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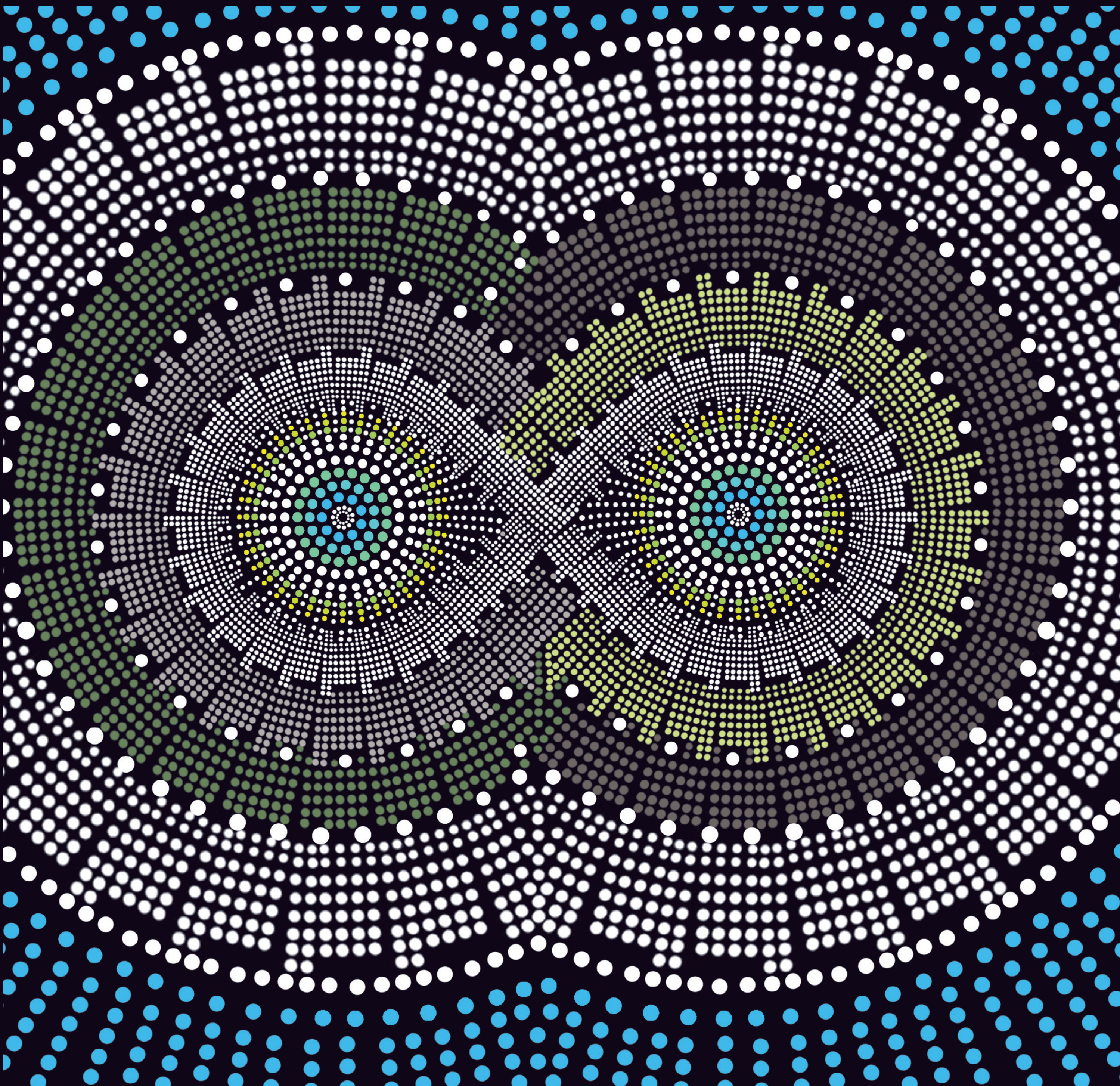
Fit for purpose?

Discussion on the future of audit



CIPFA The Chartered Institute of Public Finance & Accountancy

PF Perspectives

This is the ninth in a series of *PF Perspectives*, produced by CIPFA and *Public Finance*. They are designed to stimulate discussion on key public finance and policy issues. These essays, by leading public sector practitioners and experts, examine the future of the audit process and its implications for the financial management and delivery of public services

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FOREWORD

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It is absolutely vital that our public institutions are able to gain and retain the trust of the public. Audit has a key role to play in this.

Local audit is the long-stop for financial and governance failure and is a vital means of providing assurance and accountability to the public, stakeholders and government. But with financial failures in both the public and private sectors making such a splash in the press, it's no wonder that public trust is turning to public scepticism.

There have been significant shifts in the approach to audit in many areas of the public sector. The passing of the Local Audit and Accountability Act 2014 signalled the end of almost two centuries of district audit, and the creation of new local audit arrangements to scrutinise councils and other local authorities.

While this change may have generated savings for councils – a valuable benefit given the cost pressures faced by local government – a real question has been raised around the consequences of valuing cost over quality. As comptroller and auditor general Gareth Davies points out in this edition of *Perspectives*, this question is particularly pertinent at a time when authorities are turning towards commercial investments to generate revenue. When entering into these more commercial activities, the need to manage risk well and account properly for assets and liabilities is becoming more and more important. Such investments carry unfamiliar risks, meaning more assurance is needed, not less.

It's clear that these shifts, both in the way local audit is delivered and the broader context of austerity and councils' responses, have presented challenges for local audit. It is more important than ever that the sector comes together as a community of practice to identify solutions to these challenges and forge a new way forward.

In the essays collected here, sector leaders consider the processes that scrutinise government and hold its institutions to account, and tackle the debate around the future of external audit head on.

What role should audit play in policymaking? Do auditors have the right skills to meet the needs of modern public bodies? What changes are needed to make audit more effective?

There is no single player that can take this forward. It is vital that everyone with a stake in this issue contributes to the debate in order to form a shared vision for a future that we can all get behind.

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TRUST

Power to the audit

ESSAY

BY GARETH DAVIES

Public audit must create a clear, concise dialogue with people to regain their confidence and call out abuse where it sees it. But to do this, its independence must be protected, because without it we would all be poorer

Gareth Davies is comptroller and auditor general, National Audit Office

IMAGINE THERE'S NO AUDIT. I wonder if you can? No, not an extra verse, subsequently discarded, from an earlier draft of *that* song, but, perhaps, a timely thought given the chorus of anger and concern about the effectiveness of audit. If we don't have confidence that auditors will flag issues that threaten the sustainability of public services, or the survival of companies in the market, why bother?

Let's contemplate for a moment a UK in which tax-funded public bodies must report each year on what they've done with the money entrusted to them. There might even still be a set of standards setting out how they should do so. But what they say they've received and spent, and what they claim to have achieved, is not subject to independent external audit. The argument might be that public bodies are accountable to government, to Parliament or to their electorates and so their assertions can be challenged by the media, politicians and by the public – including those armchair auditors we've heard about. It might be said that it is in the court of public opinion, and ultimately through accountability to the electorate, that the value of public services is truly tested.

Continue with this thought, turn it over in your mind. Imagine...

So, even where minimum standards exist by which public bodies report their financial position, performance and achievements, what will the leaders and managers in this UK do when the going gets tough? When there are hard choices to make involving winners and losers, uncertainty and risk, how transparent and rigorous will the reporting be? Even in the most straightforward scenarios – for example, how much was spent? – there will be varying ways by which bodies could present their financial performance and position.

How confident would the public feel about what they are being told? How sure would we be that the way one body measures what it owns and owes is comparable to another's? To whom would we turn if we needed an objective and trusted view on whether public bodies are doing what we expect of them by making good use of our taxes?

Private sector lessons

Let's abandon my thought experiment. To have trust in public bodies, there has to be independent assurance about what public bodies say they do with taxpayers' money. It's needed to support effective transparency and accountability for the decisions of those who are stewards for the public purse, and to examine objectively what works and what doesn't in the pursuit of value for money. But that assurance must be relevant and reliable.

