EXPLANATORY MEMORANDUM TO

THE LOCAL AUDIT (APPOINTING PERSON) REGULATIONS 2015
2015 No. [XXXX]

THE LOCAL AUDIT (SMALLER AUTHORITIES) REGULATIONS 2015
2015 No. [XXXX]

1. This explanatory memorandum has been prepared by the Department for Communities and Local Government and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instruments

2.1 The Local Audit (Appointing Person) Regulations 2015 make provision for the appointment of a local auditor by a person specified by the Secretary of State to audit the accounts of certain local authorities that choose to opt into such arrangements.

2.2 The Local Audit (Smaller Authorities) Regulations 2015 make provision for the appointment of a local auditor by a person specified by the Secretary of State to audit the accounts of smaller authorities and other bodies that choose to opt into such arrangements. They also make provision for authorities that are exempt from local audit.

3. Matters of special interest to the Joint Committee on Statutory Instruments

None.

4. Legislative Context

4.1 The Local Audit and Accountability Act 2014 makes new provision for the audit of local public bodies ("relevant authorities" – defined in section 2 and Schedule 2) once the Audit Commission for Local Authorities and the National Health Service in England and Wales is abolished in 2015. It imposes a requirement on relevant authorities to appoint an external and independent auditor on the advice of an independent auditor panel and to publish information about the appointment within 28 days of appointment It also creates a regulatory framework for local audit which applies, with modifications, Part 42 of the Companies Act 2006, whereby the Financial Reporting Council and professional accountancy bodies regulate the provision of local audit services.

4.2 Section 5 gives the Secretary of State the power to make provision about the audit of the accounts of smaller authorities. Section 6(1) sets out how the definition of a "smaller authority" applies to a body. In order to avoid bodies flipping in and out of being a smaller authority on an annual basis, a body is not classified as a smaller authority if it has exceeded the £6.5m threshold in the year of audit and in the previous two years. If the body has not

existed for those three years then either two years or one year is used as appropriate. Subsection (3) allows estimates to be used when determining whether a body falls above or below the £6.5m threshold, as only estimated figures will be available for its gross expenditure and gross income by the 31st December deadline for appointing an auditor. Subsection (4) gives the Secretary of State the power to make regulations to provide for cases where an authority has been treated as a smaller authority for a financial year, but was in fact not a smaller authority for that year. The Local Audit (Smaller Authorities) 2015 are made under the powers in sections 5 and 6 (the first use of the powers).

4.3 Section 17 gives the Secretary of State power to make provision, by regulations, for certain relevant authorities to have a local auditor appointed on their behalf by a body (an 'appointing person') specified by the Secretary of State. This is to allow for sector-led collective procurement arrangements, under which relevant authorities would be able to opt to have their auditor appointed by a specified sector-led body, rather than appoint locally. The Local Audit (Appointing Person) Regulations 2015 are made under this power (the first use of the power).

5. Territorial Extent and Application

This instrument applies to England.

6. European Convention on Human Rights

Kris Hopkins MP, Parliamentary Under Secretary of State at the Department for Communities and Local Government, has made the following statement regarding Human Rights: "In my view the provisions of the Local Audit (Appointing Person) Regulations 2015 and the Local Audit (Smaller Authorities) Regulations 2015 are compatible with the Convention rights"

7. Policy background

7.1 Local authorities must appoint their own auditors. However, as signalled in the Act, we are providing for bodies to be specified to appoint auditors on behalf of authorities who choose this approach, and for the body to manage ongoing contracts. The aim of this provision is to facilitate large-scale collective procurements, while maintaining independence in appointment and ongoing contract management. Authorities opting in may be able to achieve lower audit prices, through collective procurement; they will also not need to appoint an auditor panel to advise on the appointment and ongoing relationship with the auditor, as the appointing person will be independent of the authority in appointing and have a role on ongoing contract and independence issues.

7.2 Independence, in auditor appointment to local authorities and in ongoing contract management, is a key objective of the new arrangements for local audit. Therefore both sets of Regulations include a role for the Secretary of State to appoint the person (in practice more likely to be a body than an

individual), or persons, considered appropriate for the role, to perform this function.

