Future of local public audits

Summary of report prepared by FTI Consulting Limited

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Contents

Future of local public audit

This document comprises a public summary of the report that FTI Consulting Limited prepared for the Department for Communities and Local Government (DCLG) pursuant to its instructions in the contract with DCLG dated 14 April 2011. This summary should not be considered a full summary of FTI's analysis or considerations as it excludes certain commercially sensitive information and information likely to prejudice the achievement of value for money for taxpayers if made public. FTI Consulting Limited acted exclusively for DCLG and no other person in relation to its work and will not be responsible to anyone other than DCLG for its advice.

Introduction

The current system for the audit of local public bodies is operated and overseen by the Commission under the provisions of the Audit Commission Act 1998 (as amended). Since its inception in 1983, the Commission has acted as the regulator, commissioner and provider of local public body audit services.

The three current roles of the Commission in England may be summarised as follows:

- **Regulatory**: defining standards and guidance for audit of local public sector bodies, in addition to those published by the Auditing Practices Board
- **Commissioning:** conducting procurement tenders and appointing an auditor to each local public body; and,
- **Provider:** providing auditors from the Commissions' in-house practice to undertake the audits and sign audit reports.

Around 11,000 bodies across the public sector are audited under the current Audit Commission regime, including local councils, health trusts, police and various other smaller bodies. Of the larger principal bodies, approximately 70 per cent of the audits are performed by the in-house practice and the remaining c.30 per cent is outsourced to private sector firms (principally KPMG, PwC, Deloitte, Grant Thornton and PKF).

On 13 August 2010, the Secretary of State for Communities and Local Government announced his proposal to disband the Commission as part of a Government-wide review of 'Arms-Length' Bodies. The announcement stated that:

> "*a range of options will be developed for converting the audit practice into a business independent of Government which could be sold off or otherwise transferred into the private sector*".

In March 2011, DCLG published a consultation document , *Future of local public audit*[1], which set out proposals for all local public bodies with a turnover of over £6.5m to appoint their own auditor, based on the advice of an independent audit committee. Responses to the consultation document have been invited by 30 June 2011 and we understand that a summary of these, together with a Government response, will follow.

[1] www.communities.gov.uk/publications/localgovernment/localpublicauditconsult

As a sub-set of the broader review of the Future of Local Audit, DCLG appointed FTI Consulting to provide high level advice relating to the transfer to the private sector of the in-house practice under three main Options*:*

- Sale Option
- Outsourcing Option; and
- Hybrid Option (combination of outsourcing and sale).

FTI's advice included a high level summary assessment of the likely impact on the audit market of the three scenarios in terms of potential effects on public sector audit fees and the concentration, level of competition and contestability of the local public audit market.

There are a number of potential evaluation criteria which are summarised below. Some of the criteria conflict and therefore need to be weighed up against each other in forming a view of the potential Options to effect the transfer of the in-house practice to the private sector.

- minimisation of any redundancy costs for the taxpayer
- obtain potential capital receipt(s) for the benefit of the taxpayer
- minimise local public audit fees
- maintain quality of local public auditing
- encourage competition within the audit market (including private sector)
- minimise execution risk associated with delivery of reform
- minimise timeline associate with the implementation
- minimise disruption throughout transition period/arrangements
- auditors chosen at local level in future
- minimise other implementation costs.

Sale Option

During 2011/12, the in-house practice would transition to an arms-length commercial business. In 2013, after the necessary legislation was passed, the Commission would establish (one or more) government owned Newco(s) and make a direct award of contracts under the Teckal exemption for the whole of the 70 per cent of audits currently carried out by the in-house practice and transfer all existing in-house practice staff into it (under the Transfer of Undertakings (Protection of Employment) Regulations (TUPE) terms). The in-house practice Newco would therefore inherit all of the current staff of the in-house practice.

During 2014, Newco would bid to local public sector bodies for audit contracts in competition with the private sector firms. The length of the new contracts remains to be determined but could be for, say, three to five years. We consider that longer audits will be more attractive to private sector firms as they would provide better ability to plan and greater assurance of future revenues. A sale process could then be undertaken during 2015. Buyers would benefit from the audits secured by the in-house practice in competition during 2014.

