

# **LOCAL DEMOCRACY, ECONOMIC DEVELOPMENT AND CONSTRUCTION ACT 2009**

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## **EXPLANATORY NOTES**

### **COMMENTARY**

#### **Part 2: Local Authorities — Governance and Audit**

#### *Chapter 3: Audit of Entities Connected With Local Authorities*

#### **Introduction**

105. This Chapter provides for an audit authority to appoint an auditor to an entity connected to one or more local authorities in England and Wales and for the auditor to issue a public interest report where it is in the public interest to do so. For the purposes of this Chapter an “audit authority” is the Audit Commission in England (“the Commission”) and the Auditor General for Wales in Wales (“AGW”). An entity which has an auditor appointed in this way can appoint the same auditor, at no additional cost, to carry out the statutory audit which it is required to have carried out. The entity remains free, however, to appoint a different auditor to carry out the statutory audit – in which case the audit authority-appointed auditor will carry out an audit which is identical to the statutory audit.
106. This takes forward recommendations from Lord Sharman’s independent review into the audit and accountability of public money  *Holding to Account: The Review of Audit and Accountability for Central Government (2001)*.<sup>1</sup> Lord Sharman recommended that, among other things, the Comptroller and Auditor General (and Auditors General for Wales and Scotland and the Comptroller and Auditor General for Northern Ireland) should be appointed as the auditors of Non-Departmental Public Bodies (NDPBs) which are companies, and be eligible for appointment as auditors of those companies where Departments or NDPBs have a substantial stake or influence. This endorses one of the key principles of the Public Audit Forum on the independence of public sector auditors from the organisations being audited.
107. The Government accepted the principles of this recommendation and Parliament gave it statutory backing in the Companies Act 2006. Lord Sharman also recommended that similar arrangements should apply to local government entities. This Chapter implements that recommendation in relation to companies, limited liability partnerships and industrial and provident societies that are connected with local authorities.

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<sup>1</sup> <http://www.hm-treasury.gov.uk/d/38.pdf>

***Section 36 - Overview; Section 37 - Notification duties of local authorities; and Section 53 - Regulations***

108. **Section 36** provides that the relevant audit authority may appoint a person to carry out audit functions in relation to a local authority entity which meets certain qualifying criteria. An entity for the purposes of this Chapter is a company, a limited liability partnership (“LLP”), or an industrial and provident society (“I&PS”). The qualifying criteria are that the entity is connected with a local authority and that it meets other conditions specified in regulations made by the Secretary of State in England or by Welsh Ministers in Wales. A local authority is as defined in the Local Government Act 2003, and is required by accounting and auditing regulations to prepare statements of accounts. The smaller parish councils are excluded from the provisions for whilst they are covered by the 2003 Act definition, they are not required to prepare statements of accounts.
109. **Section 37** provides that a local authority in England or Wales must notify the entity and the relevant audit authority if an entity meets, or ceases to meet, the qualifying conditions or ceases to be connected with the authority. Notification must be made within 21 days of the matter coming to the attention of the local authority.

***Sections 38 - Power to appoint auditor; Section 39 - Power to appoint replacement auditor; and Section 40 - Exclusions***

110. **Section 38** provides that the audit authority may appoint a person to carry out an audit of a local authority entity where the entity appears to the audit authority to meet the qualifying criteria. The audit authority must consult the entity before making the appointment; and, after making the appointment, the audit authority must notify the relevant local authority. The appointment is made for a financial year of the entity and must be made before the start of that year. In the case of an appointment to a qualifying entity for its first financial year, an appointment may be made during the year.
111. **Section 39** provides that where an appointed auditor dies, is dismissed, or is unable or unwilling to act, the audit authority may appoint a replacement auditor for that financial year. The audit authority must consult the entity before making a replacement appointment and after making the replacement appointment must notify the relevant local authority.
112. **Section 40** provides that, unless the entity otherwise requests, the audit authority must not make an appointment if the entity appears to be exempt from statutory audit. A company, an LLP or an I&PS is to be exempt if it appears to the audit authority that the entity is, or will be, exempt from audit under Part 16 of the Companies Act 2006 (including as applied to LLPs) or under the Friendly and Industrial and Provident Societies Act 1968.

