



GOVERNANCE COMMITTEE

REPORT

11 MAY 2011

Subject Heading:

Future of Local Public Audit –
Government Consultation

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Policy context:

To consider the Government's
consultation document on the future of
local public audit and to approve the
Council's response to it

Financial summary:

There are no immediate financial
consequences from the consultation,
although changes to the landscape of
public audit will inevitably create financial
implications

The subject matter of this report deals with the following Council Objectives

Clean, safe and green borough	<input type="checkbox"/>
Excellence in education and learning	<input type="checkbox"/>
Opportunities for all through economic, social and cultural activity	<input type="checkbox"/>
Value and enhance the life of every individual	<input type="checkbox"/>
High customer satisfaction and a stable council tax	<input checked="" type="checkbox"/>

SUMMARY

This report sets out a summary of the Government's consultation document on the future of local public audit and includes a draft response for comment on and approval by the Committee.

RECOMMENDATIONS

1. To note the Government's consultation document The Future of Local Public Audit and to advise any comments on it.
2. To amend and/or otherwise approve the Council's draft response to the consultation.
3. To delegate to the Cabinet Member for Value authority to approve the final version of the Council's response.
4. To note that this report is being referred to the Audit Committee for their information.

REPORT DETAIL

1. On the 13 August 2010 the Secretary of State for Communities and Local Government (DCLG) announced plans to disband the Audit Commission, and refocus audit of local public bodies on helping local people hold those bodies to account for local spending decisions, which the Coalition Government sees as the very essence of localism.
2. The aim is to replace the current, centralised audit systems managed by the Audit Commission, with a new decentralised regime, which will support local democratic accountability, and one that will also cut bureaucracy and costs, while ensuring that there continues to be robust local public audit. This consultation sets out proposals on the new audit framework where:
 - Audit quality is regulated within a statutory framework, overseen by the National Audit Office and the accountancy profession
 - Local public bodies will be free to appoint their own external auditors with stringent safeguards for independence.
3. This consultation runs until 30 June 2011. The consultation sets out DCLG's vision for the future of local audit. This vision is based on four principles:
 - Localism
 - Transparency
 - Lower audit fees
 - High standards of auditing.
4. To meet these principles, the consultation sets out proposals which would see all local public bodies with a turnover of over £6.5m appointing their own

independent auditor. This appointment would be made on the advice of an independent audit committee. Auditors would be regulated under a system which mirrors that of the audit of companies with a role for the Financial Reporting Council and the professional audit bodies. DCLG envisages that the National Audit Office will set the code of audit practice and have put forward options for the scope of audit in the new framework.

5. The consultation asks a number of questions, 50 in total, of which a number relate to two-tier authorities and smaller authorities, on which DCLG is seeking responses.
6. The consultation document is divided into 6 sections and is attached at Appendix A; a summary of each section follows, together with comments on the proposals:
 - Introduction
 - Regulation of local public audit
 - Commissioning local public audit services
 - Scope of audit and the work of auditors
 - Arrangements for smaller bodies
 - List of consultation questions.

Regulation of Local Public Audit

7. The Audit Commission is currently responsible for setting audit standards through codes of practice for local government (and health) bodies. Once the Commission has been abolished, local public audit will need to be regulated differently. The consultation paper proposes a regulatory system for local public audit that is similar to that for private company audit under the Companies Act 2006. The consultation proposes that:
 - The National Audit Office would develop and maintain codes of audit practice and any supporting guidance. Any codes of practice will require parliamentary approval as under the current system
 - The Financial Reporting Council, the body responsible for the supervision of private sector external auditors, will regulate who can undertake local public audit work.
8. There would be a list (referred to as the register of local public statutory auditors in the consultation paper) of audit firms who are recognised as qualified to undertake public audit work. Local councils would be required to appoint their external audit from those firms on the register. The consultation paper states that the costs of the new regulatory regime will be passed on to individual audit firms, who are likely to recover such costs as part of their audit fee.