It would be necessary to conduct a competitive sales process in order to maximise any capital receipt from this process.

Procurement law

We understand from DCLG that the transfer of the in-house practice into Newco would rely on the Teckal exemption to European Union procurement rules and that it is otherwise not possible to transfer work awarded without a public procurement exercise to such Newco.

The Teckal exemption allows a public authority to award audits directly to a company without a public procurement process providing that it fully owns it and the company does the vast majority of its work for the parent. We have been advised that there must be no private investment in that company, or any intention that there will be any sale in the future of the awarded work. All such work under this scenario would expire and/or have been re-tendered in competition by the time of sale.

Redundancies

We consider that the most likely outcome to a 2014 tender is that the Newco would win a smaller share of the incremental work tendered than its current c.70 per cent share. To create a profitable Newco for sale therefore implies that there may be a need to make existing in-house practice staff redundant during the transition period if such staff have not left through natural attrition – such costs would be borne by the taxpayer.

The in-house practice management has prepared forecasts with varying assumptions around the level of work which the in-house practice Newco could win in competition with private sector firms. These estimates are inherently uncertain and, to the extent that the in-house practice wins less work, they may need to make more redundancies to achieve profitability with consequently higher redundancy costs than currently estimated.

Execution risk

We set out below some of the potential constraints on a significant capital receipt via a sale of the in-house practice.

APPETITE AMONGST MAJOR AUDIT FIRMS?

The largest audit firms in the UK (typically referred to as the “Big 4”) have significant positions in the private sector audit market. Most also have an existing position in the local public body audit market. The Office of Fair Trading may be concerned if the local public body audit market moved towards further concentration for the largest existing participants and that may constrain bids by the biggest players (i.e. the Big 4 and Grant Thornton).

ABILITY TO FUND AN ACQUISITION?

Other private sector audit firms, particularly amongst the mid-tier accounting firms outside of the "Big 4", may feel that an acquisition of the in-house practice could provide a significant step to critical mass and assist in closing the gap with the Big 4 firms. However, it should be noted that almost all of the major audit firms have ownership models based on partnership structures. This makes it challenging for them to fund significant acquisitions using external sources of equity capital.

POTENTIAL NEW ENTRANTS?

It is possible but not certain that there are providers of outsourced professional services to the public sector that could have a strategic interest in entering a new market and building a presence in the public sector audit market.

CAPITAL RECEIPT

It is impossible to quantify potential proceeds with any degree of assurance as this depends on the result of future tenders and how successful the in-house body Newco is at winning audits against the private sector.

However we consider that any capital receipt would be limited under this scenario by a number of factors but principally by the size of the order book likely to have been won by Newco during 2014.

Management has made assumptions around the market share that will be won through the competitive tender process. We have used this to illustrate the potential sales proceeds which could be achieved with a sale of the in-house body to a private firm.

We emphasise that the quantum and achievement of a capital receipt via a sale are inherently uncertain.

To the extent that bidders expect to make further redundancies post-acquisition, this would have a cost which they would likely factor into their acquisition price. Such costs (if any) would in practice depend upon the individual buyer.

BIDDERS
Potential bidders might include:

- Private sector audit firms
- Other providers of outsourced services to public sector (i.e. new entrants); and
- Employee owned company (referred to as the “mutual”).

We understand that “favouring” an employee owned firm would be open to challenge under State Aid and other legal considerations (including from unsuccessful participants in such auction) and moreover would be unlikely to maximise capital receipt from such a sale.

It has been suggested that an employee owned Newco could fund a potential acquisition of the in-house practice by partnering with a private sector joint venture partner. However we consider this would entail drawbacks which include:

- loss of additional competition if Newco was owned, controlled or influenced by an existing audit firm
- loss or compromise of mutual status / ethos; and
- expectation that Newco would likely be sold to its joint venture partner as an exit route.