Even in the private sector, where criticism of auditors has been the angriest and loudest, there is no serious suggestion that we should do away with external audit completely and just leave companies to their fate in the market. The public's stake in these entities is too great and we recognise it is essential to have someone independent of management to provide assurance to the providers of capital. This is fundamental to the deal that goes with enjoying limited liability. Instead, rightly, there are calls to strengthen audit, bring in more safeguards to ensure its independence, and better and more timely reporting based on a deeper understanding of the business and governance of the audited body.

In this respect there may well be lessons for private sector auditing from the public sector. Across the UK you'll see that public audit generally has stronger arrangements to ensure its independence, is wider in scope than company audits, and has an impressive track record of reporting without fear or favour. Public audit has the most impact when it can use its wide powers to cast new light and gain fresh insights on problems concerning governance, legality and regularity, and value for money.

Auditors can access people, information and systems, examine and report on annual accounts, and look at how well public servants exercise proper stewardship. But with these privileges and powers comes a heavy responsibility to support effective accountability, promote improvement in the use of public money and seek to improve the quality, impact and value for money of the audit process itself.

'It is essential that the public has reliable assurance about how local bodies use and account for their money'

A new code of practice

What more can be done to further strengthen public audit?

Local public bodies in England are subject to audit under the Code of Audit Practice published by the National Audit Office (NAO). The NAO is currently considering how local public audit in England can be strengthened through a new code of audit practice – a new code that's needed no later than spring 2020.

Local public services in England account for a significant amount of public spending. In 2017-18, 495 local authorities, police and fire bodies were responsible for approximately £54bn of net revenue spending, and 442 local NHS bodies received funding from the Department of Health & Social Care of approximately £100bn. These bodies are also responsible for delivering many of the services local taxpayers rely on every day.

It is essential that the public has reliable assurance about how local bodies use and account for their money. But are local auditors focusing on the right things? Should they instead be looking to report more effectively on the present and future challenges facing local public bodies? For example, the effects of austerity, uncertainty arising from the UK's withdrawal from the EU, climate change, and the demographic changes increasing demands for services. Public bodies need to continue to innovate and find new ways of responding to these challenges, while maintaining the trust of taxpayers.

To take just one example, in recent years, the number of local bodies entering into partnerships with other organisations – including private companies – and the number looking into "commercial" activities to generate income streams to support new ways of delivering services has grown rapidly. When entering into these more commercial activities, the need to manage risk well and account properly for assets and liabilities is becoming more important. Private companies and lenders expect assets and liabilities to be properly accounted for in accordance with recognised standards. ▶

Local auditors have a key role in providing independent assurance, not only about financial statements, but also arrangements to transform and manage services and finances sustainably. This integrated approach is a defining strength of the wider scope of public audit. However, there are concerns that auditors' work on arrangements to secure value for money has been crowded out by a combination of the volume of work needed on financial statements and the constraints of significantly lower fees. Through the NAO's work on a new code we want to look at how the focus and balance of work within an integrated local public audit has the right focus and impact.

To have impact, it is vital that when local auditors report findings, and especially when they flag concerns, their reports are relevant and accessible, especially to people without a finance background.

When organisations fail, or encounter significant difficulties, people often ask what the auditors were doing. Auditors need to ensure that where they are identifying risks and issues they draw attention to them promptly and clearly, so bodies can take appropriate action and the executive can be held to account.

The new code should play an important role in setting the expectations for when and how local auditors report issues to the bodies they audit. One way it could do this would be by introducing explicit principles of effective reporting, to make clear that local auditors should report on a timely basis – clearly, concisely and objectively, without fear or favour.

When reporting in public, auditors should use language that the readers will understand. Auditors should use the most appropriate form of reporting available and, if making recommendations, be clear what actions the audited body should take and when. More should also be done by auditors to follow up actions taken and to escalate their reporting if bodies aren't doing enough to address concerns.

Public audit matters hugely, but it must have the right impact. When so many are questioning the effectiveness of auditors we should reinforce the principles of public audit, its independence, wider scope and reporting.

As I embark on my term of office as NAO comptroller and auditor general, I am determined to see public audit – both nationally and locally – evolve to meet the needs of a changing society. Never has there been a greater need for independent, relevant and trusted auditing in the public interest. ●

'Auditors should use the most appropriate form of reporting available and be clear what actions the audited body should take and when'

When identifying risks, auditors must draw attention to them promptly and clearly... so the executive can be held to account

Looking up from the books

ESSAY

BY SARAH HOWARD

Public audit needs to re-engage with taxpayers, become less technical and put its energies back into value for money

IT WAS AT A GRADUATE recruitment fair in 1986 when the Audit Commission first caught my eye. The commission was in its heyday and public audit was an exciting place to be. In those days I learnt not just about the accounts, controls and stewardship, but also about economy, efficiency and effectiveness in public spending. I delved into planned and responsive housing repairs, the operation of direct labour organisations, legality of land sales and vehicle fleet management. We talked about probity, public interest, reasonableness and the Wednesbury principles. Audit was about making a difference and driving improvement. There was engagement with members and, in the extreme, the issuing of high-profile public interest reports and even surcharge.

Others, like me, were drawn to what is unique about public audit. I still work alongside colleagues who joined the commission the same time as me. We are all steeped in public audit, we care about how public money is spent and what excites us goes far beyond simply auditing the accounts.

It wasn't all plain sailing. I had a wobble, just after I'd passed my CIPFA exams. It was soon after, when I found myself sitting in front of a chief constable, discussing the correlation between control room demand (999 calls) and supply (resourcing), that I realised that public audit is the best job in the world.

I never looked back – until now. My year as CIPFA president has given me the chance to reflect and look to the opportunities that lie ahead.

The nature of public audit is significantly different now. We seem to have lost sight of what is important, those very things that attracted me and others to public audit in the first place. So how did we lose direction?

First, the commission was abolished. While the commission had lost its sense of purpose and suffered from scope creep, reform – not abolition – was the answer. Instead the failings of the commission were conflated with the public audit model underpinning it, and the principles of public audit (independent appointment, wider scope and public reporting) were cast aside.

The result was that trust was eroded, the expectations gap increased, and the impact of audit diminished. Auditors are no longer appointed independently in the NHS and independence has been weakened in local government. The scope of the audit (not to be confused with quality) has become too narrowly focused on the accounts. Value for money work is no longer having an impact at a time when the financial sustainability of the sector is precarious, finance colleagues are under immense pressure and risk in service delivery is increasing. Auditors are reporting less in public, yet the public's expectation of them is rising.

It is interesting that the debate about trust, the expectations gap and impact is very much alive in the corporate sector and are areas being considered by Sir Donald Brydon in his review.

The various functions of the commission have been dispersed and the regime has become fragmented. The scope of audit is set by the National Audit Office (NAO) in the Code of Audit Practice; procurement in local government is managed by Public Sector

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Audit Appointments (PSAA); and quality is regulated by the ICAEW and the Financial Reporting Council (FRC). The broader oversight role of the commission has gone – notably its ability to look up and across local government and the NHS – so things tend to fall between the gaps.

Second, local government accounts have become far too long and complex in areas that do not impact on the general fund. This means that scarce audit resources are being diverted away from value for money and directed instead at technical areas of the accounts that appear to be of least relevance to taxpayers. Local government in England has done well in delivering early close, but this has created a significant peak in audit workload that the agencies in Scotland and Wales can not deliver. This can create pressure for NHS and local government audit teams working long days, weekends and bank holidays over a three-month period, causing recruitment and retention challenges. This at a time when, more generally, the respect that specialism in audit should command is at risk of being eroded.

Third, the regulatory regime is no longer tailored to public audit. In his review last year, Sir John Kingman pointed out that the FRC, which in the future will have a much wider remit, "is an expert in private sector corporate audit; and its expertise on, and detailed understanding of, issues relevant to local audit are currently limited". The complex accounting standards are also requiring the regulator to focus on aspects of the accounts that councils frequently tell us are of least relevance to local government. Other aspects of the corporate regime do not sit well, for example, the definition of "public interest entities" as authorities with listed debt bears little relation to where real risk lies in local government.