***Sections 41 - Eligibility for appointment; and Section 42 - Terms of appointment***

113. **Section 41** specifies who is eligible for appointment as an auditor under this Chapter. The audit authority may appoint as an auditor under this Chapter: a member of the staff of the audit authority; an individual; or a firm. However, those individuals or firms which are not eligible for appointment as a statutory auditor under the Companies Act 2006 or who do not satisfy the test of independence in that legislation may not be appointed.
114. **Section 42** sets out the terms of appointment for an auditor appointed under this Chapter. An appointment made under this Chapter begins on the first day of the financial year or, in the case of a replacement auditor, on the date of the appointment. Unless terminated earlier, the appointment ends when the auditor has discharged their functions. An audit authority may terminate the appointment of an auditor if it appears that the entity has ceased to be a qualifying entity. However, the appointed person may not be dismissed for any divergence of opinion on accounting treatments or audit procedures.

***Section 43 - Right of entity to appoint auditor to conduct statutory audit; and Section 44 - Functions of auditor not appointed to conduct statutory audit***

115. **Section 43** provides that where an audit authority appoints an auditor to an entity, the entity may also appoint that same auditor as its statutory auditor under Part 16 of the Companies Act 2006 (including that Part as applied to LLPs) or section 4 of the Friendly and Industrial and Provident Societies Act 1968. This appointment, if made, will be on the standard terms and conditions (including fees) as published by the audit authority. However, some entities may require certain modifications to be made to the standard terms and conditions and these modifications may be agreed between the entity and the auditor. The intention is that where the entity wishes to appoint the audit authority's appointed auditor as its statutory auditor, that it is able to but not obliged to do so. This may be done for no additional fee beyond that agreed for the audit under this Chapter unless agreed with the auditor as part of the modification of the terms and conditions on appointment.
116. Before publishing any terms and conditions, the audit authority must consult the Secretary of State (in the case of the Commission) and Welsh Ministers (in case of the AGW) and such associations of local authorities and bodies of accountants as they consider appropriate. If the audit authority terminates the appointment of an auditor made under this Chapter, it does not terminate the appointment by the entity of their statutory auditor.
117. **Section 44** applies when the entity does not wish to exercise the power in section 39(1) and instead chooses to appoint a different auditor as its statutory auditor, or where the entity exercises the power in section 39(1) but then terminates the appointment. In such a circumstance, the audit authority's appointed auditor has the same powers as in the Companies Act 2006 (including as applied to LLPs) or the Friendly and Industrial and Provident Societies Act 1968 to enable the auditor to make a report to the company, partnership or society on the annual accounts. The auditor must also send a copy of the report to the local authority with which the entity is connected and the relevant appointing audit authority.

***Section 45 - Public interest reports; Section 46 - Codes of practice; Section 47- Access to information; Section 48 - Consideration of report by entity; Section 49- Consideration of report by local authority***

118. **Sections 45 to 49** provide the powers for an auditor appointed under this Chapter to make a report in the public interest. This adopts, for this Part, one of the principles of public audit endorsed in Lord Sharman's report, namely that public auditors should be able to make the results of their audits available to the public and to democratically elected representatives.
119. By virtue of section 45, an appointed auditor must make a report to the entity about any matter relating to the financial affairs or corporate governance of the entity which comes to their attention in discharging their functions under this Chapter and which they consider that it would be in the public interest to bring to the attention of the entity, the local authority with which it is connected, or the public. A copy of the report must be sent to the local authority with which the entity is connected and the relevant audit authority. The auditor may notify any person that a report has been made and supply a copy, or part of a copy to any person. Section 46 provides that the Audit Commission must prescribe the way in which the auditor carries out their functions in a code of practice made under section 4 of the Audit Commission Act 1998, and the Auditor General for Wales must prescribe such conditions in a code of practice made under section 16 of the Public Audit (Wales) Act 2004. In carrying out their public interest reporting functions, an auditor is required to comply with the provisions in the relevant code of practice.
120. **Section 47** requires the entity to provide the auditor with every facility and all information which the auditor may reasonably require for the purpose of preparing

