

Local Government Audit Committee Briefing

Quarter 2, June 2019

The EY logo consists of the letters 'EY' in a bold, white, sans-serif font. A yellow diagonal line is positioned behind the 'Y', extending from the bottom left towards the top right.

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working world



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This sector briefing is one of the ways that we support you and your organisation in an environment that is constantly changing and evolving.

It covers issues which may have an impact on your organisation and the Local Government sector as a whole.

Our national Government and Public Sector (GPS) team have produced this briefing using our public sector knowledge, and EY's wider expertise across UK and international business.

This briefing brings together not only technical issues relevant to the Local Government sector but also wider matters of potential interest to you and your organisation.

You can find out more about any of the articles featured by following the links at the end of the briefing.

We hope that you find the briefing informative and should this raise any issues that you would like to discuss further please contact your local audit team.



Government and economic news

Economic forecast – EY Club Item

There will be little respite from the weakness the UK economy experienced last year. The economy expanded by 1.4% in 2018, the slowest rate since 2009. It looked like growth was picking up over the first three quarters of 2018, but this pattern was driven largely by erratic factors related to the weather, dragging on activity early in the year, then boosting it over the summer, and the last quarter of 2018 saw growth slip back. 2019 offers some upsides – lower inflation is boosting spending power, as should a relaxation of fiscal austerity. If a Brexit deal passes before the October-end deadline, some pent-up investment may come back on stream. However, more caution by consumers at home, and weakness abroad, particularly in the Eurozone, present downsides. If a 'no-deal' Brexit is avoided, we forecast GDP to rise by 1.3% this year, with growth in 2020 running at 1.5%. The UK leaving the EU without an agreement, however, would see the economy likely suffer stagnation or even a mild recession in the first half of 2020. In that eventuality, we forecast growth of only 0.1% next year.

The bank of England will struggle to raise interest rates more than once this year

With inflation forecast to run below the Bank of England's 2% target this year and economic growth – even under our assumption that a Brexit deal is struck – running at a modest pace, the need for tighter monetary policy is questionable. At most, the Bank may pursue one hike in Bank Rate in 2019, with August

the most likely date for a rise in the official interest rate from 0.75% to 1%. But a 'no-deal' outcome to the Brexit negotiations would probably lead the Bank to cut rates, as well as engage in unconventional policies such as quantitative easing.

Office for Budget Responsibility 2019 Forecast

The Office for Budget Responsibility has forecasted the following relating to the general economic outlook for the country:

- ▶ GDP growth is expected to stabilise at 1.5 % over the medium term
- ▶ The unemployment rate remained broadly flat at 4%; this is the lowest rate since 1975
- ▶ Average earning growth for 2019 is expected to be 3.1%
- ▶ CPI inflation is expected to remain close to the target inflation rate of 2%

The Government's public finances have continued to improve since the previous autumn statement. The Government has announced that it is to take a balance approach to its public finances; reducing borrowing and debt while also committing to support public services.

It was also announced that the Government will hold a Spending Review for Government departments during 2019 including three year budgets for resource spending, if an EU exit deal is agreed. The results of which will be announced as part of the Autumn 2019 Budget.

The Local Government Association (LGA) have responded to the OBR's forecast commenting that 'now is the time to invest in our people and our places'. The LGA were disappointed that Government has not resolved the £3bn funding gap for local authorities for the 2019/20 financial year. Additionally, the LGA are calling for the Government's Spending Review to provide better financial sustainability for local authority funding, and for the Spending Review to be published before the Autumn Statement so that local authorities have time to plan ahead for the next financial year.

Sustainability of local authority spending: an IFS review

The Institute for Fiscal Studies (IFS) report of 29 May 2019 concluded that the current funding system for local authorities is unsustainable in its current form. According to the IFS, overall spending by English councils fell by 21% between 2009/10 and 2017/18. For some services the reduction in spending was much deeper; for example, culture and leisure services were cut by 40% while planning, development and housing experienced reduced expenditure by up to 50%.

The report also examined future funding and cost pressures for local authorities. Local authorities are reliant on council tax and business rates to support the provision of services. However, the IFS forecast that within 15 years, adult social care costs alone will use up to 50% of local tax revenues (compared to the 38% during 2017/18). This forecast has factored in annual council tax increases at the maximum amount currently allowable (without holding a local referendum) of 3%, including the social care precept. If adult social care costs require 50% of local authority budgets to fund the service, then there would be scarce resources available to fund all the other services that local authorities provide, especially given the context that many of these services have already had funding reduced significantly since 2010.

The IFS has stated that in the future government will be faced with a big choice – councils will need to be provided with additional revenues to enable them to continue providing existing services; or government and society must accept that councils will only be able to provide fewer and/or lower quality services. David Philips, Associate Director at the IFS, has said: "A proper national debate on how much we are willing to pay and what we expect of councils is therefore needed".