Finally, there is the matter of cost. Since 2012 the audit of local bodies in England has been provided exclusively by audit firms and fees have fallen by about 60%. Regimes in Scotland and Wales have not seen the same reduction. The consequence is that over time the number of firms involved has reduced. Firms have spent many years growing and investing in public audit teams around the country and remain committed to the market. At a time when over two thirds of engagement leads (a partner or director leading an audit) are over 50, this investment is critical in growing the leaders of the future. But with operating margins being squeezed it's easy to see a regime that is unsustainable, that fails to provide the assurance local bodies need or create an environment that will inspire a next generation of public auditors.

We need to remind ourselves what the purpose of public audit is and be clear about who it is for. While wider public interest is important, I believe we may be overlooking local taxpayers as a key stakeholder and we need to define, and then focus proportionate assurance on, what is most important to them. If we get that right, then we will have a chance of inspiring our future talent to build a career in public audit.

One solution, which Kingman proposes, is to recreate a single oversight body for public audit. The debate about that needs to happen urgently, but the government's current response risks kicking it into the long grass. In the meantime, there's no magic ▶

'Local government accounts have become far too long and complex in areas that do not impact on the general fund' wand. Like many challenges facing public services, no one organisation holds the key. All stakeholders need to put aside short-term organisational priorities and join together behind one longer-term goal of ensuring the sustainability of public audit.

So, which road would I take?

First, we need to reset the scope of audit through the Code of Audit Practice. My firm has suggested how to do that, and increase public reporting, in our response to the NAO's code consultation. Getting the code right is critical to providing the assurance that local bodies and taxpayers need, and also in attracting and retaining future talent – offering the same rich experience that I had.

Second, we need to refocus time within the accounts audit to where it matters most. CIPFA has a key role to play in reviewing the accounting code to improve the usefulness of local government accounts, which, in turn, will improve the effective use of audit time. In order to further smooth the workload peak, I recommend moving the deadline for value for money work from July to September.

Third, and following on from the above, the regulatory regime needs to better focus on what is important to the users of public audit. We look forward to working with the FRC in considering how its regime can best meet the needs of taxpayers and other stakeholders, and how all of our actions and reporting can support the sustainability of public audit.

Last, we need sustainable fees to encourage firms to remain in the market. This is not simply about increasing fees. While getting the accounting code and regulatory regime right is key to ensuring existing resources are focused on areas of greatest risk from a taxpayer's perspective, PSAA also needs to have a conversation with the sector about what assurance it wants and is prepared to pay for. I welcome that the PSAA is considering how it will approach the balance between cost, scope and quality as part of the next procurement in such a way that will sustain a vibrant and balanced market, encouraging firms to remain committed to public audit.

Now is the time to take the opportunity to build on the rich history of public audit. All of us in the sector want the same outcome – good quality audit that meets the needs of local taxpayers – and we each need to embrace the challenge of change. Let's all engage the right gear and drive on to deliver a regime that delivers for all stakeholders and ensures that public audit remains sustainable for generations to come. ●

'All of us in the sector want the same outcome – good quality audit that meets the needs of local taxpayers'

One solution is to recreate a single oversight body for public audit. The debate about that needs to happen urgently...

The constant gardeners

ESSAY

BY GENE L DODARO

Independent information is crucial to helping policymakers sow the seeds of good government and weed out bad practice

GOOD GOVERNMENT IS DRIVEN by facts and public audits help drive those facts. Auditors shed light on difficult issues by bringing together evidence-based reports that are crucial in the overseeing of government programmes and the allocation of resources to better serve the public.

In the US the oversight provided by public audit is more critical than ever given the opportunities and challenges facing the nation, including governmental fiscal health, national security and public healthcare.

The Government Accountability Office (GAO) is the supreme audit institution in the US. We are an independent, non-partisan professional services agency in the legislative branch of the federal government. Commonly known as the investigative arm of Congress or the "congressional watchdog", we examine how taxpayer dollars are spent and develop non-partisan, objective and reliable information to help lawmakers and agency heads make government work better.

To be useful, our reporting needs to be fact-based, non-ideological, fair and balanced. Public auditors evaluate and verify information that is assembled in evidence-based reports. These reports inform the decision making of elected officials and their staff. As a public audit institution, the GAO is committed to maintaining its integrity, objectivity and independence. These principles allow auditors to serve the public interest and maintain the credibility of public audit. If our reporting was not objective, it would not provide the unique information needed by lawmakers and agency heads to make decisions and operate the government effectively.

The US federal government is one of the world's largest and most complex entities; about $4.1trn in outlays in the fiscal year 2018 funded a broad array of programmes and operations. Public audit therefore needs to provide information to assist lawmakers and agencies in prioritising actions. In the fiscal year 2018, we issued 633 reports and testified 98 times before Congress.

The high-risk list

One of the GAO's key bodies of work is our high-risk list. This identifies government operations vulnerable to fraud, waste, abuse and mismanagement, or needing broad transformation. Every two years with the start of each new Congress, GAO issues an updated list describing the status of high-risk areas, outlining actions needed to ensure further progress and identifying new areas needing attention by Congress and executive branch officials.

The high-risk programme continues to be a valuable tool for congressional oversight, one that yields tangible benefits for the American people. Lawmakers use the high-risk list to help set oversight agendas and the findings have formed the basis for both agency-specific and government-wide solutions. The financial benefits to the federal government in addressing high-risk areas over the past 13 years (fiscal years 2006-18) stands at nearly $350bn, or an average of about $27bn per year.

Areas cited on the high-risk list include: Department of Defense financial

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management and business operations; Medicare (health insurance for persons aged 65 and over) and Medicaid (a healthcare programme for low-income and medically needy individuals); veterans health care; postal operations; enforcement of tax laws; and the management functions at the Department of Homeland Security. The list also highlights areas where the government faces potentially large financial liabilities, such as billions of dollars in flood insurance claims, pension system guarantees and disability claims. The list also includes a number of areas that have a direct impact on the health, safety and wellbeing of the American people, including the control of toxic substances, food safety, oversight of medical products and protecting the nation's cyber critical infrastructure.

‘If our reporting was not objective, it would not provide the unique information needed by lawmakers and agency heads to… operate the government effectively’

The audit report
Another key GAO product is our annual audit report, required by Congress, on how to reduce fragmentation, overlap and duplication in federal programmes, agencies, offices and initiatives, as well as lowering costs and increasing revenue. The imbalance between revenues and spending means federal government is on an unsustainable long-term fiscal path.

Addressing this problem will require broad fiscal policy changes, but our reports have identified a number of areas where improvements can be made in the near term. Resulting action taken by Congress and executive branch agencies, from 2011 to 2018, has led to about $262bn in financial benefits – $216bn through 2018, with $46bn more expected.

Elected officials and the American public rely on the GAO's work because it is fact-based and independent. Our high-risk list and annual report, as well as hundreds of other reports and testimonies on day-to-day government operations, are useful precisely because of our reputation for integrity and objectivity.

By suggesting improvements to federal agency operations, we help increase their spending effectiveness and enhance taxpayers' trust and confidence in government. When the GAO proposes change, federal agencies do listen: in 2018, 77% of our recommendations were implemented. However, Congress is concerned that some agencies need to do more.

In 2019, to spur progress, the GAO made public the letters we send to federal agencies with our recommendations to help improve the management of government programmes and operations, improve public safety and security, and achieve significant cost savings. Congress has also passed a law requiring each federal agency, in its annual budget justification, to report on any GAO recommendations that have not been implemented and their status.

To continue to meet Congress' growing need for information, the audit profession also needs to enhance its capacity in emerging fields. For example, we recently combined and enhanced our technology assessment functions, and science and technology evaluation into a single, more prominent office. This will expand the GAO's support to ▸

lawmakers on topics such as artificial intelligence, regenerative medicine, 5G wireless communication and quantum computing.

It is important for public audit to continue to provide fact-based information and reports, and for the GAO to strive to be a model government agency. This helps to enhance the profession's set standards for integrity, objectivity and independence. Moreover, the GAO by leveraging its domestic and international partnerships can build collaborative networks to share best practice with the wider audit and accountability communities.

The focus of our profession must continue to be providing evidence-based, independent reports. Maintaining independence is key to providing policymakers with objective information necessary to make decisions. These good practices can drive results to one overarching goal – effective and efficient government for the benefit of our citizens.