Comments

9. Whilst it could be argued that the introduction of a register of audit firms suitable for public audit work will restrict the choice local councils have in appointing their own external auditor, the system does have the advantage of removing the need for individual authorities to confirm the qualification and experience of audit firms to provide a quality audit service. In addition, the likelihood is that only larger auditing firms would have the skills and capacity to be able to undertake extensive audit work across local authorities, certainly the larger unitary ones. This it could be argued may restrict local choice, but the current system in reality only allows either the Audit Commission (via the District Auditor) or one of the “Big Four” audit practices to undertake the work.
10. However, any regulatory framework will have a cost attached to it, which will inevitably be passed onto to councils in audit fees. Therefore it is essential that any regulatory system is kept straightforward to ensure that costs are kept as low as possible for councils and they do not in themselves act as a barrier to entry for audit firms wishing to apply to be placed on the register. Clearly, predicting the level of audit fees given the Government’s stated intention to reduce the overall costs of the audit regime, set against what many commentators see as an inevitable increase in market costs, will be very difficult until this is implemented.

Commissioning local public audit services

11. The consultation paper proposes that all larger local public bodies (defined as those with income/expenditure over £6.5million as in the revised Accounts and Audit Regulations) will be able to appoint its own auditor. The appointed auditor must be on the register of local public statutory auditors.
12. The appointment will be made by full Council, on the advice of an audit committee with opportunities for the electorate to make an input. It is proposed that the Secretary of State should have the power to appoint an external auditor to any local public body who fails to appoint a suitable one themselves. Auditors would be appointed annually, but with a requirement to open the role to competition at least every five years. The council could re-appoint the incumbent audit firm for a maximum of ten years, after which a different audit firm must be used for further audit work.
13. The consultation paper recognises that there is more than one way of arranging such an audit committee but sets out the following possible structure:
 - The audit committee chair and vice-chair would both be independent of the local public body (i.e. not elected members)
 - The elected members on the audit committee should be non-executive, non-cabinet members from the audited body

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- At least one member should have recent and relevant financial experience, but with a recommendation that a third of the members have recent and relevant financial experience where possible.
 - There would be a majority of members of the committee who are independent of the local public body.
14. Independent members can only be considered for a position if they:
- Have not been a member or an officer of the public body within five years before the date of appointment
 - Are not a member or officer of any other relevant body
 - Are not a relative or close friend of a member or an officer of the body
 - Have applied for the appointment
 - Have been approved by a majority of the members of the council
 - Position has been advertised in at least one local newspaper and in other similar publications and/or websites.
15. The consultation paper also seeks views on the role of the new audit committee and presents two options:
- **Option One:** The audit committee would be required to provide advice to the council on the engagement and resignation or removal of the auditor. It would then be for the council to decide whether or not the committee has any other function or duty
 - **Option Two:** There would be a much more detailed mandatory role for the audit committee, possibly including providing advice on the procurement and selection of an auditor, ensuring effective relations between internal and external audit and reviewing audit reports and quality. Under this option the audit committee would report annually to the full council on its activities during the year.
16. The consultation paper recognises that individual bodies might wish to co-operate on the appointment of an auditor and so the following legislation will allow both joint procurement of audit services and joint audit committees.

Comments

17. Members should be aware that the audit committee proposed in the consultation is substantially different to current local government audit committees. These proposals substantially amend the role of an audit committee and make it largely independent from the full council. Whilst it could be argued that the proposals ensure that an audit committee is totally independent from the council, the working relationship between the two bodies requires careful consideration. The consultation paper is seeking comments on such issues, including whether independent audit committee members would need to be remunerated for their work.
18. This raises the question of what level of remuneration would be appropriate, given the background of an independent member is likely to be significantly

different to that of an elected member. It is not clear from the paper who would set the level of remuneration and who would be expected to fund such remuneration, although the assumption is that this would fall to the local authority. Whether the existing remuneration contained within the Members Allowances' Scheme would be sufficient to attract the type of candidate with "recent and relevant financial experience" remains to be seen, but is clearly a risk. What happens if an authority is unable to attract suitably qualified members is also not clear.