MULTIPLE SALES
It is theoretically possible that a sales strategy could be executed by way of multiple sales to different bidders (as opposed to a single sale). We consider that in practice this would give rise to additional complexity and delivery risk without necessarily delivering any material uplift in value but could have competition advantages.

SEPARATION ISSUES
There are inherent issues under the Sale Option with the separation of the in-house practice from the Commission creating a number of practical considerations.

The core areas that will likely require focus include the following:

- migration of data and systems onto buyers systems
- exit and establishment of property requirements to house the in-house practice and associated relocation costs
- establishment of in house legal and regulatory support and subsequent novation of all contracts to the Newco entity; and
- migration of all employee contracts, benefits and pensions to Newco.

Given the potential separation issues, we recommend that a more detailed review be conducted if the Sale Option is considered, particularly under the Employee Ownership' model, whereby a new infrastructure would be required. Consideration should also be given to potential transitional service agreements and project management support that may be required to effect the separation.

Outsourcing Option

During 2011/12, the Commission would, under its current powers, tender to private sector firms all audit work currently provided by the in-house practice. In-house practice staff would become employees of the successful private sector bidders pursuant to a TUPE transfer.

We understand that under this Option the Commission could divide England into a number of contract areas/lots and invite bids from private sector firms. Firms would be able to bid for one, some or all lots depending on the strategy developed. Based on the tenders received it might prove more beneficial to outsource to a number of firms on a regional basis or, potentially, to one firm nationally, were the terms sufficiently attractive (and subject to competition considerations).

The Commission has not yet completed planning for the procurement process; however, it believes it should be possible to structure bundles of audits in such a way that audit staff could TUPE transfer, albeit to varying degrees dependent on the size of lots.

A privately owned Newco owned and managed by in-house practice employees could be allowed to bid for some or all of these audits, thereby potentially creating a new audit firm in the private sector. There would need to be safeguards in place to ensure that there is a level playing field with a Newco participating in the process.

Redundancy costs

It is our opinion that such an outsourcing process should start from an objective of minimising any redundancy costs of the in-house practice staff borne by Her Majesty's Government and maximising the transfer of staff to private sector firms pursuant to the tender process.

TUPE AND COSOP
The Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) provide that on the transfer of an undertaking staff transfer with the work. TUPE will generally apply to the outsourcing of an in house service as long as the work is suitably packaged. Staff members associated with the undertaking have no choice as the transfer is automatic by law. Staff may choose to resign but would not be entitled to redundancy in such circumstances. The TUPE transfer is on current terms

and conditions, including redundancy terms, but excluding pensions (the new employer must provide a minimum level of pension provision).

It is important that DCLG reviews the implications of Cabinet Office Statement of Practice (COSOP) on staff transfers in the public sector) treatment of Fair Deal on pensions and obtains internal/external advice as appropriate. We consider that outsourcing bids would be impacted if bidders are required to transfer-in staff on comparable pension arrangements, given the resultant liabilities.

NATURE OF AUDITS

DCLG has identified that three year audits would be the minimum duration to be commercially attractive to bidders and we consider this a reasonable conclusion. It is likely that the contracts will need "break" clauses that can be triggered in certain events e.g. negligence by the auditor. We consider, however, that longer audits (e.g. five years) would be more attractive to private sector firms as they would provide better ability to plan, greater assurance of future revenues and a longer timeframe over which to manage the transition of existing in-house practice staff transferred in.

CAPITAL RECEIPT(S)

It would be commercially possible to ask bidders to tender not just on the basis of minimising cost (whilst maintaining audit quality) but also to invite firms to tender on the basis of an upfront payment they would be prepared to make to secure in-house practice staff and future contractual revenues.

BIDDERS

We consider the principal bidders under outsourcing would be the existing audit firms that perform public audits plus potential other accounting firms (see page 9) and lots could be structured to encourage bids from a mix of firms.

Participants in the tender process are likely to require access to due diligence information to allow them to analyse and evaluate the nature of the staff resources and liabilities that they would be accepting under the transfers.

