



# House of Commons Communities and Local Government Committee

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## Audit and inspection of local authorities

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#### *Volume I*

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Written evidence submitted by Professor David Heald<sup>1</sup>

THE IMPLICATIONS FOR PUBLIC AUDIT OF THE ABOLITION OF THE AUDIT COMMISSION

INTRODUCTION

1. This memorandum is submitted in response to the Communities and Local Government Committee's call for evidence for its inquiry on "The audit and inspection of local authorities". That call for evidence notes that:

- The Committee will consider future arrangements in all the areas that previously fell within the responsibility of the Audit Commission, including:
  - audit of local authority expenditure;
  - oversight and inspection of local authority performance; and
  - value for money studies.<sup>2</sup>

I will consider each of these topics but also place much emphasis upon the wider context of public audit in order to provide a framework grounded on principle.

2. Whereas the Committee did not construct the circumstances in which this inquiry is being held, that does not diminish their relevance to its deliberations. The brutal manner of the announcement of the abolition of the Audit Commission,<sup>3</sup> made on 13 August 2010 during the summer recess and allegedly without pre-informing the Audit Commission, creates suspicions of score-settling and lobbying. There have been other recent instances of the undermining of the authority and independence of public bodies that have various measures of constitutionally necessary independence from the core Executive: the Financial Services Authority; the Food Standards Agency; the BBC; the National Institute for Health and Clinical Excellence; and Ofcom. These convey messages not "to step out of line", with damage to the ability of such organisations to perform their public functions. Effective public regulation is vitally important to the functioning of a modern society but the instruments can be fragile and require constant nurturing.

3. I have elsewhere analysed the specific features of public audit, which inherently involves difficult relationships:

"Independence" is the cornerstone of auditing wherever it takes place, but has specialised dimensions when the audited organisation is in the public sector. The wide scope of audit combined with ambiguities in the measurement of performance mean that governance arrangements are substantively important. In the private sector, the principal concern about independence is that the external auditor, engaged in practice by the management of the auditee, can report fearlessly to the shareholders who collectively own that company. The public sector context is more complex: independence is not only from the management of the entity but also from government and other politicians who will pursue private interests as well as advance the public interest (Heald, 2008b, p. 22).

With public expenditure under great pressure for the rest of this decade, the need for well-grounded performance evaluation and Value-For-Money (VFM) work will be greater than ever.

4. The remit of private audit is much narrower, the statutory and regulated segment of "audit and assurance services" being restricted to published financial statements giving a true and fair view in accordance with accepted accounting practice and the audit itself having been undertaken in accordance with recommended auditing practice. Performance measurement ("oversight and inspection") and VFM studies are not audit matters in the case of a private sector client. Over the past 25 years there has been a remarkable expansion in what public audit has been expected to achieve: this has added to the traditional differentiation that public audit has long gone beyond the certification of financial statements (the core content of private audit) to include "regularity" (expenditure is in conformity with budgetary authorisation) and "propriety" (there has been no fraudulent or inappropriate use of "public money") (Heald and McLeod, 2002; Treasury, 2007).

5. Public audit should belong to Parliament because of its crucial role in scrutinising the Executive (Heald, 2009), yet it also needs protection from Parliament itself. The dual existence of the National Audit Office (NAO) (Parliament's auditor) and the Audit Commission stemmed from an era when central government had more respect for the constitutionally separate authority and legitimacy of local government. If there was to be a structural change, such as the abolition of the Audit Commission, Parliament and local government ought to have been centrally involved. In August 2010, it was obvious that, by the time Parliament resumed in the Autumn, the regulatory and operational capability of the Audit Commission would be irretrievably damaged, and that all Parliament could do would be play "catch-up".

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<sup>1</sup> Declaration of interest: From 2002 to 2008 I was a (paid) specialist adviser to The Public Accounts Commission. Since 2003 I have been an (unpaid) member of the Technical Advisory Group to the Audit Commission. I hold a chair in Accountancy at the University of Aberdeen Business School. I take sole responsibility for the contents of this memorandum and the views expressed should not be attributed to organisations with which I am or have been connected.