19. A further issue is that members of a local authority are bound by its rules, including those of confidentiality. This applies not only to the papers produced for meetings, but also the issues discussed at them. Strict rules prohibit the use of such information. There is a need to ensure that the rules regarding conflicts of interest and confidentiality apply to the independent members.
20. The paper proposes that independent members would be elected by a majority of members on council. This risks turning a process to appoint independent members into a political one. It is not clear how any appointment process would operate, for example is the appointment to be preceded by interview and if so, who should conduct it. This applies especially if there are more applicants than positions. Currently, the allocation of the number of places on each committee is decided on a proportional basis, reflecting the political composition of each council. It is also not clear if this would remain the approach.
21. The planned appointment of independent members does not make clear the proposed duration of their appointment. Elected members serve a four year term, whereas the proposal is that appointed auditors would be in place for five years. So it is possible that there will be a churn of members at differing times, with elected members possibly changing every four years but independent members to a different timescale.
22. Turning to the issue of membership, council rules currently require a quorum, ie a minimum number of members. Whilst council procedure rules provide for substitutes being nominated for any member unable to attend a meeting, it would not appear to be feasible for this to operate for independent members. This runs the risk of meetings becoming inquorate if independent members are unable to attend, thus bringing committee work to a halt.
23. At present, only senior officers are barred from standing to be an elected member. The rules proposed in the paper would mean that no council officer would be able to become an independent member.
24. The paper proposes that the appointment of the auditor would be a decision of full Council, whilst offering two different options for the involvement of the audit committee in the process. Currently, auditors are appointed by the Audit Commission. There are therefore issues over both the skills needed to appoint an auditor, and the resources and cost implications of doing so.

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No other contracted services require the involvement of full Council in their selection, and historically only issues of major concern have been flagged by auditors with the Council, so this seems an unnecessarily bureaucratic step.

25. In addition, the trend for modern local government is to remove operational decisions, such as the award of contracts, from the political process, except for larger, longer contracts. This is partly because such decisions are in many cases not strategic and partly because not all members will have either experience or training in the contract process. Elevation of a decision to appoint an auditor to full Council implies that all members would need to be trained in procurement decision-making. The only alternative would be for the decision to be made by the Audit Committee, and then simply ratified by full Council, which would seem to be solely a bureaucratic exercise.
26. It would be worthwhile considering that, if there is to be a list of approved auditors from which the Councils must choose, then it would be advantageous if their procurement was covered by either national or regional framework contracts with savings on procurement costs for both the audit firms and Councils – the value of a 5 year audit contract being comfortably in excess for the EU threshold for such services.
27. On the future role of the audit committee, option 1 is in reality just an external auditor appointment committee that would only need to meet annually to recommend the external auditor (the consultation paper does not really explain why there should be an annual appointment within a 5 year contract. Option 2 is slightly wider, but does not take on the full extent of the work carried out by the Council's existing Audit Committee. Unless the Council wanted to give all the Audit Committee work to the new body, there may be the need for an "internal Audit" Committee and an "external Audit" Committee.
28. Finally, it is not clear if the paper is proposing the adoption of a specific model for audit committees, or to allow local authorities to select their preferred model. Either way, there is a risk that, to avoid the potential impact an independently-led audit committee might have, a local authority may choose to water down the remit of the committee, leaving it largely bereft of any meaningful role.

Scope of audit and the work of auditors

29. Currently, public sector bodies are subject to audit with a wider scope than in the private sector, including, for example, value for money and legality issues. The consultation paper presents four possible options for the scope of the audit of councils. These are:
 - **Option one:** The scope of the audit would become similar to private companies with the auditor giving an opinion on the financial statements and review and report on other information published with the financial statements.

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- **Option two:** The scope would be similar to the current system in local government, with auditors providing an opinion of the financial statements, concluding as to whether there were proper arrangements to secure value for money and reviewing and reporting on other information including the annual governance statement.
 - **Option three:** New arrangements to provide stronger assurances on regularity and propriety, financial resilience and value for money.
 - **Option four:** A new requirement for councils to prepare and publish an annual report, which would be reviewed by the auditor with them providing reasonable assurance on the annual report.
30. Auditors would continue to have the power to prepare public interest reports, with the costs of such reports being recovered from the audited body. Local people would still be able to question the auditor, but the right to make formal objections to the accounts would be removed. Audit firms would be able to provide such non-audit services as long as they adhere to the ethical standards produced by the Auditing Practice Board and that permission is sought from the audit committee.
31. One of the key elements on this section concerns the right of objection to the accounts. As the paper points out, this dates back some 150 years, and the cost of investigating an objection can often be disproportionate to the nature of the objection. It is now proposed to remove the right of objection, but to allow members of the public to make representations, with the auditor having discretion in deciding whether to follow these up or not. The individual would have the right to go to judicial review if not satisfied with an auditor's decision not to investigate.