The chair of the LGA, Councillor Richard Watts, has commented on the IFS study saying that huge uncertainty remains on the future of local government funding. The Spending Review, currently underway by central Government, will be critical to secure the sustainability and financial viability of some services and councils.

In a separate study conducted by PwC, commissioned by the County Council Network, it is thought that the funding gap faced by local government authorities by 2025 could be as large as £30bn. With such a large funding gap it is likely that authorities are more likely to only offer the 'core minimum' of services.



Accounting, auditing and governance

NAO consultation on the Code of Audit Practice

Under the 2014 Local Audit and Accountability Act a review of the Code of Audit Practice (the Code) is required every five years. The Code sets out what local auditors are required to do to fulfil their statutory responsibilities under the Act. This encompasses how audits of a local body's financial statements are conducted, including reporting, and also how assurance is gained on local body's value for money arrangements. The current form of the Code came into force on 1 April 2015, so a revised Code will be required to take effect from 1 April 2020 for the audit of local body's financial statements for 2020/21.

The National Audit Office (NAO) is responsible for the Code and has launched a consultation in two phases. Firstly, through consultation of key stakeholders, which closed on 31 May 2019, and then a public consultation on the draft text of the new Code. The second phase is expected to run from September to November 2019.

The NAO has estimated that in 2017/18 £64mn was spent on fees to external auditors for both local government and local NHS bodies in England. External auditors provide independent assurance that local bodies are properly accounting for spending and that adequate value for money arrangements are in place to manage their affairs. This review of the Code is a valuable opportunity to shape the future of local authority audit. For more information on how to contribute to the NAO's Code consultation refer to the NAO website.

NAO consultation response – EY point of view

At EY, we welcome the timing and context underpinning the NAO's Consultation. We believe the NAO has a critical role to lead and shape the future of local audit and through that role help to secure the future sustainability of the public audit profession. The Code of Audit Practice (Code) and supporting auditor guidance notes present a significant opportunity to reform local public audit. We believe it should be guided by the following principles:

- ▶ Reforms should enhance, or at least should not create risks to, audit quality.
- ▶ The importance of the multi-disciplinary model to support local auditors to respond efficiently and effectively to the increased complexity and risks facing public sector bodies.
- ▶ That there should not be a two-tier system of generally accepted accounting and auditing standards between the public and corporate sectors.
- ▶ To be effective and sustainable, reforms need to focus on the local public audit ecosystem, including changes to how local auditors conduct and report their work on local public bodies Value for Money arrangements. We also believe that increased transparency of reporting to local taxpayers is needed to improve the effectiveness of local public bodies' corporate governance, financial position, risk appetite and rationale for significant decisions.

We also recognise that the consultation comes at a time of significant scrutiny of the UK audit market and profession. We believe it is crucial that the Code is closely aligned with the outcome from various reviews.

CMA Publishes Final Report on Audit Market Study

In April 2019, the Competition and Markets Authority (CMA) released its findings following an investigation in to the UK audit industry.

The following recommendations seek to address the vulnerability of the industry in the event of a loss of a 'Big 4' firm and the current views on choice and competition.

Operational split of UK Audit work

The CMA has recommended that auditors should focus exclusively on audit to avoid being influenced by consultancy services. To do this the CMA have recommended that firms should have separate management and Boards for the audit service line, separate financial statements for the audit service and no profit sharing between audit and consultancy divisions.

Mandatory joint audits

Barriers for entry to the audit market for firms outside of the 'Big 4' are large. The CMA recommends mandatory joint audits to increase the capacity of firms outside of the Big 4, to increase choice and to drive audit quality.

Audit Committee regulations

It is essential for Audit Committees to appoint auditors that are likely to provide robust and constructive challenge to the accounting policies applied. The CMA recommends that regulators should hold Audit Committees more vigorously to account, including reporting the process for appointment and supervision of auditors.

Regulator five-year progress review

The CMA recommends that the effects of these changes should be reviewed five years after implementation in the first instance and periodically thereafter. This should consider:

- ▶ Advantages of the transition to independent appointment of auditors
- ▶ If the operational split should go further
- ▶ How to adapt the joint audit approach to changing markets

EY's response to the CMA recommendations

EY continues to believe that the right set of comprehensive changes is needed to enhance protection for UK pensioners, employees and investors. The CMA proposals announced risk reducing the UK's attractiveness for business. They represent a missed opportunity to create lasting change and make the UK the best and safest place to invest and work.

We were surprised that the CMA has recommended mandatory Joint Audits, given the level of opposition from companies in their submissions to the market study and the lack of evidence internationally that this measure would improve audit quality or auditor choice. We look forward to understanding the basis of this recommendation and seeing the supporting analysis.