'By suggesting improvements to federal agency operations, we help increase their spending effectiveness and enhance taxpayers' trust in government'

CHALLENGES AND OPPORTUNITIES

Pulling in the same direction

ESSAY

BY TONY CRAWLEY

What are the challenges faced by those working within the new local audit landscape? And how can the industry create a sustainable market for the long term?

THE LANDSCAPE OF LOCAL AUDIT in England has changed considerably since 2010. We have migrated from a model where the Audit Commission controlled all aspects of local audit arrangements, to a plural system that is entirely dependent on firms for its audit supply. Public Sector Audit Appointments (PSAA), created in 2014 as part of these changes, procures audit services, makes auditor appointments and sets scale fees for the 484 public bodies that have opted into our national scheme.

After completing our first collective local government audit procurement, valued at £140m for five years, we asked Cardiff Business School (CBS) to review our performance and help us develop and progress. Its report concluded that our work represented "an outstanding example of sector-led improvement". This was particularly rewarding for the team given our compressed timetable, which meant that the invitation to tender and the contract design had to be finalised before we knew how many of the 495 eligible bodies had opted in to our offer.

CBS' report also provides an interesting analysis of, and commentary on, the new local audit landscape. Its value lies in its identification of the challenges to be addressed if the regime is to succeed in the long-term, particularly the emphasis on the sustainability of audit supply. This chimes with CIPFA president Sarah Howard's challenge to the sector, namely, where is the next generation of public sector professionals coming from?

Before considering sustainable audit supply in more detail, it is worth reflecting on the depth of the changes in the local audit framework since 2010.

The Audit Commission's control of local audit arrangements has been supplanted by a system that is dependent on a range of specialist firms. The Ministry of Housing, Communities & Local Government is the commission's residual body and has an overarching responsibility for the new framework set out in the Local Audit and Accountability Act 2014 (LAAA). The National Audit Office sets the Code of Audit Practice that establishes the scope of the auditor's work – it is consulting on the next version which will apply for 2020-21 onwards. The Financial Reporting Council and ICAEW have complementary regulatory roles and responsibilities.

So, what are the issues identified by CBS that need to be tackled to future-proof the new regime and assure its resilience and success for the long-term?

Working in the new landscape

First, with so many different players in the new system, we need to face up to the risk of fragmentation. All the bodies involved must have a shared commitment to the system's overall efficiency and effectiveness. We must all work collaboratively, respecting each other's specialist roles, to deliver a seamless, joined-up system.

Second, we need to be ready for possible changes impacting audit regulation, auditing standards and audit firms. By coincidence, the LAAA is being rolled out at a point at which there is significant government and public concern about auditing, following a number of high-profile corporate failures in the private sector.

Recommendations from the Kingman and Competition & Markets Authority reviews

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Tony Crawley is chief executive, Public Sector Audit Appointments

are already in the public domain, with more to come when the Brydon review, looking at the quality and effectiveness of audit, completes its work. While the principal focus is on the audit of large companies, any resulting change in regulation, standards, firms or services will almost inevitably impact on local public audit. Some changes may be easy to accommodate, while others may be highly disruptive.

Third, if change has the effect of making the local audit market more or less attractive to suppliers, it may have a direct bearing on the sustainability of the audit model. This is a question that must be met head-on. We must also be alert to unintended consequences in important areas such as audit quality.

Local audit is a niche market in which there are fewer than 10 accredited suppliers, with six currently carrying out local government audits. Distinctively, there is no longer a state auditor in the system to guarantee full coverage and continuity. Given the total dependence on firms, we have to find a way of ensuring that the market remains competitive and sustainable for the long-term. This is not an issue limited to PSAA. It is also a real challenge for organisations in the NHS and elsewhere opting to make their own appointments, particularly those that are relatively remote geographically.

Possible solutions include encouraging more firms to enter the local audit market by lowering the barriers and the costs of entry. Could we, for example, provide interested firms with access to advice and support to ease the entry route? Or adjust our tendering arrangements to offer smaller "starter-pack" contracts for new entrants?

We are also carefully following the private sector debate on joint audit appointments, as they have the potential to enable new entrants to gain experience of local public audits alongside established audit suppliers. Could such arrangements work effectively in local audit – including the likely additional cost? Would local bodies be willing to accept the appointment of inexperienced auditors or joint auditors in the interests of developing a more sustainable market in the long-term?

Other, more radical, options may include some form of state or not-for-profit audit supplier. This, in turn, would pose questions around viability, affordability, political acceptability and competition.

Old skills and new timetables

The sustainability of the local audit market is not just about the attractiveness of the sector to firms. It is also about the availability of people with the right skills. Auditors are required to understand the nature and business of the organisations they audit, and have a detailed knowledge of the requirements of the relevant audit, accounting and governance codes.

Auditors must also look at the organisation's value for money, alongside their financial statements opinion, exercise a range of statutory powers and, in local government, deal with electors' objections. This all requires experience and expertise. In a system in which the market shares of individual firms may ebb and flow as contracts are won or lost, investment in training and development of local audit staff is likely to ▸

'The Audit Commission's control of local audit arrangements has been supplanted by a system that is dependent on a range of specialist firms' fluctuate. This can lead to shortfalls in the supply of well-trained, suitably experienced audit staff. This is a particular challenge in audit leadership and management positions.

A further challenge arises from the local government accounts publication timetables introduced by the Accounts and Audit Regulations 2015 from 2017/18. This has created a pronounced spike in local government auditors' work in June and July each year to meet the non-statutory target date for publication of audited accounts of 31 July (previously 30 September). This has effectively halved the window for delivery and doubled the staffing requirement for this period. For most firms this follows on immediately from intense activity in April and May on NHS audits and we know it is a major challenge for planning and resourcing audits.

The local audit system clearly needs continuous investment in training and development of staff over an extended period. Options include securing contractual commitments from firms and/or developing some form of joint training programme for local public auditors.

Finally, all of the challenges and questions posed need to be considered in the context that the sector itself is subject to increasing pressures and is developing different strategies to respond to its new circumstances. In particular, several high-profile cases have focused attention on the financial resilience of local authorities. This in turn has highlighted the gap in expectation between the requirements of the current code and the desire of officers and members for reassurance about arrangements for financial resilience and sustainability.

The NAO's current two-stage review of the code provides an opportunity to discuss this issue and make appropriate adjustments. The debate alone will be valuable in terms of establishing a higher level of understanding of what auditors can and cannot do, and hopefully a consensus on what we want them to do within those boundaries. Their remit can be flexed, but it is not infinitely flexible.

The new local audit model has been successfully implemented, despite high levels of turbulence in the sector and the industry. That is no small achievement. But now it is up and running we need to look to the future and address some important issues to ensure that it remains effective and resilient for the long-term. No single party has a monopoly of wisdom to determine the precise road map that needs to be followed. We need all of the interested parties – the sector, the profession and all of the stakeholders of local audit – to engage and contribute to a collective response.

'No single party has a monopoly of wisdom to determine the precise road map. We need the sector, the profession and all of the stakeholders of local audit to engage'

Telling the whole story

ESSAY

BY FIONA KORDIAK

A number of high-profile business scandals has put auditing in the pillory. But a mixture of transparency, relevant skills and codes of practice – and good old-fashioned scepticism – can build back public trust

Fiona Kordiak is director of audit services, Audit Scotland

IN MY 30 YEARS as an auditor I've never seen the profession as under the spotlight as it is now. High-profile company collapses have dented public confidence in accountants, auditors and our regulatory regime. It hurts to see my profession pilloried in the press. And although attention has focused on the corporate sector, there is an obvious risk of contagion to the public sector. I now worry about the attractiveness of audit as a career for our new finance professionals. This is a shame as most public sector audit work is of a high quality and has a positive impact on public services. Audit has also provided me with a great career, full of variety and challenge.

The reality is that high-quality public sector audit has never been more important. Declining budgets, increasing demand and political uncertainty bring risks. The auditor general for Scotland, Caroline Gardner, concluded last year that decisive action is required to secure the future of Scotland's health service. Words not said lightly. Meanwhile, recent work by the Accounts Commission highlighted that recurring control weaknesses are becoming apparent in Scottish councils. South of the border, the problems at Northamptonshire County Council are an extreme example of what can happen when things go wrong.