Comments

32. Clearly there is a trade off between the amount of audit work undertaken and the cost of the audit to a local council. There is the added issue of how much additional work councils wish to undertake, for example the production of an annual report and its publication brings with it an additional level of cost, and if the auditors' powers extend to this, an additional audit fee as well. Auditors are already charged with commenting on value for money, there is a risk that any additional requirements will lead to the type of bureaucracy introduced as part of the use of resources assessment, with a consequent impact on both audit fees and local authority workload.
33. Option two is the closest to the current arrangement and provides both members and the local community with an assurance on both the financial statements of the council and its associated value for money and governance arrangements. It could be argued that, unless there are good reasons to the contrary, this model has worked well. Whilst the general financial climate remains volatile, the public sector in general and local government in particular has remained financially stable, with robust budget-setting and a proven ability to overcome budget problems. Introducing additional checks would seem to be contradictory to a reduction in central

controls and further indicate a lack of trust in the sector's ability to self-police its financial performance.

34. The removal of the right of objection, where residents can object to the whole of an authority's accounts on the basis of a single issue, seems a sensible and appropriate measure. However, the auditor would still have discretion to follow up a representation, and there is the possibility that auditors could adopt a risk-averse strategy; in turn, this seems to imply that authorities would therefore still have to foot the bill for any such work.

Arrangements for smaller bodies

35. This is not relevant to Havering.

Proposed Response to Consultation

36. The report sets out comments on the different elements of the consultation paper and these have formed the basis for the proposed response, which is set out in Appendix B for comment on and otherwise approval by the Committee. This response covers the broad areas of the paper rather than every individual question posed in the consultation paper.
37. At this stage, it is unclear whether there will be an attempt to reach an agreed position on responses between London authorities. It is possible that either London Councils or the Society of London Treasurers will seek to make a single, agreed submission. Given that consultation is open until the end of June, it is proposed to delegate approval of the final version of the response to the Cabinet Member for Value. If an agreed London position can be reached which removes the need for a local response, provided the points raised in the draft response and debated with the Committee are duly reflected, then this delegation would allow a decision to be made not to also make a local submission.
38. Officers have held an informal discussion with the Chair of the Audit Committee and broadly speaking, her views are in line with the comments contained in this report. Any further comments from the Chair will be reported at the meeting. This report is also being referred to the Audit Committee for their information.

IMPLICATIONS AND RISKS

Financial implications and risks:

Whilst this is purely for discussion at this stage, the proposed changes are likely to carry financial implications and risks. The future level of audit fees is unknown, and whilst the abolition of the Audit Commission should reduce costs, there has

been considerable speculation that market forces will drive costs in the opposite direction.

In addition, the prospect of engaging independent members may give rise to both additional costs – if some form of remuneration is needed, and for providing appropriate training – and risks, as it may prove difficult to attract suitable candidates into these roles.

The process for appointing an external auditor is not one which local authorities have undertaken for many years. Although the procurement process is likely to be a standard one, this will bring an additional workload for authorities to absorb.

The removal of the right of objection to the accounts would be replaced by an ability to make representations to an auditor. In practice, this could well mean that the cost of any additional work by an auditor would be at a similar level to that arising from an existing objection.

Legal implications and risks:

There are no direct legal implications from the proposed decision. Depending on the final proposals from the government after considering the results of the consultation exercise, it is probable that the Council will have to vary its constitution to incorporate a new form of external audit committee. It will be necessary to appoint an external auditor via a competitive procurement exercise.

Human Resources implications and risks:

None arising directly from this report.

Equalities implications and risks:

None arising directly from this report.

BACKGROUND PAPERS

None.

APPENDIX A

COMMUNITIES & LOCAL GOVERNMENT

**THE FUTURE OF LOCAL PUBLIC AUDIT
CONSULTATION DOCUMENT**

DRAFT RESPONSE

TO BE FORMATTED – DRAFT CONTENT ONLY
LETTER FROM ANDREW BLAKE-HERBERT, GROUP DIRECTOR FINANCE &
COMMERCE

Thank you for the opportunity of commenting on the consultation paper on the Future of Local Public Audit. Our comments are set out below under each of the main headings of the consultation paper.