We fundamentally disagree with the CMA's proposal for an operational split of the Big Four. We believe this would undermine audit quality by reducing our ability to draw on critical skills, capabilities and investment and diminish the resilience of the audit business. Evidence supports the benefits of a multidisciplinary model to delivering quality audits.

At a time when the FRC is reviewing corporate reporting and the Brydon Review may change the scope of audit, it appears ill-timed for the CMA to restrict the skills needed to deliver high quality audits now and in the future.

We will continue to play an active and constructive role in all the interconnected reviews into corporate reporting and audit.

We remain committed to working with regulators, standard-setters and other stakeholders, to ensure that the profession best serves the evolving needs of business, investors and the public interest. EY believe that our strong track record on audit quality, with no fines from the FRC on any audit conducted in the last five years, positions us well to make our views heard.

CIPFA consultation: new Financial Management Code

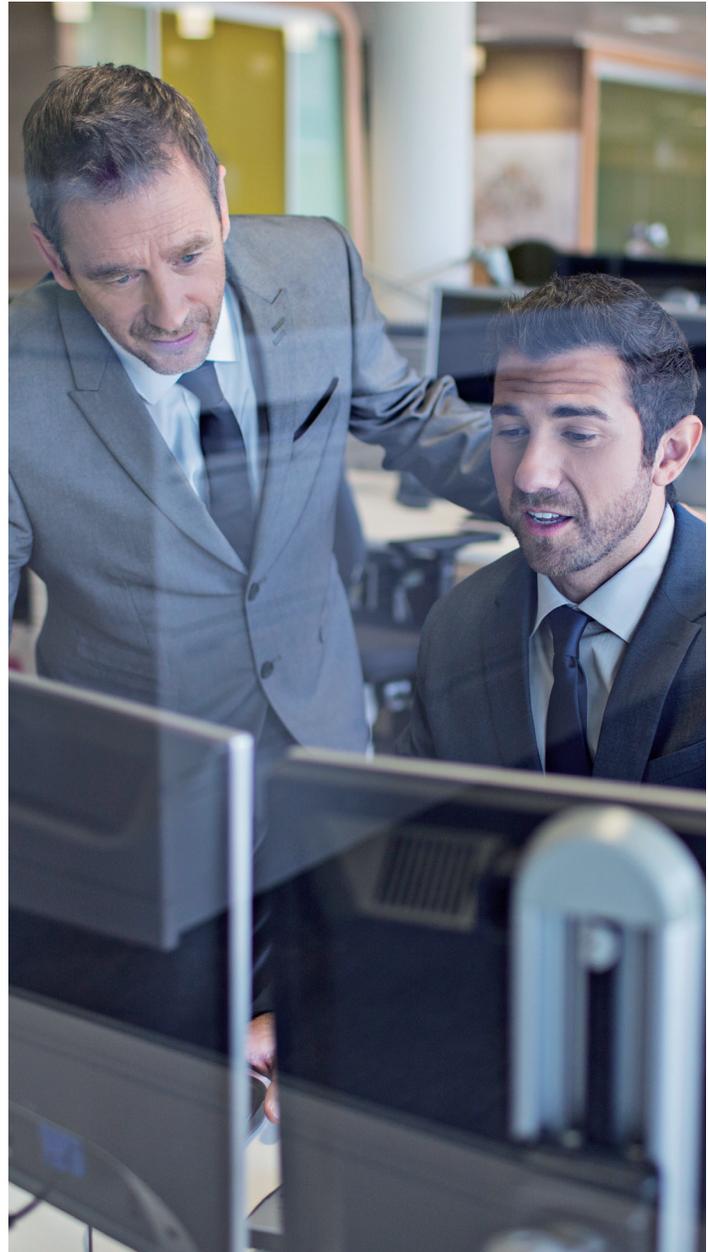
The Chartered Institute of Public Finance and Accountancy (CIPFA) has completed its consultation on a new Financial Management Code (FM Code) which aims to improve financial management for all local authorities. The FM Code is designed to help officers of local authorities to navigate the increasing complex issues of public sector finance, including financial sustainability. The FM Code is the first time that many areas of local government financial management have been considered and consolidated in the context of a code.

The consultation version of the FM Code is available on the CIPFA website. It has been 'road tested' by a range of local authorities to consider whether it is fit for purpose and the practicalities of implementing the FM Code.

EY has responded to CIPFA's consultation on the FM Code. It is EY's view that the FM Code would assist officers of local authorities to manage their finances. The FM Code should apply to all local bodies because the principles of sound financial management are relevant for all entities; however consideration should be given as to the reasonableness of whether local authorities have sufficient time to comply with the FM Code's implementation date of 1 April 2020.