In order to maximise value from the tender process it is important that the private sector firms have clarity in terms of the underlying audit regime including:

- arrangement to re-appoint auditors at the end of the audits; and
- scope and regulation of audits including the role of value for money opinions and any other proposed changes impacting auditors.

Hybrid Option

This Option combines elements of the Outsourcing and Sale Options. It is similar to the previous Sale Option but differs primarily in the transfer of a significant proportion of in-house practice staff to the private sector upfront, dependent on the results of an initial outsourcing tender.

In the Sale Option, the in-house practice Newco inherits all current in-house practice staff and then would likely need to make redundancies as it lost work to the private sector firms over time. In the Hybrid Option, such redundancies would be mitigated by holding an outsourcing tender in respect of all of the 70 per cent of audits currently performed by in-house practice. To the extent that the in-house practice Newco wins audits, it would keep the staff (and associated cost) and the level of audit work (and associated income).

Conversely, to the extent that it loses audits to private firms, it would reduce headcount via TUPE transfers, thereby removing (or at least reducing) the need for redundancies.

The primary disadvantage with this Option would appear to be greater overall complexity together with a prolonged period of transition and uncertainty.

Outsourcing

As with the Sale Option, during 2011/12, the in-house practice is moved towards being run as an arms-length commercial business.

In 2013, after necessary legislation passed, a government owned Newco would be formed and in-house practice staff and work would be transferred into this company. The Commission would then run a full outsourcing tender process in respect of the c.70 per cent of audits currently carried out by the in-house prctice. Newco would participate in this tender process in competition with the private sector firms.

As noted above, to the extent that Newco lost some or all of these bids, its redundancy costs would be mitigated by TUPE transfers of in-house prctice staff to the successful private audit firms, with residual employees being made redundant.

Sale

Under this Option, it is envisaged by DCLG that a sale process could be undertaken during 2015. As with the Sale Option, it would be appropriate to conduct a competitive sales process in order to maximise any capital receipt from this process.

Whilst we emphasise that the quantum and achievement of a capital receipt via a sale are inherently uncertain, we have assumed that the present value of such a future receipt, based on varying assumptions, would be comparable to that achieved in the sale scenario. No specific forecasts have been prepared in support of the Hybrid Option; however, we consider that the percentage of market share won under the Hybrid Option could be less due to the in-house practice having less time to prepare and establish a standalone business (as opposed to the Teckal transfer process in the Sale Option).

Other Options

Dissolution

Under this Option the Commission would be closed down (or at least the entire in-house practice element thereof). This would entail redundancy for all of the field staff of the in-house practice as well as the remaining in-house practice management and administration staff with redundancy costs borne by the taxpayer.

In future, local public sector bodies would choose their own auditor and this function would be performed by private sector firms – including (but not necessarily limited to) the five main firms currently providing this function in England.

This Option would have the benefit of structural and legal simplicity and should therefore be relatively rapid to implement, subject to any necessary legislative approval.

We understand that the existing audits between the Commission and the private sector firms would need to be terminated but this could be implemented without additional cost.

There would likely be an uneven impact on the staff of the in-house practice with some benefiting from redundancy payments then getting jobs (some perhaps with private sector audit firms) but others then finding it difficult to obtain jobs in the private sector.

Under this Option, there would be a likely loss of market capacity as a significant proportion of the skills and experience built up within the in-house practice were lost to the local public audit market. All other things being equal, this would likely have an upward impact on audit costs.

The value is largely driven by the audit contracts, however to the extent that there is intrinsic value in the in-house practice, this would be lost to the taxpayer. Some compensatory gains might be picked up by the private firms that recruited staff and benefitted from the additional audit revenues.

This Option would clearly not provide a new player into the audit market and therefore would be unlikely to generate any significant increase in market competition.

Immediate sale

It would in principle be possible for HMG to conduct an immediate transfer of the current audits and staff into a new company (Newco) owned by HMG, with a view to this company being sold to private sector firms as soon as practicable. However, we understand that this would contravene European Union procurement law as the Government can not transfer work to a company with a view to sale unless that company has won that work in competition. We understand that DCLG have previously taken legal advice on this.