We've had a flurry of reviews and reports in response to corporate failures and audit quality issues. Failure of independence, failure in the scope of audit, failure of audit quality and failure of regulation have all been highlighted. So how does public sector audit measure up against this?

Beyond the numbers

In Audit Scotland we are confident, but not complacent. Scottish public bodies do not appoint their own auditors – the auditor general and the Accounts Commission do this. Auditors are rotated every five years to avoid overfamiliarity and to bring a fresh eye to the audit. Financial audit work is undertaken by a mix of Audit Scotland auditors and firms (big four and non-big four), so we don't have the same issues of market concentration and lack of competition.

Debate has accused auditors of focusing on the numbers in the financial statements over considerations of financial sustainability and that they are being insufficiently challenging of management estimates.

The wider scope of public audit in Scotland goes beyond the numbers. Our performance audit work considers how well public money is used to implement policy, address risks and improve services and outcomes for people. Our code of audit practice for financial auditors ensures a judgment that goes beyond whether a body is a going concern, with auditors looking to the medium and longer-term financial horizons. For example, in addition to reviewing financial and savings plans, our auditors are increasingly expected to comment on the realism and likelihood of success of these plans, and report on that publicly.

We all recognise that complexity, lack of transparency and the extent of estimation are all factors in public sector accounts, particularly in local government where the

'Our code of audit practice for financial auditors... goes beyond whether a body is a going concern, with auditors looking to the medium and longer-term financial horizons'

financial statements attempt to present the position in both accounting and funding terms. This means that some financial statements do not "tell the story" as clearly as they should. We know auditors can do more to work with their clients to streamline financial statements and improve clarity. To help, we've produced a good practice note on improving the quality of the performance report in central government and are planning a similar publication for management commentaries in local government.

Despite the wider scope of public audit, and arguably because of it, there remains a gap between what we do as public sector auditors and what the public think and expect. We don't have the power to stop things, change policy decisions or force public bodies to act in response to our findings. We need to be clear and unapologetic about our role and what it does and doesn't do.

We also shouldn't underestimate the power of public reporting and political scrutiny. There is nothing like the thought of an appearance at the Public Audit and Post-legislative Scrutiny Committee (PAPLS) – the Scottish equivalent of the Public Accounts Committee – to concentrate minds and galvanise action in response to audit findings. And we have clear escalation processes when needed. The controller of audit can make a statutory report to the Accounts Commission on any local government issue and the auditor general can make a statutory report to PAPLS. This provides a very public means of holding organisations to account.

Escalation, of course, only works if the auditor has found the issue in the first place. As soon as something goes wrong the cry goes up of "where was the auditor?" Sometimes they will have found the issue and reported it, but no action was taken. Sometimes there will have been a failure of audit quality – the auditor should have spotted the issue but didn't. Sometimes, however, the issue is simply not something the auditor could be reasonably expected to detect.

The right balance

Fraud is a good example of this. Auditors design their testing to detect material fraud, error and irregularity. But materiality extends to several million pounds in most public sector bodies, while I imagine most members of the public would consider a fraud of £10,000 as a sum of some importance. Public sector auditors also evaluate the adequacy of the arrangements that public bodies have in place to detect and prevent fraud. In Audit Scotland, we are thinking how we could better target this work to focus on high-risk areas. Could we do more? Of course we could, but at what cost? There is a debate to be had about the level of assurance we want from the auditor and what we are prepared to pay for it.

High-quality audit cannot be assured through rules and standards alone – by its nature it is judgmental and based on human decisions. The Financial Reporting Council (FRC) has highlighted that recent failures in audit quality have also included a failure to show appropriate scepticism.

It's a skill influenced by personality and circumstances, so some of us are just naturally more sceptical than others. But we do train our auditors on what is needed to deliver a sceptical audit through knowing the organisation, gathering the right evidence, asking the right questions and challenging judgments through team discussion and peer review.

As in most things, there is a balance to be achieved. A team full of auditors at the extreme scepticism end of the trust/doubt spectrum would never finish an audit or develop a constructive relationship with their client. Care is needed to get the right blend in an audit team.

And we need to equip our auditors with the right skills and support to make difficult judgments. Even technical accounting questions are rarely black and white, and judgments can be more difficult in our performance audits or when considering questions of financial sustainability, leadership and culture. The stakes are high for getting it wrong. We aren't exposed to the high fines imposed on firms by the FRC, but we report in public on some very sensitive issues. Every member of our staff is acutely aware that the reputation of the organisation lies in their hands.

In Audit Scotland we already benefit from a team that isn't only comprised of accountants. Our performance audit team come from a wide variety of backgrounds and increasingly work in mixed teams with our financial auditors. But there are still gaps in our skill set. Sometimes we fill this by bringing in specialists for short-term assignments or using panels to test our findings. For example, we have recently established a youth panel to work with us to identify priority issues for young people and improve the relevance and targeting of our work.

'We need to equip our auditors with the right skills and support to make difficult judgments. Even technical accounting questions are rarely black and white'

Digital future

New technology is also having an impact on what we audit and the way we do our audits – auditing digital and digital auditing. We are increasingly using new visualisation tools to present our work. We have only started this journey but recognise that a lack of digital skills is slowing us down. We are reliant on a small number of skilled enthusiasts and need to both increase the size and resilience of our specialist team and train our audit teams to conduct data-enabled audits. This will not be easy as digital skills are scarce and expensive, but we can't afford not to.

As new financial powers come to Scotland, the impact of the performance of the Scottish economy on public finances is increasing so we need to improve our economic analysis skills to enhance our audit. In the future we are likely to make greater use of specialists, such as actuaries and valuers, to support the financial audit given the level of estimation and complexity in the accounts, and the increased focus on questioning management's judgments.

The audit of the future may look quite different from what we do today, with routine work automated and greater use of specialists to ask the right questions and interpret the results. But the mission of public sector audit won't change. We've seen the difference our work can make, with action taken by government before the ink is even dry on some of our reports. Our aim will be to continue to be constructive and forward-looking, providing assurance on the use of public money, identifying areas for improvement and recommending and encouraging good practice. That's the best way to build trust.

Called to account

ESSAY

BY PREM SIKKA

The auditing industry resembles a closed shop that polices itself, constantly blurs the line between providing and selling services, and is protected by government when things go wrong. There has to be change

Prem Sikka is professor of accounting and finance at the University of Sheffield

A PARADE of real or alleged financial issues at companies such as BHS, Carillion, London Capital & Finance and Patisserie Valerie has dominated news headlines in the past 12 months.

The 2008 financial crash was a clear sign that a complete overhaul of overall auditing processes was needed. But instead of carrying out a root and branch reform, regulators have sought to appease the auditing industry, rather than protect shareholders.

The industry's fault lines are many, but the emphasis here is on just three: auditor independence, audit quality and auditor liability.

Auditor independence

The principle of auditor independence is a key cornerstone of external audits relating to areas such as health and safety, food hygiene, taxation and immigration controls. In no case is the auditee permitted to directly hire or remunerate the auditor. Auditors are also not permitted to give business advice to the auditee.

In the world of financial audits, however, such norms are overturned. Companies are permitted to appoint and remunerate auditors and, even worse, auditors can become business advisers to companies. Such arrangements could create subtle pressures upon audit firms to appease company executives.

The auditing industry and the big corporations have long resisted the independent appointment and remuneration of auditors. Yet this arrangement works well elsewhere. For example, following the Local Government Finance Act 1982, the Audit Commission appointed and remunerated auditors for local authorities and a range of public bodies. All auditors appointed by the commission were generally forbidden from selling non-auditing services to audit clients, with the exception of statutory returns.

The big four auditing firms – PricewaterhouseCoopers (PwC), KPMG, EY and Deloitte – had difficulty in penetrating this market and lobbied for change. The Local Audit and Accountability Act 2014 replaced the Audit Commission with Public Sector Audit Appointments (PSAA), a company limited by guarantee and owned by the Local Government Association. The PSAA is responsible for appointing auditors to the principal local bodies: fire and rescue, police, national parks, waste authorities and transport. It also sets audit fees. Contracts are independently awarded to create a portfolio of clients that match a firm's capacity to deliver.