<sup>2</sup> Available at:

<http://www.parliament.uk/business-committees/committees-a-z/commons-select/communities-and-local-government-committee/inquiries/audit---com> (last accessed 06/01/2011).

<sup>3</sup> BBC Radio 4's *‘da r gra e* (23 August 2010) broadcast revealing interviews, indicating the breakdown of relationships between Ministers and the Audit Commission.

6. There should have been the due process of a Green or White Paper, and then legislation should have been through the vehicle of a public audit bill, not through a general bill (public bodies bill) whose passage would be dominated by issues affecting Executive bodies. To my knowledge, the only public domain reference to a possible merger of the NAO and the Audit Commission was made in the report commissioned from Mr John Tiner by The Public Accounts Commission (TPAC) (2008, pp. 18–19). This fell outside his terms of reference and did not promote any public discussion, other than the rejection of the proposal for each to have a Non-Executive Director on the other's Board.

7. During this Inquiry, the Committee should resist the invitation to concentrate exclusively upon detailed operational arrangements.<sup>4</sup> Although extremely important, the kernel of present debates should be the higher level issues to which this memorandum draws attention. I will return to the general context in the final section of this memorandum.

#### SUBSTANTIVE IMPLICATIONS

8. The Government's announcement about the Audit Commission had three components. First, the abolition of the role of the Audit Commission in appointing auditors and setting the framework for local authority audit, including how that differs from, and extends beyond, the financial certification audit undertaken in the private sector. The transparency that has been created by the Audit Commission's framework, beneficial to local authorities, private sector audit suppliers and external stakeholders, is likely to be lost. Some substitute will have to be devised and this is likely to be a matter that the Committee may wish to explore, in the absence of a specific-purpose arms-length body. This is the regulatory function in relation to local authority audit and of major significance for public audit as a whole. Given long-standing trends to diminish the effective autonomy, particularly financial, of English local authorities, and the insensitivities of central government to constitutional relationships, my view is that Parliament has stood aside for too long. The required involvement and influence cannot be secured through after-the-decision inquiries; the Audit Commission should never have been subject to abolition or reconfiguration without advance Parliamentary involvement. The fact that this has happened, and has been treated as a fait accompli, is highly disturbing.

9. Second, there is the privatisation or dissolution of the "District Audit" (ie audit supplier) function of the Audit Commission, with all audits to be undertaken by private sector firms. One of the stated advantages of a mixed model, as also adopted by the NAO, is that having an in-house provider allows for benchmarking against external providers and also provides the operational knowledge base on which the performance of private sector audit suppliers can be evaluated. This will now be lost, giving more market power to the private sector firms and putting great demands on contract specification and management, wherever these functions are performed. This constitutes the substitution of a private provider of audit services for the in-house public provider. The Australian State of Victoria adopted this model in 1998 in relation to the Victorian Auditor-General's Office, a reform that was later reversed after an unusual amount of public controversy (English, 2003).

10. Without the Audit Commission to devise a Code of Audit Practice and operate a framework agreement under which private sector auditors are commissioned, the market power of those of the Big 4 (Ernst & Young have had little involvement in public sector audit for many years) that wish to do public sector audit will increase. For reputational reasons, clients prefer a Big 4 firm as that reduces the chances of being criticised for the choice of auditor, and provides valued blame deflection. Some local authorities may not be able to find a credible auditor, with reputational risks for local government as a whole. The Audit Commission took responsibility for ensuring that councils lacking capacity or with particular problems were handled with care.

11. The "liberation" of local authorities to appoint their own auditors breaches Sharman principles (Sharman, 2001; Treasury, 2002), enunciated after important contributions to the debate on (what became) the Local Government Resources and Accounts Act 2002, made, inter alia, by Robert Sheldon (then Chairman of TPAC) and David Davis MP (then Chairman of the Public Accounts Committee). The focus was on (central government) Executive Non-Departmental Public Bodies but the same principle should apply across the public sector. This principle was breached in the case of NHS Foundation Trusts by the Labour Government which had accepted and implemented Sharman's specific recommendations. Parliament did not react when the audit regulatory function for NHS Foundation Trusts was allocated to Monitor and NHS Foundation Trust Boards were made responsible for appointing their own auditors.<sup>5</sup>

