

MUTUALISATION AND THE AUDIT COMMISSION

1. There are a wide range of options for transferring the audit function of the Audit Commission to the private sector. These include, but are not limited to, a trade sale, with either a private firm buying the entirety of the audit practice or different firms buying different parts of the practice, a management buy-out, mutualisation or some other form of employee ownership. Before a decision is taken on the way forward, the full range of option need to be evaluated and considered.

2. If we are to maximise value from the transfer, it would be quite wrong to identify only one method of sale at this stage, or to suggest publicly that there is a favoured or preferred option. Not least, we should avoid creating an expectation among the Commission’s employee base for any option, particularly for an option that might appear favourable for them, given that on subsequent analysis this might not prove practicable or only practicable on financial terms that gave poor value to the public purse.

Mutualisation

3. A mutual is an organisation that is wholly owned by, and run for the benefit of, its members who can be its customers or employees. In the case of the AC audit practice a mutual involving its customers – i.e. audited bodies – would not be appropriate as it would raise conflicts of interest. A mutual where each employee has a stake in the business which is 100% owned by employees might be a possibility for the audit practice, although this raises issues.

4. Examples of mutual organisations include building societies or certain insurance companies. The retailer John Lewis is a limited liability partnership with the characteristics of a mutual where employees determine the direction of the organisation and share in any profit or liability.

5. A mutual has no external shareholders and so does not have external drivers to generate large profits or capital gains. Profits made are usually reinvested in the organisation to sustain or grow the organisation.

Issues

6. Mutualisation of the audit practice raises two key issues.

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9. A related option to mutualisation that will also need to be considered is that of employee ownership. In this case the employees would own only a percentage of the business, that percentage perhaps reflecting the amount of capital that the employees were prepared to put into the business or the proportion of the business that Government in order to fulfil say some social agenda was prepared to gift to employees.

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Annex C

HMT queries on the future of local audit – some initial thoughts

1. Direct financial impact

(a) savings from cutting the Audit Commission’s overheads

The Audit Commission’s corporate and central directorates cost £52.1m in 2008/09. While these costs are already being cut through the internal efficiency programme there is greater scope from stopping activities completely and dismantling the Commission.

(b) Any profit from selling off the Commission’s audit practice

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DRAFT FOR DISCUSSION

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 National and local government bodies are not mutually exclusive and need to work closely together to deliver public services. To ensure effective assessment of value for money across systems the NAO and the Audit Commission already need to collaborate, for example in joint audit reports on areas such as the finances of the NHS and in interpreting changing international regulations (i.e. the recent move to International Financial Reporting Standards (IFRS)).

John Tinner's 'Review of the National Audit Office's Corporate Governance' in January 2008 listed arguments for merging the two audit bodies as:

For	Against
<ul style="list-style-type: none"> • Cost savings secured through the benefits of scale and synergies. • A single identity for the organisation responsible for the audit of public money in the UK (I am told there is much confusion between the NAO and the Audit Commission, even among the better informed). • A single, unambiguous approach to policy development. • Improved consistency and quality through better sharing of knowledge and intellectual capital. 	<ul style="list-style-type: none"> • There is no empirical evidence which suggests the current divide in responsibilities is operating against the public interest. • The constitutional background and the lines of accountability for the audit of central government and local government are, properly, quite different and could become unclear if one body was responsible for both. • There will be a substantial challenge for the leaders of a merged organisation in bringing together the different cultures and professional backgrounds of the people in the two organisations, which might divert focus from its formal responsibilities.

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At the time (2008) John Tinner considered it more important to put the structure of the NAO on a firmer footing, continue to strengthen relationships between the two organisations and then evaluate in 6 years the cost effectiveness of maintaining the divided structure against moving to a single body.

The NLGN cited potential efficiency savings, improved awareness of the audit bodies functions and the experience of the Wales Audit Office, as well as a more holistic view of public expenditure as reasons for merger. With localism it is not so much merger as a reallocation of functions being considered.