This model should also apply to about 7,500 large companies as defined under the Companies Act 2006. In addition, auditors of these companies must only conduct audits and no other business. This is to prevent them becoming part of the very transactions that they need to independently audit.

Some companies object to audit-only firms. Some claim that an organisational split, where audits and non-auditing services are separated by Chinese walls within one unified entity, is preferable. Such a structure, however, even where internal codes of conduct exist, does not curb the temptation for audit firms to sell consultancy services to clients. But a structural separation of audit from non-audit business is essential.

In resisting reforms, accounting firms may state that a structural separation would somehow constrain them from recruiting good staff. There is, however, no substance to this. You only have to look at the National Audit Office, HMRC and the Health and Safety Executive: all recruit multidisciplinary teams to conduct audits, made up of individuals familiar with accounting, tax, information technology, security, systems and law. There's no reason why accounting firms can't follow their example.

Separation anxiety

Some accounting firms also claim that a structural separation of audit from non-auditing business would somehow prevent them remaining part of their respective international networks. Again, such a claim has no substance. For example, many firms have offices in offshore jurisdictions. Such jurisdictions rarely require companies to publish audited financial statements. The firms in these boltholes have the ability to sell a variety of consultancy services, but are still part of international networks.

Organisational culture is a key ingredient in the manufacture and quality of external audits, but is not the subject of any public disclosure. At company AGMs, resolutions to (re)appoint auditors are not accompanied by any meaningful information. There is no information about the composition of the audit team, time budget, hourly charges, audit contract, major questions asked by auditors and the replies from directors, recent regulatory action against the firms or anything else. The public availability of such information would persuade firms to examine their organisational practices and also empower stakeholders.

Consider the case of former retailer BHS, which was audited by PwC. According to a published report by the FRC[1], the audit partner spent just two hours on the audit and 31 hours doing consultancy work for the company and its directors. The audit senior manager recorded only seven hours and was not involved in the final stages of the audit – while an audit manager recorded 29.25 hours and a "junior" team recorded 114.6 hours. Despite a record of losses, cashflow problems and withdrawal of financial support from its parent company, BHS received an unqualified audit report. The investigation by the FRC showed that the audit work in relation to a number of areas was inadequate.

Now imagine what would have happened if audit reports and resolutions to (re)appoint auditors were accompanied by information about the composition of the audit team, its time and budgets. That requirement would have encouraged reflections on organisational practices and checked some of the more corrosive ones. The public availability of this information, together with the audit contract, management representations and a list of recent regulatory actions against the firm would have enabled stakeholders to make an informed assessment of the desirability of appointing the firm as an auditor.

For far too long the auditing industry has sheltered behind secrecy and confidentiality to organise its own accountability off the political agenda. The public availability of audit files would enable stakeholders to assess the quality of recorded audit work: stakeholders ▶

'Organisational culture is a key ingredient in the manufacture and quality of external audits, but is not the subject of any public disclosure' bear the cost of audits and should have the right to see the outcomes. In a consumer society, organisations from potato crisp manufacturers to airlines have to ensure that their product is fit-for-purpose and customers are compensated for poor quality of service. In contrast, successive governments have indulged auditors by granting them more liability shields without any quid pro quo. These shields include: no "duty of care" to any individual stakeholder; proportional liability under which auditors can only be held liable for losses arising from their own negligence; contributory negligence; limiting liability by trading as a limited liability partnership (LLPs) or limited company; and disclaimers of responsibility. It is almost impossible to sue auditors for delivering shoddy audits.

> 'The FRC's 2018 annual report showed that 27% of the audits it inspected needed more than limited improvements'

Audit liability

It is difficult to think of an economic theory or practice that suggests that the weakening of producer liability and of consumer or societal recourse incentivises producers to improve the quality of goods and services. This is even less so in the state-guaranteed market of auditing, reserved for accountants belonging to a few trade associations.

The FRC's 2018 annual report showed that 27% of the audits it inspected needed more than limited improvements. Lax liability laws have weakened incentives for diligent audits and do not encourage partners to police each other or strengthen the desire to improve the quality of audits.

Key reforms must include pinning personal liability on audit partners and their firms for the delivery of poor audits. Individuals and society at large must be empowered to sue negligent auditors, and auditors should owe a duty of care to individual stakeholders.

An audit is manufactured within the organisational context of the firm, which provides training, personnel, commitment, communicative and operational competence, technology, client recruitment and infrastructure necessary for the production of all audits. The firm receives the fee and its name appears on the audit report. The firm is central to the production of audits and must be held liable for any shortcomings. Any agreement enabling auditors to escape liability must be null and void. The veil of incorporation upon LLPs must be lifted and the Companies Act 2006 should be amended to state that where a partner of the audit firm acts negligently, fraudulently or colludes with directors, civil and criminal liability shall fall upon the partners concerned and upon the firm jointly and severally.

Inevitably, all this will be resisted by an industry that has got used to having its way. Audits are a means of securing trust and public accountability of businesses, and protecting stakeholders from financial malpractices. Governments have two basic choices: impose reforms in the teeth of opposition and/or develop alternative ways of delivering audits. ●

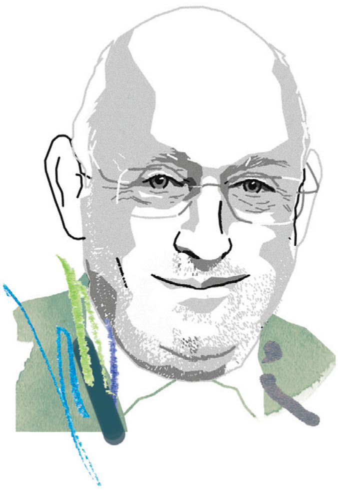
Prem Sikka was the chair of an inquiry into the auditing industry, commissioned by the shadow chancellor John McDonnell. It published a report in December last year: *Reforming the Auditing Industry*

[1] FRC Report into PwC's auditing of BHS, published by the FRC, August 2018. To download the report, visit: **https://bit.ly/2nBSMo6**

FIT FOR PURPOSE

A local difficulty

ESSAY



BY MAX CALLER

Failures in local government are too easily blamed on a lack of due diligence, but is the problem down to councillors' political inexperience and not understanding the rules of the game?

__Max Caller__ is a consultant and was lead inspector for the Best Value inspection of Northamptonshire County Council

IN RECENT YEARS there have been several accounting scandals. In the private sector, Carillion and Patisserie Valerie. In the public sector, Northamptonshire and Tower Hamlets councils.

The failure to either discover or act on these events until it was too late has led to calls to make changes to the way the audit process is regulated and organised. But are there other forces at work? Are we really saying that the system of checks and balances designed to allow the public to have confidence in the published state of an organisation doesn't work? And that it's OK for management failure not to be found out by the internal governance process?

While I'm not qualified to pass judgment on the private sector failures, the collapse of Carillion, which had significant interaction with the public sector, was not particularly surprising.

I am, however, well placed to comment on the local government context. I was the chief executive brought in to turn Hackney council around in 2000; one of the intervention commissioners imposed on Tower Hamlets during 2014-17 to bring it back from illegality; and the lead inspector who undertook the Best Value inspection of Northamptonshire county council in 2018.

Dealing with failure

Hackney was a failure arising from political chaos and inadequate management leadership not challenged by elected members. There was a complicated system of internal trading accounts that were never reconciled with the statutory accounts, and the budget was balanced using heroic assumptions on such things as tax collection rates, which were never capable of delivery. There was no shortage of external audit observations setting out concerns and qualifications. The district audit service had a very good handle on what had happened and what the current position was, often better and more insightful than many other external inspectors and commentators, and they were prepared to say so.

Without compromising its audit independence in any way, on my arrival, district audit was prepared to help by focusing its efforts on achieving maximum effect and providing constructive challenge on the road to improvement. What marked out this relationship was the fact that district audit understood both the business and the context. Its reports provided the springboard for the first use of powers under the then recently enacted Local Government Act 1999 to impose Best Value performance plans.

Tower Hamlets and Northamptonshire were different. In both these authorities there was a failure of leadership – both political and officer.