Regulation of Local Public Audit

Whilst it could be argued that the introduction of a register of audit firms suitable for public audit work will restrict the choice local councils have in appointing their own external auditor, the system does have the advantage of removing the need for individual authorities to confirm the qualification and experience of audit firms to provide a quality audit service. In addition, the likelihood is that only larger auditing firms would have the skills and capacity to be able to undertake extensive audit work across local authorities, certainly the larger unitary ones. This it could be argued may restrict local choice, but the current system in reality only allows either the Audit Commission (via the District Auditor) or one of the “Big Four” audit practices to undertake the work.

However, any regulatory framework will have a cost attached to it, which will inevitably be passed onto to councils in audit fees. Therefore it is essential that any regulatory system is kept straightforward to ensure that costs are kept as low as possible for councils and they do not in themselves act as a barrier to entry for audit firms wishing to apply to be placed on the register. Clearly, predicting the level of audit fees given the Government’s stated intention to reduce the overall costs of the audit regime, set against what many commentators see as an inevitable increase in market costs, will be very difficult until this is implemented. As much certainty as possible is needed in the scale of audit fees, especially in the current financial climate.

Commissioning local public audit services

The audit committee proposed in the consultation paper is substantially different to current local government audit committees. These proposals substantially amend the role of an audit committee and make it largely independent from the full council. Whilst it could be argued that the proposals ensure that an audit committee is totally independent from the council, the working relationship between the two bodies requires careful consideration.

The consultation paper asks whether independent audit committee members would need to be remunerated for their work. This raises the question of what level of remuneration would be appropriate, given the background of an independent member is likely to be significantly different to that of an elected member. It is not clear from the paper who would set the level of remuneration and who would be

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expected to fund such remuneration, although the assumption is that this would fall to the local authority. Whether the existing remuneration contained within our existing Members Allowances' Scheme would be sufficient to attract the type of candidate with "recent and relevant financial experience" remains to be seen, but is clearly a risk. There is no current requirement for elected members to have any particular qualifications, experience or background; this is partly because their level of involvement in the running of an authority will vary. Training is provided to assist members in their particular areas of involvement, for example in pensions administration or treasury management. There is a risk that less well-qualified yet democratically elected members would be over-whelmed by independent, unaccountable, experts

In addition, if there are more "applicants" than independent roles, it is assumed that there would then need to be some form of appointment process; this may leave authorities facing disputes from unsuccessful candidates, as well as the additional expense of making such appointments. Finally, what happens if an authority is unable to attract suitably qualified members is also not clear.

We believe that there are significant issues arising from this aspect of the paper. Council Members are directly accountable to the local community, and as part of the democratic purpose, are also accountable to the Council itself; their responsibilities are also governed by the Council's rules of procedure. Independent members would have no such accountabilities, and may in fact have vested interests. If such members are being remunerated by a local authority, how truly independent are they?

A further issue is that members of a local authority are bound by its rules, including those of confidentiality. This applies not only to the papers produced for meetings, but also the issues discussed at them. Strict rules prohibit the use of such information. There is a need to ensure that the rules regarding conflicts of interest and confidentiality apply to the independent members.

The paper proposes that independent members would be elected by a majority of members on council. This risks turning a process to appoint independent members into a political one. It is not clear how any appointment process would operate, for example is the appointment to be preceded by interview and if so, who should conduct it. This applies especially if there are more applicants than positions. Currently, the allocation of the number of places on each committee is decided on a proportional basis, reflecting the political composition of each council. It is also not clear if this would remain the approach.

The planned appointment of independent members does not make clear the proposed duration of their appointment. Elected members serve a four year term, whereas the proposal is that appointed auditors would be in place for five years. So it is possible that there will be a churn of members at differing times, with elected members possibly changing every four years but independent members to a different timescale.

Turning to the issue of membership, council rules currently require a quorum, ie a minimum number of members. Whilst council procedure rules provide for

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substitutes being nominated for any member unable to attend a meeting, it would not appear to be feasible for this to operate for independent members. This runs the risk of meetings becoming inquorate if independent members are unable to attend, thus bringing committee work to a halt.

At present, only senior officers are barred from standing to be an elected member. The rules proposed in the paper would mean that no council officer would be able to become an independent member.