7.3 Transparency and accountability are further objectives. These are provided for in the Regulations by requirements for openness of decision-making, and publication where appropriate. An objective of value for money, is also addressed in the provision for collective procurement, enabling bulk-buying of audit in cost-effective packages. A principle objective, to ensure continuity of quality audit of local public bodies, underlies these arrangements.

7.4 There are two separate sets of Regulations, to take account of the differing roles for auditors, and different procedures for opting in or opting out, for larger and smaller authorities.

PRINCIPAL AUTHORITIES

7.5 The Appointing Person Regulations make provisions for a person or body to appoint auditors on behalf of principal authorities – with an annual turnover over of more than £6.5m - who opt in to that arrangement. The Regulations, in particular:

- allow for specialisation in categories of bodies to be audited, for cost-effective packaging of audits, by providing for the Secretary of State to be able to specify more than one appointing person;
- maintain accountability by requiring an authority's decision to opt in to the appointing person's services to be taken by the full council of the authority, a decision which must be reviewed on the expiry of the appointing period set by the Secretary of State;
- permit a body to opt in to the appointing person's services once the appointing period has commenced; to protect against costly changes to contracts within the period; where a principal authority requests to opt in late, but not because of a change in its circumstances, the appointing person is not compelled to accept the request.
- extend the Secretary of State's options for addressing an authority's failure to appoint an auditor to include appointment on behalf of that authority by the appointing person, with a potential for greater efficiency in that appointment process;
- provide the Secretary of State with an optional reserve power to act if the appointing person fails to make an appointment to an authority opted into the appointing person's services, ensuring that the Secretary of State's powers cover all potential circumstances of failure to appoint, protecting continuity of audit;
- require the appointing person to consult opted in authorities on the scale of fees they will be charged for audit services, giving them an opportunity for input on value for money issues;
- require the appointing person to: oversee auditor independence; monitor the auditor's compliance with contracts; and deal with disputes between auditor and audited body. These actions replace those that would be undertaken by an authority - with advice from an auditor panel - which had appointed its own auditor; this assures auditor independence and value for money.

SMALLER AUTHORITIES

7.6 The Smaller Authorities Regulations make provision for a person(s) or body(ies) to be specified by the Secretary of State to appoint auditors on behalf of smaller authorities subject who opt in, or do not choose to opt out, of that arrangement.

7.7 Smaller authorities, for the purposes of these provisions, are local public bodies with a turnover of less than £6.5 million p.a.. Those with a turnover between £25,000 and £6.5 million p.a. must have an appointed auditor to undertake an audit of their accounts. This audit is a limited assurance engagement, consisting of a review of an annual return submitted by the authority. The requirements of the annual return and the nature of that review will be set out in the code of audit practice to be prepared by the National Audit Office, prepared under schedule 6 of the Local Audit and Accountability Act 2014. Authorities with a turnover of less than £25,000 p.a. are exempt from this requirement, however it is necessary to appoint an auditor to them if an auditor must consider, for instance, an objection to the authority's accounts.

7.8 The Smaller Authorities Regulations, in particular:

- set out the conditions under which a smaller authority qualifies as exempt from audit: that the authority has been established for long enough that their typical turnover is clear; that the authority has not been subject to a public interest report, or dispute about accounts. This ensures that authorities who need the closer scrutiny of audit, despite their smaller turnover, are subject to it;
- allow for specialisation in categories of smaller authorities to be audited, for cost-effective packaging of audits, by providing for the Secretary of State to be able to specify more than one person to make audit appointments;
- require the appointing person to consult representative bodies of smaller authorities on the scale of fees they will be charged for audit services, giving them an opportunity for input on value for money issues;
- require the specified person to issue, and publish, an invitation to all smaller authorities setting out the specified person's audit arrangements, including the length of appointing period, and closing date for opting out of the arrangements;
- provide that a smaller authority not expressly opting out by the closing date will be deemed to have opted in; this is a reverse of the arrangement for principal authorities, and reflects that most smaller authorities will wish to opt in, so providing a more efficient initial process;
- provide that the decision to opt out, or into the specified person's services are not to be delegated to a committee or officer, providing for transparency and accountability in the decision;
- make provision to address circumstances where authorities who have been incorrectly invited to opt in, requiring authorities to inform the specified person of this fact; there are a large number of authorities, and this provides a protection against costly erroneous opt ins in case of incorrect identification;