In the case of Tower Hamlets, the external Best Value inspection report found significant irregularities in a number of areas. Most notably, in the awarding of grant funding to the voluntary and community sector. All the processes that one would reasonably expect in other councils were absent, including proper documentation of the decisions themselves. Concerns had been raised but these had not been followed up on by either the council's statutory officers or the external auditor. Yet the evidence was plain to see – in some instances because there was no evidence to support the decisions taken.

The Northamptonshire failure began with an unwillingness to accept fiscal responsibility by both leading councillors and officers, and a strategy promoted by a chief executive that had no underpinning analysis of risk and reality. Even after external audit had qualified the accounts as failing to meet Best Value principles, the authority still failed to act.

In both these cases it required an additional outside challenge before intervention by central government exposed the scale and scope of the issues, and allowed a path back to legality to be followed.

Never say 'never again'

While these cases are rare, they are not so isolated that we can confidently say "never again". Even today, I am aware of a small number of authorities that like to adopt a pick-and-choose attitude to statutory guidance when it comes to balancing the books, while ignoring the overall context. Their auditors have either signed this off or seem not to deem it worthy of comment.

Every time an event along the lines of Northamptonshire and Tower Hamlets occurs it means that all councils suffer from the resulting regulatory changes. We need to be careful that potential changes in the external audit regime do not follow in that same vein, even if, like myself, you are convinced that the current system is not fit for purpose.

The current system of checks and balances can only be successful if the culture of an organisation, its leaders and its compliance with a complicated set of rules are fit for purpose. This was covered in part by the Committee on Standards in Public Life in its review of local government ethical standards, published in January this year.

Evidence to the committee suggests that a culture of poor governance in some local authorities is, in part, due to the effect of spending restrictions, which has produced slimmer structures, and the added pressure of external audit fees. This has resulted in a hollowing out of knowledge, expertise and context. It is as though institutional memory and knowledge has been so eroded that no one understands how things are supposed to work, and how the system of checks and balances provides security and integrity. As the report states: "Scrutiny, oversight and audit process can stagnate when there is a lack of appreciation of why they exist."

Some councils know there are rules that need to be considered, however, the rules have no anchor or foundation in the culture and working practices of the organisation. They have lost sight of why the rules exist – Northamptonshire being a prime example. Those individuals with statutory responsibilities do not fully understand their roles, so fail to act or improve standards.

Being a good professional does not automatically mean that you can be a success as a statutory auditor, a section 151 officer with the remit of overseeing the financial health of the council, a monitoring officer, or a head of paid service. It is also not ▶

'Even today, I am aware of a small number of authorities that like to adopt a pick-and-choose attitude to statutory guidance when it comes to balancing the books'

clear how it is possible to gain the necessary experience to cope with the range of challenges these roles require in the new-style organisations. No longer will aspirant leaders go to meetings to be challenged by the public, draft coherent reports which meet organisational and legal requirements, or even understand how we got here. It is not clear that the various professional bodies, either individually or collectively, recognise this as a gap. They do not promote appropriate development programmes, or performance manage those charged with statutory responsibility.

In my view this is the biggest gap. Organisational changes designed to break up commercial groupings will not address the problem and may serve to make things worse by narrowing further the experience necessary to make sense of the data.

So, what can be done? Do we need specific targeted development opportunities aimed at equipping future office holders? Should there be a requirement for the attainment of a form of certificate of professional competence and regular mandatory development, either before or within six months of being appointed to a statutory role? How might we support these individuals when facing challenges they've never seen before, and how do we do this in real time? How best do we learn from the past, while recognising that things are changing quickly?

What is clear is that we have many good people who can lead when things are going mostly to plan, but less who can cope when things go wrong. The current framework won't reduce the incidence of public failure. There needs to be a much wider and considered approach, which looks at the system as a whole. ●

'We have many good people who can lead when things are going mostly to plan, but less who can cope when things go wrong'

Evidence suggests that a culture of poor governance in some local authorities is, in part, due to the effect of spending restrictions

Internal audit – beyond the crossroads

ESSAY

BY ELIZABETH HONER

In an increasingly complex world, with all the business risk associated with it, internal audit needs to adapt – and quickly

“WE CANNOT SOLVE our problems with the same thinking we used to create them.”
Albert Einstein

From small beginnings
It’s 9 December 1941, two days after the attack on Pearl Harbour. Twenty-four men (one might assume), all internal auditors, convene in New York City. The Institute of Internal Auditors is born. Exactly what triggered the meeting on that particular date is opaque and no doubt coincidental to the shock that brought the US formally in to the Second World War. More relevant was that John B Thurston, internal auditor for a utility company based in New York and who became the Institute’s first president, was agitating for internal audit to be recognised as distinct from, and not as an extension to, external audit. The need for that distinction continues to this day.

Internal audit has never been more needed than it is now. The scale and complexity of risks facing organisations is rising, with internal audit being well placed to influence better outcomes, combining deep business knowledge with objectivity. But with technology doubling in power each year, dramatically accelerating the pace and style of service delivery, as well as the way organisations are run, internal audit needs to change, and change quickly.

Risk just got riskier
A recent US study notes that “the magnitude and severity of risks affecting [their] organisations are greater in 2019 than in the prior year”[1], with boards perceiving a much riskier environment than their executive counterparts. Concerns that existing operations and legacy infrastructure may not be able to meet expectations, as well as those of competitors “born digital”, has leapt from 10th to top position. Other risks in the top five are: succession and retention challenges; heightened regulation and scrutiny; cyber security; and resistance to change. That’s the global picture, across different industries and sectors.

These risks chime with an analysis by the Government Internal Audit Agency (GIAA) of audit plans for the current year, with the notable addition of those arising from the supply chain in commercial arrangements and, perhaps inevitably, a lesser concern about regulation and scrutiny which is in the genes of government.

The same US study concludes that organisations need to realise “that the level of investment in risk thinking and their willingness to engage in robust risk management tools and dialogue is inadequate”. Internal audit has a vital role to play here, in helping organisations assess and modernise their risk management capabilities and processes, in looking ahead and anticipating new risks, and, of course, appraising the effectiveness of the measures put in place to manage them. Internal audit, with its unique combination of deep internal knowledge and professional objectivity, is a power to be harnessed. A report by the Chartered Institute of Internal Auditors UK and the Institute of Directors reminds audit committees and directors of internal audit’s ability “to speak with authority and objectivity about the entire business and the risks it faces”[2].

__Elizabeth Honer__ is chief executive of the Government Internal Audit Agency

The 21st-century organisation

We live in an era of exponential developments in technology and data processing – a post-digital age some argue – which is affecting how services are delivered, but is also rightly prompting some to reconsider how organisations are run. Management academics acknowledge that their research is based "on an understanding of organisations that dates back to the 1950s, 1960s and 1970s"[3]. This sees control as coercive as opposed to enabling, with a focus on formal rather than informal control mechanisms, and where controls are singular not holistic.

All three forms of control, which I am sure we all recognise as still prevalent, not least in the public sector, are, the academics argue, "increasingly outdated for modern organisations as both organisations and the world has changed". Prompted by the need to deliver products and services more quickly, with a preference by employees for greater empowerment, modern organisations are restructuring to be less hierarchical, more fluid, flatter, using technology to enable teams to stay aligned.

These shifts have significant implications for internal audit. The purpose, as expressed in the CIPFA's Public Sector Internal Audit Standard, is "to improve the effectiveness of risk management, control and governance processes" and so "enhance and protect organisational value". With organisations changing, along with the nature of control, to become less formal and more dynamic, that does not alter our core purpose but, rather, the way we achieve it.

Transforming internal audit

Whatever the organisational paradigm, delivering essential services at best value to the taxpayer will remain paramount in the public sector. That will continue to require effective risk management, controls and governance. It is the way they are exercised that will need to be adjusted to meet the pace of change today, with internal audit needing to transform alongside .

We in the internal audit function are exploring and planning for what that means, for the methods, technology and skills needed. That in turn has implications for professional training and the continuous development of our people.

Methods

The pace at which risks are changing requires more agile internal audit methods that provide a real-time insight so swift adjustments can be made by management.

Traditional methods, of taking time to negotiate terms of reference, conducting fieldwork over a number of weeks, preparing a well-crafted written report and agreeing written recommendations, no longer work if findings are to be relevant in dynamic environments.