Accordingly we understand that procurement law dictates that, absent a fresh competitive tender process, the Commission / DCLG could not sell the Newco until after the transitional period of directly awarded audits, thus delaying any capital receipt.

Two-stage approach

An alternative approach could be to sell a minority share of the in-house practice to a strategic partner followed by a subsequent sale at a later date of either of the remaining majority shareholding or 100 per cent of the share capital.

In the event that it were considered practicable from a legal perspective to sell a minority stake in an in-house practice Newco as the first part of a two stage process, we consider that there would be commercial disadvantages to so doing. The principal disadvantage would be that once an external strategic or financial investor had taken such a stake, it would be hard to ensure that value was maximised on the eventual sale of the remaining shares. This is because the initial investor may be able to exercise its influence to prevent, frustrate or restrict an open competitive sale process to third parties.

DCLG would therefore have less ability to plan, control and execute a full competitive sale process in the manner of its own choosing. In extremis, the risk would be that a situation was created where the only realistic buyer for the remaining shares was the initial investor.

Alternative mutual

In the discussions we have had, the “Mutual” Option has referred to an employee owned in-house practice. An alternative mutual concept would be to have an in-house practice owned by public sector bodies themselves. In addition to complexity, this would not result in a full transfer to the private sector and would give rise to potential conflicts / risks to auditor independence and so we have not explored this further.

Status quo

Whilst the current status quo is a potential theoretical alternative, it is beyond the scope of our work and clearly will not meet ministers stated aims and objectives. Accordingly we have not analysed this Option.

Market considerations

To date the market for local public body audits has been managed by the Commission, which has managed both prices and firm selection. Fees charged appear to be lower than those charged to the private sector, and whilst this may reflect many factors, it is also consistent with economic theory – the Commission is a monopsony buyer. However, the Commission is also a public sector monopoly provider and theory suggests it may be less efficient than a private sector provider.

The research and academic literature on audit markets provides some useful pointers but is not decisive. Much focuses on the private sector and/or overseas markets. The main implications are: higher auditor concentration leads to higher fees; brand/reputation is an important driver for choosing an audit firm; size, complexity and location are important drivers for audit fees; mandatory audit firm rotation may lead to higher audit market concentration; and there are significant barriers to entry, and switching, in the UK audit market.

In respect of competition, there is a question as to how the Office of fair Trading would define the market – which could be as narrow as local public bodies in a geographical area or as wide as the whole audit market. The Office of Fair Trading may have concerns if there was a move towards replication of the structure of the private sector audit market. We note that on 17 May 2011, the Office of Fair Trading announced that it had:

> *"provisionally decided that there are competition problems in the audit market that pass the statutory test for referral to the Competition Commission. However, it is now to discuss with interested bodies whether, in practice, potential remedies exist that could allow the Commission to resolve these problems… Having reached this provisional view, the Office of Fair Trading needs to decide whether or not to exercise its discretion to make a reference of the market to the Competition Commission. The provisional decision on whether or not to refer the market to the Competition Commission will be subject to a statutory consultation."*

There are major barriers to entry in the market for audit services, particularly in the FTSE 100 and FTSE 250 segments and competition may be limited. Barriers exist because of brand/reputation, client inertia, scale and scope factors, amongst others.

Barriers to entry also exist in the local public bodies audit market, and there are some additional ones, but overall barriers appear to be lower than for large companies' audits. Two of the main providers currently active in local public body audit are 'mid-tier' firms.

In future, the market is likely to be imperfect owing to both demand-side and supply-side factors. In respect of the demand-side, local public bodies are likely to be guided by brand / reputation and size, not just price. On the supply-side, the difficulty of new entry and of expansion limit the competition and contestability of the market. There are useful lessons from other markets. Experience in the National Health Service Foundation Trusts audit market since it opened up to competition suggests tendencies to concentration – but also fee reductions (at least in the short run).

Stakeholders views are quite variable. While most see trends to concentration they differ on the impact on prices. Much depends on other factors including how the market emerges in terms of demand aggregation, scope of audit and regulation.