The paper proposes that the appointment of the auditor would be a decision of full Council, whilst offering two different options for the involvement of the audit committee in the process. Currently, auditors are appointed by the Audit Commission. There are therefore issues over both the skills needed to appoint an auditor, and the resources and cost implications of doing so. No other contracted services require the involvement of full Council in their selection, and historically only issues of major concern have been flagged by auditors with the Council, so this seems an unnecessarily bureaucratic step.

In addition, the trend for modern local government is to remove operational decisions, such as the award of contracts, from the political process, except for larger, longer contracts. This is partly because such decisions are in many cases not strategic and partly because not all members will have either experience or training in the contract process. Elevation of a decision to appoint an auditor to full Council implies that all members would need to be trained in procurement decision-making. The only alternative would be for the decision to be made by the Audit Committee, and then simply ratified by full Council, which would seem to be solely a bureaucratic exercise.

It would be worthwhile considering that, if there is to be a list of approved auditors from which the Councils must choose, then it would be advantageous if their procurement was covered by either national or regional framework contracts with savings on procurement costs for both the audit firms and Councils – the value of a 5 year audit contract being comfortably in excess for the EU threshold for such services. This would then reduce procurement costs and enable Councils to select their auditors without the need of running their own procurement process.

Contract length is usually dictated by a variety of factors, which will include the ability to achieve best value for money. Whilst an initial five year contract for an auditor would seem sensible, it is unlikely any other type of contract would have a similar length extension period. Ten years is a long time for an auditor to be in place; part of the key controls over the operation of the audit function is to practice rotation to avoid over-familiarity. We would therefore wish to see either a shorter extension period, say two years, or a slightly longer single appointment period.

On the nature of the audit committee, option 1 is in reality just an external auditor appointment committee that would only need to meet annually to recommend the external auditor. It should be noted that the consultation paper does not really explain why there should be an annual appointment within a 5 year contract, unless there is a further proposal to annually review performance, which in turn suggests an ability to change more frequently. Option 2 is slightly wider, but does

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not take on the full extent of the work carried out by the Council's existing Audit Committee. Unless the Council wanted to give all the existing Audit Committee work to the new body, there may be the need for an "internal Audit" Committee and an "external Audit" Committee. This seems to add a further layer of bureaucracy rather than reducing it.

Finally, it is not clear if the paper is proposing the adoption of a specific model for audit committees, or to allow local authorities to select their preferred model. Either way, there is a risk that, to avoid the potential impact an independently-led audit committee might have, a local authority may choose to water down the remit of the committee, leaving it largely bereft of any meaningful role.

Scope of audit and the work of auditors

Clearly there is a trade off between the amount of audit work undertaken and the cost of the audit to a local council. There is the added issue of how much additional work councils wish to undertake, for example the production of an annual report and its publication brings with it an additional level of cost, and if the auditors' powers extend to this, an additional audit fee as well. Auditors are already charged with commenting on value for money, there is a risk that any additional requirements will lead to the type of bureaucracy introduced as part of the use of resources assessment, with a consequent impact on both audit fees and local authority workload.

The enforced publication of an annual report – and the subsequent requirement to audit it – flies in the face of removing bureaucracy. It should be a local choice whether such reports are produced, bearing in mind much of this information can be made readily available at minimal cost to the local community. The publication of the annual accounts already provides detailed information on a local authority's finances, and this would be the place to include any commentary on value for money; it is unclear what further purpose a prescribed annual report would have.

Option two is the closest to the current arrangement and provides both members and the local community with an assurance on both the financial statements of the council and its associated value for money and governance arrangements. It could be argued that, unless there are good reasons to the contrary, this model has worked well. Whilst the general financial climate remains volatile, the public sector in general and local government in particular has remained financially stable, with robust budget-setting and a proven ability to overcome budget problems. Introducing additional checks would seem to be contradictory to a reduction in central controls and further indicate a lack of trust in the sector's ability to self-police its financial performance.

The removal of the right of objection, where residents can object to the whole of an authority's accounts on the basis of a single issue, seems a sensible and appropriate measure. However, the auditor would still have discretion to follow up a representation, and there is the possibility that auditors could adopt a risk-averse strategy; in turn, this seems to imply that authorities would therefore still have to foot the bill for any such work.

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