- permit authorities who have previously opted out to request to opt in during the appointing period; as a protection against impracticable late additions to contracts however, the specified person may refuse; in recognition of costs involved, the specified person may pass those on to an authority accepted as a late opt in.
- place a duty on the specified person to maintain and publish a record of: all smaller authorities opted in, and contact details for the auditor appointed to these authorities, so that local electors will know who to contact in case of query or objection to the authority's accounts;
- require the appointing person to: oversee auditor independence; monitor the auditor's compliance with contracts; and deal with disputes between auditor and audited body. These actions replace those that would be undertaken by an authority - with advice from an auditor panel - which had appointed its own auditor; this assures auditor independence and value for money;
- require smaller authorities opted in to the specified person's services to notify the specified person if they are exempt, so that the specified person knows which authorities will kind of audit provisions need to be in place for them. In the interests of transparency and public understanding of local audit arrangements, the authority must also publish a statement of that exemption.

8. Consultation outcome

8.1 The Appointing Person regulations were subject to public consultation, lasting four weeks, from 20th June to 18th July; the consultation paper can be found here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/324239/Local_Audit_Consultation3.pdf

8.2 A summary of consultation responses can be found here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/383694/Future_of_Local_Audit_Consultation_Summary_and_Response.pdf

8.3 The consultation asked in particular:

- Whether regulations should require that the decision by principal local authorities to opt in to sector-led arrangements be taken at full council. Of responses to this point, 58% were in favour, 42% against. The Government has decided to retain this provision: it is a decision of equal importance to auditor appointment; an authority's audit committee, if it has one, can play a part by making initial consideration of, and a recommendation about, the decision.
- Whether the maximum period, for the appointing person's responsibility, should be set at five years. 28% of respondents disagreed with the maximum; 10% were in favour of an extension to this period to enable savings through contract extensions. The Government has decided to retain this provision unaltered; it is important that the audited body has an opportunity to review its opt in to this collective procurement, which the five year limit provides for in a timely manner.

8.4 The Smaller Authorities Regulations are the result of two rounds of public consultation.

8.5 The first, lasting four weeks, from 25th November to 20th December 2013, was undertaken on an initial draft of these Regulations. The consultation paper can be found here: http://localaudit.readandcomment.com/wp-content/uploads/2013/11/Future_of_Local_Audit_-_Consultation_on_secondary_legislation_.pdf

8.6 A summary of consultation responses can be found here: https://www.gov.uk/government/consultations/future-of-local-audit-consultation-on-secondary-legislation

8.7 This consultation asked for comments on the Regulations, and in particular:

- Whether authorities should be permitted to opt out of audit services arranged by the specified person, once opted in, in certain circumstances. 58% of responses explicitly supported this proposal; however no responses supported in-period opting out without justification. However the Government considers that the circumstances in which an opt out during the appointing period might be desired can be addressed or forestalled more appropriately in other ways: for instance, by ensuring an active role for the specified person in auditor independence issues, and failure on the part of the specified person to be addressed by de-specification.
- Whether the specified person may forcibly opt out a smaller authority. 75% of responses said there were no circumstances in which this would be appropriate; 28% however identified circumstances which might place a pressure to do so, such as non-payment of fees. The Government has opted not to allow forcible opting out, however; fee non-payment can be recovered through the courts.
- Requiring the specified person to publish a list of opted in and opted out authorities. 78% of responses agreed with this approach; 14% raised potential costs of the approach. The Government considers the cost of publishing these records would be marginal, so maintains the requirement.
- Power for Secretary of State to order that an opted out authority who fails to appoint an auditor be opted in so that the specified person appoints their auditor. 88% of responses agreed with this proposal; the process for this to take place and recovery of costs involved were also raised. The Government has therefore retained this power, with provisions setting out the process and cost recovery.
- Provisions for authorities with turnover below £25,000 p.a., whereby their exemption from audit is suspended if they are newly established, or if an item in their accounts has been declared unlawful or they have been subject of a public interest report in the previous year. 78% of respondents supported this criteria; of respondents commenting on the proposed process, 55% were in favour, 45% against: the main concern being the auditor's role in certifying the exemption. The Government considers the criteria outlined for suspension are appropriate, but has added to these, at the suggestion of consultees: auditor's

issue of written recommendation; seeking of judicial review of the authority; issue of advisory notice, in the previous year.

