Council or another body?

MHCLG should take more interest in what is happening, although an opinion should also be reached on how they are fulfilling their responsibilities

The Financial Reporting Framework

36. Do local authority accounts allow the user to understand an authority's financial performance and its financial resilience? If not, how could they be revised to be more understandable? What information could be presented to enable users of the accounts to understand whether the financial position of a specific LA is getting better or worse?

No, there is a large number of tables and notes that are likely to be impenetrable to most users of the accounts. Items like the expenditure and funding analysis, financial instruments, and IAS19 notes currently give detailed information that most users will not have any interest in. While it is important that the council can demonstrate to auditors that it has effective controls and is following financial regulations, the amount of information that needs to be published is considerably less than what is published now. A more proscribed annual report, like the Narrative Statement, with high level numbers could be the answer, but should not just be more work and remove some notes from the accounts. In this way narrative can be provided alongside the numbers to give users an idea of the authority's financial position.

37. The UK Government is committed to maintaining IFRS based accounting for the UK public sector. Given this, how would you recommend resolving the mismatch between the accruals and funding basis to improve the understandability of local authority accounts?

This is the complexity of local authority accounts. The recent introduction of the Expenditure and Funding Analysis (EFA) notes help to make the link but are too detailed and too many for most readers of the accounts. A summary in the Narrative statement and a reduction in the notes to one main table (currently four tables) will help readers and practitioners.

- 38. Do you think that summary financial information should be reported in the annual report section of the accounts? If so, on what basis and should this information be covered by the financial audit opinion?**

Yes, a brief summary showing how the local authority has performed should be a proscribed part of the Narrative statement, as it would be in the private sector. Ideally this would explain the management accounts outturn vs accounting position in a simplified way – links to response to Q37. The auditors should be able to track these numbers back to the main statements and notes. This would tell the story in a much clearer way to users of the accounts without a finance background. Most users reading the accounts would not be differentiating between the Narrative Statement being an unaudited document, and the statements and notes being audited – they would assume the audit opinion would cover the whole document.

- 39. If you think that summary financial information should be reported in the annual report section of the accounts, should it be presented with performance information? If so, what performance information would be of most interest to stakeholders?**

Yes. This information should be clear and concise, with comparisons with the previous year and performance against budget. If there are major financial trends then performance information could be used to support any trends, such as analysis of demand for services.

Other Issues

- 40. For larger authorities, does the inspection and objection regime allow local residents to hold their council to account in an effective manner? If not, how should the regime be modified?**

Yes. Requests for inspection are uncommon and objections even rarer – largely due to FOI's and the transparency agenda, including the reporting of all transactional data over £500 each month. Please also refer to previous comments about usefulness of accounts.

- 41. Is more guidance needed to help auditors assess the impact of significant changes to common business models? If so, is this guidance needed to support the financial audit, the VFM audit or both?**

The County Council does not have any significant business models that require group accounts to be produced.

Where authorities have commercial operations, these should be reflected in the VFM report, as these organisations look to use assets to generate income to meet funding gaps, as well as meeting statutory objectives. The CIPFA Code of Practice needs to keep up with these developments, as well as audit standards.

There should also be clear guidance to auditors on what reliance they can put on audits of other entities to give assurance on local authority numbers.

- 42. Is the financial reporting and audit framework for larger category 2 authorities appropriate? If not, what additional information should be subject to audit/assurance and what would be the cost implications of this?**

Yes, but this can be improved for the reasons provided in other responses.

- 43. For smaller authorities, does the inspection and objection regime allow local residents to hold their council to account in an effective manner and is the cost of processing and responding to objections proportionate? If not, how should the regime be modified?**

The Council makes no specific comment regarding Question 43.

Officers to Contact

Jason Firth, Technical Accounting Manager, Strategic Finance

☎ 0116 305 7627 E-mail Jason.Firth@leics.gov.uk

Neil Jones, Head of Internal Audit

☎ 0116 305 7629 E-mail Neil.Jones@leics.gov.uk