Our appraisal of the Options suggests:

- There is a potential tendency to concentration that will apply in all Options. Since we know from research that concentration in audit markets leads to higher prices over the longer run, that is something to be avoided
- The Office of fair Trading would be likely to be concerned if the local public body audit market moved towards further concentration for the three largest existing participants (i.e. the Big 4 less Ernst & Young) and the knowledge of that may constrain behaviour by the bigger players
- There is a strong argument that the nature of the dynamics in this market will lead to concentration so that for the longer run it does not matter which Option is chosen. We do not dismiss this view
- The Option of trying to create many small players through careful design of outsourcing looks more likely to lead to a number of weak players who may not survive in the medium-term in a free market
- Overall, maximising competition will be only one of the criteria upon which decisions regarding the transfer of the in-house practice to the private sector will be made. Our analysis suggests that the differences between the Options are not clear or strong enough in this area to be the decisive factor
- We therefore consider that the focus in relation to competition / market considerations should be to avoid reinforcing the concentration in the wider audit market, in the absence of compelling reasons to the contrary. Maintaining or increasing competition should be one of the considerations but not the sole or over-riding criteria in assessing the Options; and

- We consider that outsourcing is more likely to increase competition and constrain fees in the short term, principally because more players would likely be introduced to the market.

Conclusions

Based on the projected operating profit, potential capital receipt and related redundancy costs associated with the three Options, we consider that the potential range of upside and downside in terms of net financial impact, is larger for the Sale and Hybrid Options. Further, there are a greater number of uncertainties associated with these two Options, presenting a higher level of execution risk.

We consider that the Outsourcing Option is likely to be the quickest, most effective and lowest risk option given that c. 30 per cent of local public audits are already delivered via private sector firms and that there is no obvious lack of appetite on behalf of these firms to increase their share from the current status quo.

Outsourcing via a process subject to TUPE is in our view likely to achieve the objective of minimising the redundancy costs of the in-house practice to be borne by the taxpayer. It is important however that DCLG reviews and clarifies the implications of COSOP treatment of Fair Deal on pensions given the impact it may have on the bidding firms.

We consider that the Outsourcing Option is commercially consistent with the possible achievement of capital receipts, although this would reflect a change from previous outsourcing tenders.

In relation to market and competition considerations, we conclude that maximising competition will be only one of several criteria on which a decision in relation to the Options is made. Our analysis suggests that the difference between the Options is not strong enough for market / competition aspects to be the decisive factor.

We do however recommend that consideration be given under the Outsourcing Option to ensuring that mid-tier firms are not effectively precluded by virtue of the size of lots from participating and winning audits. An outsourcing process that resulted in lots being awarded to a range of firms (including a number of mid-tier firms) would help ensure market diversity and competition.

We consider that such an outsourcing process which allows a successor to the in-house practice to bid for audits is possible (subject to conflict safeguards) and could potentially provide competitive benefits of developing an additional player in the market. In relation to the three principal Options, we consider that outsourcing is more likely to increase competition and constrain fees, principally because more players would likely be introduced to the market in the short-term. In the long-run, there may be consolidation so the long term effect on fees is more uncertain.

There are, in our opinion, uncertainties as to the appetite and ability of private sector firms to acquire the in-house practice in its entirety in its current form and therefore the achievability and quantum of a capital receipt from such a sale is not clear.

Whilst certain firms may welcome the chance to acquire the in-house practice in the aim of achieving a significant increase in scale within the audit market, these players may not have the capital structure or access to external funding to pay the intrinsic value of the in-house practice. Furthermore, an acquisition by one of the larger audit firms of the in-house practice may raise competition concerns.

In any of the above Options for moving the in-house practice into the private sector there is a question as to whether the end point regime should be appointment of auditors by the public bodies themselves or whether the Commission or a small successor body should perform this role.

Whilst consideration of the above issue is beyond the scope of this review, it is possible that factors such as the future appointment regime and any other future changes to the regime (e.g. to audit scope or regulation) could affect the level of public sector audit fees, irrespective of the mechanism chosen to transfer the work of the in-house practice into the private sector.