12. The third component is the abolition of the research, performance improvement and performance evaluation functions of the Audit Commission, following the earlier announcement of the abolition of the Comprehensive Area Assessment (CAA) and the Use of Resources Assessment (UoR), which extended beyond local government and covered the NHS. Because of their different remits (eg there are many local authorities to compare but only one government department in a functional area), the Audit Commission's CAA and UoR can be seen as the counterpart to the 60 VFM studies carried out annually by the NAO. If there is a dramatic reduction in the amount of independent performance evaluation work undertaken for local government and the NHS, it will not be long before pressures build up for a curtailment of the VFM work of the NAO. If anyone doubts the hostility of parts of central government towards the NAO, they should read the vitriolic and ill-informed comments on the NAO's Corporate Plan and Estimates which Treasury officials have regularly sent

<sup>4</sup> The full range of operational questions to be addressed is set out in Audit Commission (2010).

<sup>5</sup> These decisions clearly had implications for the long-term viability of the Audit Commission.

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to the Chairman of TPAC and which are in the public domain. Such capability is easy to destroy but will at a later date prove difficult and expensive to rebuild. Moreover, it is needed in the present, when a long period of strong public expenditure growth is followed by large real-terms expenditure reductions.

13. The abolition of the Audit Commission, and the claimed savings of £50 million,<sup>6</sup> represent a retreat of public audit. The Audit Commission played a valuable role in holding the ring and specifying the nature of local authority audit (certification audit and performance audit, including information on comparative local authority performance). Although closely associated with central government, the Audit Commission had a buffering effect and that increased the legitimacy of audit regulation and performance measurement.

#### THE IMPLICATIONS FOR PARLIAMENT

14. At a future date there may be a repetition of the crises and scandals which led to the development of the existing public audit framework. Immediately ahead, the dislocation may put at risk the conversion of local authority accounting on to an International Financial Reporting Standard basis from 2010–11. This has the potential to create reputational damage. Organisations that approach a scheduled abolition date are vulnerable to disintegration and meltdown, especially if the nature of their activities is such that these cannot be monitored in real time, but only with a considerable lag.

15. Moreover, the issue of relocating the functions of the Audit Commission is only part of a wider picture. My reasons for opposing the new corporate governance structure of the NAO are well-documented (Heald 2008b, 2009). Leaving aside my substantive objections, the legislative journey<sup>7</sup> of these proposals confirms that Parliament collectively has little concern for, or understanding of, the importance of public audit arrangements. As with Parliamentary expenses, this failure to see the link between “governance” and “housekeeping” is intensely damaging to the image and legitimacy of Parliament, and also to its performance in its essential scrutiny role in relation to public expenditure. Even when these links are seen, there is too little willingness to voice these matters in public, leading to a gulf between what is publicly stated and what is privately known and discussed.

16. The implications for the NAO itself are potentially dramatic. The Government’s argument is that private sector auditors are capable of doing public sector audit without the Audit Commission as audit regulator with its own in-house audit capacity. If this view is accepted, then there is no reason for the NAO to employ its own auditors, as all central government audit could also be commissioned and out-sourced. This means that an NAO role in relation to the supervision of local authority audit is a poisoned chalice. If the arrangements do not work, the NAO will be held responsible, though its involvement has been reactive. If the NAO succeeds in making the new arrangements work, then this can be taken as an argument for closing down the NAO’s own audit capacity. If local authorities are “liberated” from performance audit, one would expect central government to seek liberation from the NAO’s VFM audit, a development that would fundamentally affect the work of the Public Accounts Committee. The temptation for the NAO to take on additional tasks at the request of the government of the day manifested itself when it unwisely became involved in the validation of the assumptions underlying macroeconomic forecasts (Heald and McLeod, 2002, para 505).