Such environments require a model that sees internal auditors both integrated more into the fabric of the business – analysing and commenting in the moment – and working more closely as communities of practitioners, sharing learning and insights across organisational boundaries for the good of the profession. How results are presented also needs to be dynamic, enabling management to drill down into the details as needed.

These changes present real challenges for internal audit, in how we remain truly independent and objective, how we respect confidentiality, and how and when we record our assessments and recommendations. Critically, the three lines of defence risk becoming blurred, raising questions about how to maintain them in the modern world or, more significantly, whether the model itself needs rethinking.

Technology

Data analytics are already changing how we audit, enabling a swift analysis of whole populations rather than samples and automatically flagging anomalies in the application of controls. But what about artificial intelligence (AI) and robotics? What do they mean for internal audit, both in how to audit them and in harnessing them in audit practice?

Ben Hammersley, a "futurist", warns that AI trains itself using existing data and so mirrors and even magnifies human bias. A critical role for internal audit, then, becomes auditing the culture and relationships in an organisation to understand those biases and the risks they present. Internal auditors in turn need to understand their own culture and biases, as the audit team of the future will undoubtedly include robots which have learned from existing audit data.

A further implication to our world, where data is king, is for internal audit to ▸

'The pace at which risks are changing requires more agile internal audit methods, that provide a real-time insight so swift adjustments can be made'

help organisations understand the data they hold and the risks they present. All organisations face exposure, either through accidental data loss or malicious intent by individuals, competitors or hostile nations – it may be blackmail or worse. Hammersley declares internal audit to be "the last bastion of self-defence", with its role to protect the objective truth of an organisation, finding out what could be known about it, however unsavoury, before others do.

'Whatever the organisational paradigm, delivering essential services at best value to the taxpayer will remain paramount in the public sector'

Skills
New methods and technologies call for new skills. The internal auditor of the future will work with robots and humans in their teams, challenging traditional management techniques. They will be agile and flexible, in where and how they work, and even more intellectually nimble given the faster pace and increased complexity of their environment. Analysis will be automated, focusing the human auditor on interpretation and communication. An understanding of culture, relationships and the psychology of change will come to the fore. And all internal auditors, as a minimum requirement, will be "tech savvy".

But let's not forget the core skills of today's auditor – curiosity, an ability to create coherence from complexity, independence of mind, high ethical standards, influencing skills and the resilience needed to stand up to scrutiny and conflict. The need for these skills remains, creating a solid foundation from which our people can become the auditors of tomorrow.

External audit meets internal audit
I cannot close without mentioning external audit. Not least given the focus of this *Perspectives*. Internal audit cannot regard itself as immune from the recent and continued scrutiny of, and recommendations for, external audit. I shall leave others to debate whether internal audit will itself become regulated and comment on two elements only: lessons from the Kingman review of the Financial Reporting Council, and the current government-sponsored review by Sir Donald Brydon on the quality and effectiveness of audit .

Internal audit practices would do well to heed the recommendations of the Kingman Review, in particular: prioritising work on the basis of risk; acting in a forward-looking manner and anticipating as well as acting on emerging governance and audit risks; advancing innovation and quality improvements; promoting brevity and comprehensibility in reporting and being proportionate; and balancing the costs and benefits of recommended actions. I'd like to think we do these already, but there is always room for improvement and being reminded of their importance is helpful.

The perceived widening of the "audit expectations gap" – the difference between what users expect from an audit and the reality of what an audit is and what auditors' responsibilities entail – is the catalyst for the Brydon review. Recent company failures have brought this in to sharp relief.

Such an expectations gap exists with internal audit too – we're often judged by the things we miss, rather than what we spot and improve. I await the report with interest, eager to see what lessons may be applied to internal audit.

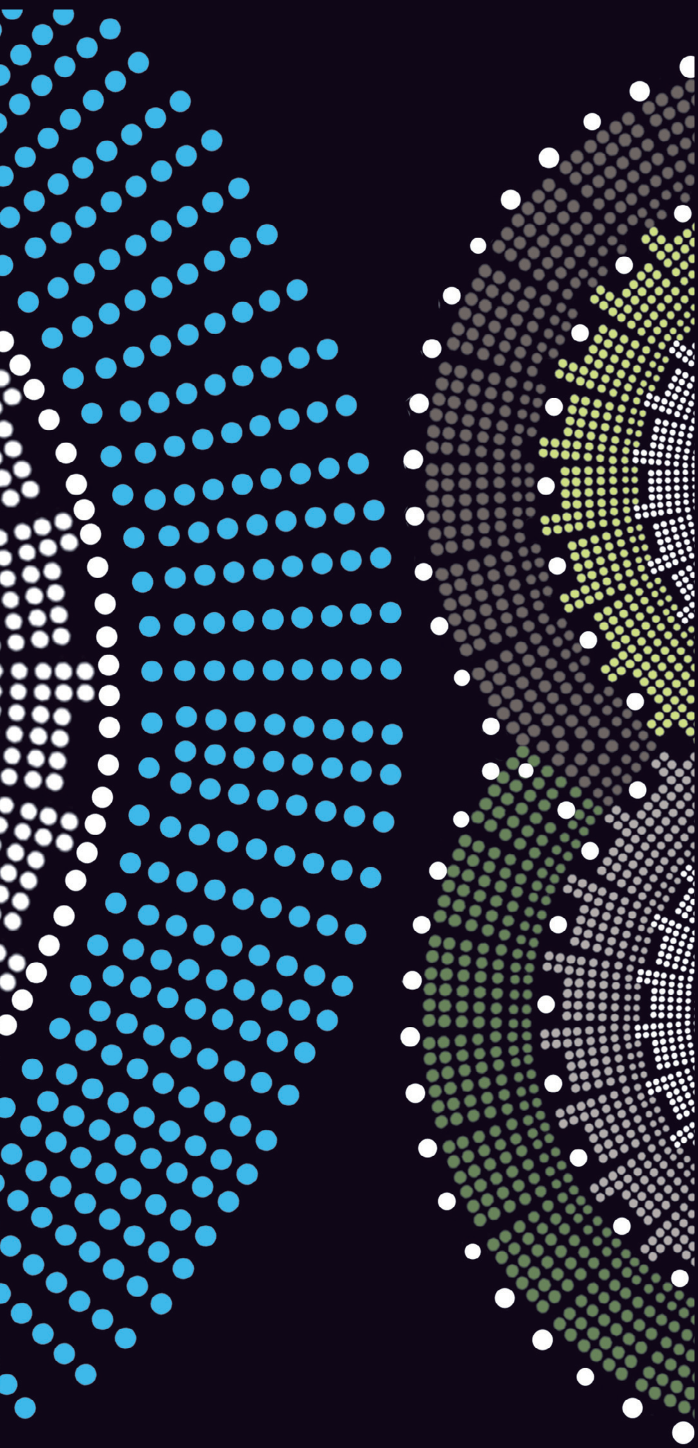
Some suggest that the improvements being sought in external audit, with calls for it to become more strategic and forward-looking, will reduce the role of internal audit or indeed erode it completely. By contrast, the role and significance of internal audit looks set to increase. The pace and complexity of modern organisations requires more real-time insight by those who are of the business, but remain professionally objective, and that's internal audit. But to fulfil that role in a dynamic environment, internal audit needs to change – and change quickly.

New generation internal audit has the potential not only to anticipate risk, but in doing so to also influence policymaking and service provision. The boundaries for public sector internal audit lie somewhere between helping organisations do things right and ensuring they do the right things. But where exactly? I look forward to the debate. ●

[1] Executive perspectives on risk 2019, Protiviti. Download the report at **https://bit.ly/2IsTcsG**

[2] Harnessing the power of internal audit, Chartered Institute of Internal Auditors. Download the report at **https://bit.ly/2ZPkgl8**

[3] Cardinal, L; Kreutzer, M; Miller, C (2017), "An inspirational view of organizational control research: re-invigorating empirical work to better meet the challenges of 21st century organizations", *Academy of Management Annals*



Raising the roof

This is the ninth in a series of *PF Perspectives*, produced by CIPFA and *Public Finance*. They are designed to stimulate discussion on key public finance and policy issues. These essays, by leading public sector practitioners and experts, examine the future of the audit process and its implications for the financial management and delivery of public services

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