In addition there needs to be an assessment of any overlap with other bodies (i.e. AIU on audit quality).

(e) Savings from reduced inspection and assessment

The savings from the abolition of the Comprehensive Area Assessment are £23m per annum. There is currently a review on the future of inspection to consider alignment to the Coalition Government's decentralisation principles.

Inspection imposes a cost burden on local bodies (and other service delivery bodies). The concern is that it also creates a culture where bodies work to Whitehall priorities rather than to local priorities and that central inspection may contribute to "cheating", where professionals have an incentive to game the system for a good inspection result, instead of delivering the best service.

Even if an area or service is never or rarely inspected, the fact that it **may** be inspected will place burdens on local bodies (such as data collection requirements) and still change local behaviour.

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2. Timing

The timetable is based on seeking to implement a new decentralised audit regime in time for the 2012/13 audit year. We recognise that transition arrangements may extend beyond this until around 2014/15.

The pressure for an announcement in August is two fold:

(i) There is a need to appoint Commissioners by September to ensure the Board maintains a quorum.

- Four commissioners, including the Deputy Chairman of the Commission, end their first term of office on 31 August this year. All are eligible for reappointment and have indicated their willingness to be

reappointed. If at least two reappointments are not made then the Board of the Commission will cease to be quorate on 1 September.

- Prior to appointment we wish to be clear on the future plans for the Commission so this can be raised with the Commission Chairman so that he can confirm with them that they are prepared to be reappointed in the changed circumstances.
- With all four reappointments made, the Board will remain quorate until March 2011.

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(ii) There is a need to engage with the Commission and others to develop the approach.....

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3. Accountability

(a) Accountability to Parliament

The approach would retain accountability of local bodies as a collective to Parliament for the use of public funds.

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..... This approach provides greater assurance on the financial planning and robustness, where the auditor has primary responsibility for the public interest in the locality – rather than to the Commission and the needs of departments.

(b) Accountability to local government

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The Commission itself is already proposing that inspection becomes a rarely used backstop for those cases in which sector-led support is insufficient. Such inspections, it envisages, would only be carried out after discussion with the council and the LGA.

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The LGA and the Audit Commission are already working together on a simple protocol for sharing information from auditors where they have unresolved concerns about financial health, governance or performance. This will be an important source of information for the LGA's self-improvement work.

This approach will already rely on private firms sharing their information and the proposed approach would simply extend the requirement to audit firms to comply with the requirements of the protocol.

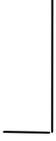
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Currently the LGA and the Audit Commission are doing research on productivity and looking to support councils. This approach would strengthen the LGA's leadership in this area.

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DRAFT FOR DISCUSSION

Disbanding the Audit Commission**Proposed timeline**

Wednesday 11 August	<ul style="list-style-type: none"> • Final HA clearance.
Thursday 12 August	<ul style="list-style-type: none"> • Interview for Saturday's Daily Telegraph (preceded by possibly ten minute pre-brief). • Meeting with Amyas Morse, Comptroller and Auditor General to discuss formal confirmation of NAO's future role (preceded by pre-briefing) • Officials to inform the Audit Inspection Unit, on a confidential basis, of the Government's intentions. • Possible SoS conversation with Dame Margaret Eaton. Officials speak to LGA. • Officials confirm with other Government Departments (Health and Home Office, who will wish to alert their key partners) that the Commission will be told on Friday (Home Office Ministers have specifically requested this), and announcement made on Saturday.
Friday 13 August	<p>Morning –</p> <ul style="list-style-type: none"> • Conversation/meeting with Michael O'Higgins and Eugene Sullivan. • Letters to Opposition spokesman and Chair of the CLG Select Committee. • Any letters inviting reappointment sent. <p>Afternoon –</p> <ul style="list-style-type: none"> • If story leaks, CLG press notice issues.
Saturday 14 August	<ul style="list-style-type: none"> • Telegraph interview runs • CLG Press Notice issues

1. The Audit Commission today

1.1 The Audit Commission for Local Authorities and the National Health Service in England (the Audit Commission) was established on 21 January 1983 by the Local Government Finance Act 1982. The Commission is a non-departmental public body sponsored by CLG and is classed as a public corporation.

