

## 11- 60 Future of Local Public Audits

To all APSE main contacts in England and for Wales, Scotland and Northern Ireland for information only.

### Key issues;

- This briefing considers the summary report prepared for DCLG looking at the future of local public audit
- The summary report is in response to announcements made to abolish the Audit Commission and explores how local public audits would operate in a post Audit Commission environment
- FTI consulting limited who carried out the report excluded certain commercially sensitive information so as not to prejudice the achievement of value for money / Best Value for local council tax-payers

### 1. Introduction

In August 2010 The Rt. Hon. Eric Pickles, MP, Secretary of State for Communities and Local Government, announced the abolition of the Audit Commission. Since its inception in 1983 the Audit Commission has acted as the regulator, commissioner and provider of local audit services. The Audit Commission services are provided to around 11,000 public bodies across England including local councils, health trusts, police and other various bodies.

There are around 70% of local audits carried out by the Audit Commission with around 30% outsourced to private sector firms, principally KMPG, PwC, Deloitte, Grant Thornton and PKF. DCLG published a consultation document in March 2011 setting out proposals for those bodies, with a turnover of £6.5m or more, to appoint their own auditor.

FTI consulting were then appointed by DCLG to explore the broader review of local audit and how the current in-house practice (the work carried out by the Audit Commission) could be transferred to private practice. Three options were explored being:-

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

The evaluation criteria on each of the options considered in summary the following matters but as some conflicted each was weighed against other considerations and included: -

- *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 associated with the implementation*
- *minimise disruption throughout transition period/arrangements*
- *auditors chosen at local level in future*
- *Minimise other implementation costs.*

## **2. Each option as considered**

**Sale Option:** Under this option there was consideration of a range of possible sale options but it is slightly misleading as a 'sale' option as this route also considered an initial arms-length Teckal arrangement. Under this option consideration was given to the following:-

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.

**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.

Under this Option, it was considered that 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 had not, it was noted, yet completed planning for the procurement process; however the FTI report stated that it believed 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.

**Hybrid Option:** This Option was also considered and combines elements of the Outsourcing and Sale Options. It is similar to the previous Sale Option, as detailed above, 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.

**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.

The report commented that 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. 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.

The report concluded that 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, FTI stated that they understood 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 and that DCLG had previously taken legal advice on this.

**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, it was considered 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.

**Alternative mutual:** A "Mutual" Option 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 it was concluded that this option was not explored any further.

**Status quo:** Whilst the current status quo is a potential theoretical alternative, it is beyond the scope of the consultants work and would not have met ministers stated aims and objectives. Accordingly FTI consulting did not analyse this Option.

### **3. Conclusions**

FTI consulting concluded that they considered that 'the Outsourcing Option is likely to be the quickest, most effective and lowest risk option given that circa 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'.

They also suggest that Outsourcing via a process subject to TUPE would achieve the objective of minimising the redundancy costs of the in-house practice to be borne by the taxpayer. FTI consulting also referenced the need for clarity on COSOP (Cabinet Office Statement of Practice) on the Fair Deal on pensions given the impact it may have on bidding firms. They also suggest that as part of the outsourcing option 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 they say, market diversity and competition.

#### **4. APSE comment**

The FTI consulting report makes some interesting observations as to the complexity of the process in developing alternative arrangements for local audits, particularly given the in-house practice at the Audit Commission currently carries out around 70% of local audits. The report acknowledges that there are risks associated in generating sufficient competition outside of the 'big four' accountancy firms and at the same time state aid issues in relation to certain proposals, which have been rejected as viable options in the report, such as setting up a staff mutual option.

The timetable set out in the report is certainly challenging and reflects the speed with which the decision to abolish the Audit Commission was reached. There are also additional complexities surrounding the potential transfer of staff, skill losses from the sector of the audit staff and staff pension issues.

It remains to be seen if the outcomes that Government are seeking in terms of more companies entering into the public audit market and greater efficiency in audit prices can be achieved through the proposed outsourcing route.

The Commission's Board is carrying out a [procurement process](#) to give private sector bidders the chance to compete for the Commission's audit work. This will mean all of the Commission's in-house work will be outsourced in time for the audit of 2012/13 accounts.

Whilst the Audit Commission will remain in place to oversee the contracts and other statutory functions it will be significantly smaller following the outsourcing arrangements.

Mo Baines

Principal Advisor