8.8 The second round of public consultation, lasting four weeks, from 20th June to 18th July, was undertaken on a further draft of the Regulations, the content of which was influenced by responses received to the first consultation. The consultation paper can be found here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/324239/Local_Audit_Consultation3.pdf

8.9 A summary of consultation responses can be found here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/383694/Future_of_Local_Audit_Consultation_Summary_and_Response.pdf

8.10 The consultation asked for comments on that latest draft of the Regulations, and in particular:

- Whether the regulations meet objectives of transparency, quality and cost effectiveness. 47% of respondents agreed, 28% disagreed: concerns were raised that the opt out procedure seemed costly; that removal of external audit from exempt authorities left them open to unfounded allegations; the type of audit to which smaller authorities are liable should be more tightly defined; that many smaller authorities would remain unaware of the new requirements; and that the regulations were particularly complex. The Government has decided to retain the opt out procedure, as it is necessary for authorities to consider it carefully; maintains the audit exemption from the smallest authorities, noting they may nevertheless choose to be audited if they wish; proposes that the Code of Audit Practice continues to set out audit regimes applicable to different classes of authority, and commits to producing a 'plain English guide' to assist smaller authorities in their understanding.
- Whether auditors should be appointed to exempt authorities where those authorities have been subject to an objection to accounts, public interest report in the previous year, etc. 63% agreed with these arrangements; 16% disagreed, proposing that the appointment regime should extend to all authorities. The Government has decided to retain this provision, however the Regulations now clarify how and to whom local electors can make an objection; the Local Audit and Accountability Act 2014 already gives auditors discretion to disregard vexatious or frivolous, repetitious, or disproportionately costly objections.

9. Guidance

The Department for Communities and Local Government will publish a 'plain English guide' on the local accountability arrangements, including audit, for smaller authorities. The Government is currently working with the sector on supporting guidance to the local government sector on auditor appointment.

10. Impact

10.1 The impact on charities or voluntary bodies is nil; however there will be an impact on audit firms, with annualised costs per annum rising from around £1.04million to £2.18million. However this is offset by the opening up

of the local public sector audit market to firms, enabling them to realise greater profits than in the baseline year and a decreased contribution to system costs (see Annex 3 of impact assessment for the 2014 Act).

10.2 The impact on the public sector in complying with the new audit arrangements in total is estimated to range from £2.98million per annum to £4.48million per annum, a best estimate of £3.73million per annum, which equates to roughly £4,800 per body per year in compliance costs (see Annex 2 of impact assessment for the 2014 Act).

10.3 An Impact Assessment was published alongside the introduction of the Local Audit and Accountability Bill to Parliament which provides an assessment of the overall cost and impact of the new regime. This can be accessed at the following address:-
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/349418/2014_FINAL_Local_Audit_IA.pdf

11. Regulating small business

Whilst the legislation does not apply to small business in a wider sense there will be an impact on audit firms. The detailed costs and benefits are set out in Annex 3 of the impact assessment for the 2014 Act. However, whilst the new arrangements will result in an increased cost to audit firms, this is offset by the opening up of the local public sector audit market to a wider range of firms, enabling them to realise greater profits over the longer term, with a decreasing contribution to system costs over the current regime.

12. Monitoring & review

12.1 As part of the Government's commitment to review the implementation of new legislation within three to five years of receiving Royal Assent, the Government has set out some general principles towards developing a possible approach to such a review and assessing the impacts/outcomes associated with the Government's reforms to local audit. An overriding objective for the final approach would be to ensure that any proposed measurement is both proportionate and cost effective.

12.2 The aims and success criteria of the local audit reforms are to:

- Deliver greater localism, decentralisation and transparency;
- Maintain competitive audit fees; and
- Uphold high standards of auditing.

The post implementation review will provide the Government, Parliament and the public with the evidence to demonstrate that the local audit framework is achieving its anticipated outcomes

13. Contact

Luke Scofield at the Department of Communities and Local Government Tel: 0303 444 2562 or email: luke.scofield@communities.gsi.gov.uk can answer any queries regarding the instrument