1.2 The Audit Commission has around 2,000 staff, of which 1,400 work in the audit practice, based in nine regional offices as well as having a presence in most councils. Of the audit staff, approximately 10% are graduate trainees and nearly 200 are contractors. The Commission also has a Board of 13 Commissioners, appointed by the Secretary of State and responsible for setting the strategic direction, monitoring performance and budget matters.

1.3 The stated purpose of the Audit Commission is to raise standards of financial management and financial reporting, challenge public bodies to deliver better value for money, encourage continual improvement in public services, promote high standards of governance and accountability and stimulate significant improvement in the quality of data and the use of information by decision makers.

1.4 The work of the Commission is funded through a combination of fees, charged for audit (and hence indirectly funded by Government grant to local authorities) and inspection of public bodies, and direct grant from Government.

1.5 In 2008 – 2009, the Commission received £135m in audit fees and £37m in inspection income, of which £25.6m was grant income from Government (primarily CAA, Fire and Housing).

1.6 The work of the commission spans four main areas:

- **Audit:** The Commission is the primary auditor of local public services, responsible for the audit of 950 principal bodies and 2,450 smaller bodies. The Commission is responsible for appointing auditors for public bodies. This can be the Commission's own audit practice or a private firm. At present 70% of audits in local authorities are undertaken by the Audit Commission's audit practice, although the Commission is preparing to review whether the split should remain 70%/30%.
- **Assessment:** The Commission carries out performance assessments for councils, fire and rescue services, and housing organisations. Comprehensive Area Assessment has been suspended with the intention of abolishing the regime as soon as possible. This has led to staff reductions at the Audit Commission of 300 staff and a saving of up to £10m in 2010-2011. The Commission is funding the redundancies from its own reserves.
- **Research:** The Commission undertakes research and produces national reports. In 2008-2009 it produced 23 national reports including 'Tougher at the top' about the role of local authority Chief Executives, 'Well disposed' about how councils are responding to the challenge of reducing the amount of

waste sent to landfill and 'Risk and return' about how the collapse of banks in Iceland affected English local authorities (acknowledging that the Commission itself lost £10m it had deposited in Icelandic banks).

- Data-matching: the Commission helps bodies detect fraud and error by comparing sets of data, such as payroll or benefits records. The Commission's National Fraud Initiative (NFI) has identified £664 million of fraud and overpayments since it was established in 1996. Areas under NFI scrutiny include council tax discounts, housing benefits and blue badges.

2. What we are proposing

Audit

2.1 We see a strong case, for each local authority, NHS body, police authority and other principal bodies to appoint its own auditor

..... There is a strong case for these appointments to be made from a market consisting of existing accountancy firms and any new enterprises resulting from taking the audit function away from the Commission. This case would seem to have merit in terms of creating genuine local choice to be exercised by locally accountable councils, of potentially lower cost audits and of potentially generating receipts from the transfer/break-up of the Commission's audit function. It also affords an opportunity to rethink the scope and level of audit required to ensure a lifting of the burden on local bodies.

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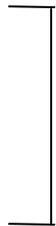
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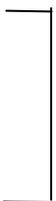
2.4 There are interdependencies on inspection, with inspections not limited to local authorities but also encompassing health, housing, the police and fire and rescue activities and authorities. CAA has already been stopped and we propose that in the remaining sectors inspection and assessment would either stop, be replaced by peer review or become a feature of the audit of that body.
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Data matching

2.5 The National Fraud Initiative works by the Commission comparing datasets (8,000 datasets from 1,300 organisations, including almost 100 in the private sector) to identify fraud, errors and overpayments.
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Research

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3. Why are we proposing change?