Additionally, in EY's view, there is merit in requiring authorities to include a statement of compliance within their Annual Governance Statement; however, consideration should be given as to the nature of the compliance statement because local auditors would have to review this compliance statement for consistency with their knowledge of the entity. Furthermore, it is important that longer term financial planning by local authorities is encouraged. Long term financial planning is challenging for local authorities due to the uncertainty of the future funding schemes and the impact of other central government decisions. These factors should be reflected, and disclosed, within the estimates and judgements used by authorities in their financial resilience assessments.

CIPFA expects to issue the FM Code by October 2019.





Other News

Protecting the vulnerable through innovation and data

Local authorities are under pressure to deliver more services at higher quality with less resources. Consequently, innovation and use of new technologies has played an important role to achieve ambitious cost saving targets across the country over the past few years. One recent example of this is of four London boroughs, working with EY, to develop a data-driven risk stratification model that enables the authorities to predict and identify families and children at risk of entering safeguarding services.

The cost of vulnerable children requiring support represents 73% of an authority's typical spend on children's services. This cost pressure is likely to increase as recent Department of Work and Pension (DWP) figures suggest that child poverty increased by 6% in 2017/18 compared to 2016/17.

The system is expected to reduce annual costs by £1.2mn for a typical London borough sized authority. Savings have been realised by the authorities involved in the project through using a data-analytics based system to improve the accuracy of predicting which children and families would require statutory intervention in the future. This has enabled early interventions to be made rather than more serious intervention measures at a later date in time.

As a result of this the system is able to use data to help protect vulnerable people by enabling early intervention. This has enabled vulnerable individuals to receive support they need to address problems before they escalate and increase the likelihood of long-term adverse effects.

Another increasing cost pressure for local authorities is homelessness, which has increased by 165% since 2008/9 according to a report published by WPI Economics. The Government has a target to end rough sleeping by 2027. The LGA has commented that local authorities are working to end homelessness by preventing it from happening in the first place. One innovative solution to do just that being used by a London borough, working in partnership with EY, is a 'whole-system' approach that identifies individuals or households at risk through bringing together a range of data sources to create a single view for each household. Predictive risk modelling is then used to assist officers to identify at an early stage those at risk of homelessness. This has enabled more targeted early intervention measures to be taken by the authority.

Key Questions for the Audit Committee

Economic Forecast – EY Club Item

Has your authority completed a Brexit impact assessment?
Has this assessment been incorporated in informed corporate and financial decision making and risk management?

Office for Budget Responsibility 2019 Forecast

How has your authority considered the latest economic outlook in their Medium Term Financial Strategy?

How will your authority prepare for the outcome of Spending Review expected in the autumn?

Sustainability of local authority spending: an IFS review

How does your authority measure the sustainability of its spending?

How resilient is your authority to the increasing demands for services, in particular adult social care service, and other cost pressures?

NAO consultation on the Code of Audit Practice

What changes would your authority like to see in the Code of Audit Practice?

CMA Publishes Final Report on Audit Market Study

If there are changes in the audit industry, what impact do you think it will have on your authority's external audit work?

CIPFA consultation: new Financial Management Code

How prepared is your authority to comply with the new CIPFA Financial Management Code?

Protecting the vulnerable through innovation and data

How does your authority encourage innovation?

How does your authority use technology and data to focus services where they are needed the most? For example, identifying vulnerable individuals at risk to enable early intervention.

Find out more

Economic Forecast – EY Club Item

<https://www.ey.com/uk/en/issues/business-environment/financial-markets-and-economy/ey-item-club-outlook-for-financial-services-spring-2019>

Office for Budget Responsibility 2019 Forecast

<https://www.gov.uk/government/news/spring-statement-2019-what-you-need-to-know>

https://cdn.obr.uk/ExecSummary_March_2019.pdf

Sustainability of local authority spending: an IFS review

<https://www.ifs.org.uk/publications/14134>

<https://www.local.gov.uk/about/news/lga-responds-ifs-report-council-funding>

NAO consultation on the Code of Audit Practice

<https://www.nao.org.uk/code-audit-practice/wp-content/uploads/sites/29/2019/03/Local-audit-in-England-Code-of-Audit-Practice-Consultation.pdf>

<https://www.publicfinance.co.uk/opinion/2019/05/nao-seeks-views-local-audit-code>

CMA Publishes Final Report on Audit Market Study

<https://www.gov.uk/government/news/cma-recommends-shake-up-of-uk-audit-market>

CIPFA consultation: new Financial Management Code

<https://www.cipfa.org/policy-and-guidance/consultations/financial-management-code-consultation>

<https://www.publicfinance.co.uk/news/2019/03/cipfa-consults-financial-management-guidance>

Protecting the vulnerable through innovation and data

<https://www.ey.com/uk/en/industries/government---public-sector/ey-protecting-vulnerable-citizens>

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