a public interest report where the auditor intends to do so. Any person who, without reasonable excuse, obstructs the auditor, or fails to comply, is guilty of an offence. An appointed auditor has a right of access to documents of the entity for the purposes of making a public interest report.

121. **Sections 48 and 49** set out the process for the entity and the local authority to consider a public interest report. Section 48 provides that where a public interest report is made, the report must be considered by the entity. In the case of a company this must be at a general meeting of the company, in the case of a LLP at a meeting of members of the partnership, and, in the case of an industrial and provident society in accordance with the rules of the society. The meeting must be held before the end of a period of one month, although the auditor may extend this period. At the meeting the entity must decide whether the report requires it to take any action and must notify the local authority of its decision. If the decision is to take no action then the reasons for this must be given in the notification. Section 49 provides that where a public interest report is made, the local authority must consider the report and the entity's decisions in relation to the report and decide whether the authority needs to take any action. The notice given of the meeting must include a copy of the report and of the entity's notification setting out the decision it has taken in relation to the report. The meeting must be held before the end of a period of one month although the auditor may extend this period. At the meeting the authority must decide whether the report requires it to take any action. Provision is made to cover admission to meetings, inspection and public access to agendas and reports.

***Sections 50 - Fees; Section 51 - Power of audit authority to require information; and Section 52 - Subsidiaries of Passenger Transport Executives***

122. **Section 50** provides that a fee must be paid by the entity to the appointing audit authority when an auditor discharges any functions under section 44 (functions of auditor not appointed to conduct statutory audit) and sections 45 to 49 (public interest reports). The audit authority must prescribe a scale of fees for the purposes of audits undertaken in sections 45 to 49. This scale also determines the fees payable under the standard terms and conditions where the auditor is also appointed under Part 16 of the Companies Act (including that Part as applied to LLPs), or under the legislation applying to industrial and provident societies as provided for in section 43. If the amount of work involved in a particular case differs substantially a different fee may be charged. Before prescribing a scale of fees, the audit authority must consult such associations of local authorities, or such bodies of accountants, as it considers appropriate. There is a reserve power for the Secretary of State or Welsh Ministers, by regulations and following consultation, to prescribe a scale of fees in place of any scale prescribed by the Commission or AGW respectively.
123. **Section 51** sets out the power of the audit authority to request information relating to the accounts audited by the auditor and any other document or information relating to the entity, which would have been available to the auditor under the powers that he had. This is to enable the audit authority to see what the auditors they have appointed have done, and allows them access to the information needed to maintain proper standards.
124. **Section 52** provides that a company which is a subsidiary of a Passenger Transport Executive is to be regarded as connected with the Integrated Transport Authority for the area for which the executive is established. This allows for the relevant audit authority to appoint an auditor to a subsidiary of a Passenger Transport Executive and for that auditor to issue a public interest report where it is in the public interest to do so.

***Section 54 - Interpretation***

125. This section contains interpretation provisions relating to this Chapter. Section 54(2) provides that an entity "connected with" a local authority has the meaning provided in subsection 212(6) of the Local Government and Public Involvement in Health Act 2007, namely that an entity is connected with a local authority if financial information about

*These notes refer to the Local Democracy, Economic Development and Construction Act 2009 (c.20) which received Royal Assent on 12 November 2009*

the entity must be included in the local authority's statement of accounts. However, a local authority is not considered to be an entity itself in the 2007 Act.