3.1 Abolition of the regime that requires the Commission to appoint auditors would increase local choice for public bodies, in that they would be free to appoint their own auditors.

3.2 Confining work to one sector inevitably leads to peaks and troughs in demand as different bodies in a single sector nevertheless all have the same year end. Allowing private firms the freedom to audit a greater number of public bodies leads to greater efficiencies and transferability in the industry as they audit different bodies in different sectors with different year ends, so allowing a more even spread of work throughout the year.

3.3 Savings would be achieved from removing an unnecessary centralised bureaucracy. The transfer of functions, such as audit and research, out of Government will have cost savings, as will ceasing functions. The annual cost of employing the Commission's staff in their 'central and corporate directorates', that is, not in audit functions, £52m. The annual cost of a Commission board of fifteen members is £295k.

3.4 Savings can also be achieved from ending unnecessary functions, as we have already done with CAA Where functions are necessary they can be more appropriately undertaken by others.

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4. How to do this

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4.4 The Commission's corporate core does not perform a technical function. Whilst audit is a technical function, it is performed by auditors and the private firms in the market. 30% of public body audit is already carried out by private firms.

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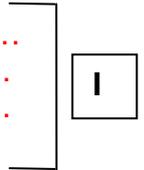
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4.5 While areas such as audit and inspection clearly require impartiality, the functions that require impartiality are not exclusive to the Commission. There is an argument that the private sector firms of the profession could be as impartial as the Commission, if not more so, particularly if those bodies are professionally accountable for their advice.

4.6 In acting independently to establish facts, private firms may be seen as more impartial than an arms length body in matters of audit and inspection or a corporate governance inspection report.

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FUTURE OF LOCAL AUDIT ARRANGEMENTS

The case for change

The underlying concept of a separate Audit Commission for two sector - local government and health - was that these bodies had had three way accountability to Parliament, Government and locally. With localism, local public bodies principally need to operate within a framework of local democratic accountability and transparency. They need to have accountability to Parliament for the use of public funds. There is at most limited accountability to Government.

Accordingly, Ministers are considering disbanding the Audit Commission in order to reallocate, and if appropriate abolish, its current functions to create an accountability framework fit for a localist world.

It is considered that such a redesign of the accountability framework will also have a direct financial impact from ending duplication, reducing bureaucracy and delivering greater efficiency. A summary of Ministers current thinking is at Annex A.

The current functions of the Commission

The Audit Commission for Local Authorities and the National Health Service in England (the Audit Commission) is an independent watchdog responsible for ensuring that public money is used economically, efficiently and effectively. The Commission's functions fall broadly into three categories:

- Activities that are essentially market based
- Activities that are essentially local
- Activities that are essentially national

Market based activities

According to the Audit Commission, the in-house audit practice is the fifth largest audit practice in the UK with income from audit in 2008/09 of £110m plus a further £13m from certification of claims and returns. The practice is a successor to the District Audit Service which was first established in 1844 and was a separate brand name until 2002.

While the Commission may appoint appropriately qualified officers of the Commission or firms of accountants, it appoints officers of the audit practice to some 70 per cent of the audits within its regime. In 2008/09, the audit practice was the appointed auditor to 580 principal bodies, and some 2,500 small bodies (charities, parish and town councils and internal drainage boards). The quality of the audit practice is not disputed, as validated by the voluntary submission to the Audit Inspection Unit, and the vast majority of its auditors are professionally qualified and experienced.

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The Commission's role in inspection and assessment has already been significantly reduced following the abolition of the Comprehensive Area Assessment. There is an on-going review of inspection as part of the Government's decentralisation programme,

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Next steps

There is a great deal of detailed design work to do in establishing the new regime, which needs the active engagement of the Commission, the profession, and the affected sectors.

Prior to announcement we are seeking to identify and agree actions on any issues and risks that may be a barrier to a new decentralised regime. We will then be looking to establish working relationships over the summer following the announcement to take forward implementation.