17. With the benefit of hindsight, the evaluation of public audit fell between two stools: the Executive did not do its job and neither did Parliament. This left scope for lots of undercurrents,<sup>8</sup> erupting into the abolition of the Audit Commission and leaving Parliament unprepared. Despite being a statutory body, TPAC appears not to have been fully functional in the vital period immediately after the May 2010 election, and had no Chairman during the critical decision period during the summer 2010 recess. There has been a characteristically British blurring of responsibilities and accountabilities, on the assumption that things would work out. There is a remarkable contrast between the neglect of these essential matters now and the Parliamentary activism which resulted in the National Audit Act .

18. I will conclude with a practical example of how the architecture and governance of public audit had substantive effects on the important topic of Private Finance Initiative (PFI) accounting:

<sup>6</sup> I am not aware of the basis for calculation, and that is a matter which the Committee might wish to explore. However, I am doubtful whether competition within the new structure will lead to major reductions in audit fees for financial certification work. Indeed, the opposite might occur for the reasons briefly mentioned above. Significant reductions in “audit costs”, now a loosely-used term, would have to come from reductions on the VFM and performance measurement component. These will be achieved in the short and medium term, but with unknown future implications for service delivery, performance and financial rectitude.

<sup>7</sup> The clauses relating to the governance of the NAO were dropped from the constitutional reform and governance bill at wash-up in the last Parliament. They are now included in the budget responsibility and National Audit Bill. The proposed corporate structure has been implemented on a non-statutory basis. This protracted legislative delay contrasts with what happens when a government wishes to enact its priority legislation.

<sup>8</sup> It has become clear that the Audit Commission had made some powerful enemies, such was the relish with which allegations of inefficient and burdensome practices were spun in the media after the abolition announcement. Unaware of there having been a systematic evaluation of the performance of the Audit Commission, I submitted a Freedom of Information request for copies of all performance reviews. On being advised that none existed, I requested an internal review of that decision, on the grounds that (a) such appraisals were formally required by the Cabinet Office, and (b) I had located a reference to a review in a Department for Communities and Local Government (2010a) publication. The response (Department for Communities and Local Government, 2010b) provided not a copy of a performance evaluation of the Audit Commission but a redacted 2002 letter on the functioning of the Board of the Audit Commission and a 2009 report, also on Board effectiveness. This episode suggests that, for all the formal apparatus for evaluating what public bodies actually do, the substance might be different. An alternative view would be that this further illustrates the neglect of the governance of public audit.

What is most striking is the variation in the On Off balance sheet proportions between departments. These differences are heavily driven by the identity of the auditor (the National Audit Office has been stricter about FRS 5A balance sheet treatment than the appointed auditors of the Audit Commission) and the control framework (local authorities and NHS bodies have known that on-balance sheet PFI would not normally be approved). This situation persisted because it suited the Government's policy of promoting the PFI as a procurement route. This inconsistency was facilitated by the scope for arbitrage between FRS 5A (published by the Accounting Standards Board) and Treasury Technical Note 1 (Revised) (published by the Treasury as an interpretation but which effectively became treated as a competitor standard) (Treasury Taskforce 1999) (Heald, 2008a, Ev.66).

The NAO came under intense pressure to accept the Treasury's position but the constitutional independence of the Comptroller Auditor General provided a protection for audit judgements that the Audit Commission (a public corporation accountable to a ministerial department) did not have. The majority of private audit firms had no interest in disputing accounting treatment with the Treasury, and indeed had extensive consultancy business advising on how to circumvent FRS 5A.

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#### Written evidence submitted by Professor Steve Martin

#### SUMMARY

The Audit Commission's inspections of local government were costly and time consuming. But there is compelling evidence that its activities helped local authorities to improve their performance and encouraged more effective joint working between local service providers. The decision to abolish the Commission is therefore a gamble which raises some important questions about how to support improvement and strengthen accountability in the future. This memorandum focuses on five issues:

- Faced with the challenge of making large budget cuts and without the external counterweight provided by inspection, there is a risk that the need to increase efficiency will override other priorities and that this will have a detrimental impact of the quality of local services.
- Self regulation and the use of "armchair auditors" are not sufficiently developed to provide credible sources of public assurance or stimuli for improvement.
- It is not clear whether local businesses, voters and other local interest groups will regard performance information provided by authorities themselves as reliable and impartial.