



Isle of Man
Government

Reiltys Ellan Vannin

Proposals for Local Government Audit & Financial Reporting Requirements 2014

The Treasury
Yn Tashtey

Consultation Paper

December 2013

The information in this consultation paper can be provided in large print on request.

1. Introduction

1.1 Background

1.1.1 The scope of the external audit and financial reporting requirements for the Local Government sector on the Island are determined by the Audit Act 2006 ¹(‘the Act’) and subsequent directions and regulations.

1.1.2 There are currently over 50 individual local government bodies required to be audited in accordance with the Act and these include Local Authorities, Civic Amenity Sites, Swimming Pool Boards, Housing Committees/Authorities and Burial Ground Authorities.

1.1.3 Under the current regulatory framework all of these bodies are required to prepare their financial statements in accordance with the Accounts and Audit Regulations 2013 which are then required to be subjected to a full annual statutory audit.

1.1.4 Treasury has established the Audit (Consultative) Committee as a consultative body in accordance with section 18 of the Act. The Committee is chaired by a political member of the Treasury and has senior officer representation from the Treasury; the Department of Infrastructure (who has statutory roles in the oversight of Local Government) and is also attended by both the external auditors for central Government and the Local Government.

1.1.5 Under current arrangements a single auditor is appointed by Treasury, via a competitive tender exercise, to undertake all Local Government audits. The existing arrangements will expire on 31st March 2014, having been in place for 5 years.

1.2 Applicability of the Audit Act 2006 to Local Government sector

1.2.1 The scope of the applicability of the Audit Act 2006 is defined at section 1(1):

1 Bodies subject to audit under this Act

- (1) Subject to subsection (2), the accounts of the following bodies shall be audited in accordance with this Act –
 - (a) every Department;
 - (b) every Statutory Board;
 - (c) every local authority;
 - (d) every body established by or under any statutory provision and consisting of or including persons appointed by one or more bodies referred to in paragraphs (a), (b), and (c);
 - (e) every company, more than half of the equity share capital of which is beneficially owned by one or more Departments or Statutory Boards or is otherwise held by or in trust for the Government, and which is not liable to comply with section 109(3) (filing of accounts) of the *Companies Act 1931*;
 - (f) every company which is a subsidiary of a body referred to in paragraph (e);
 - (g) every office or department of the Government or the Legislature;
 - (h) any other body to which the Treasury by order direct that this subsection shall apply; and
 - (i) any other body whose accounts are directed by any statutory provision other than this Act to be audited in accordance with this Act.

¹ http://www.legislation.gov.im/cms/images/LEGISLATION/PRINCIPAL/2006/2006-0015/AuditAct2006_1.pdf

1.2.2 In relation to the Local Government sector, there are 52 individual bodies that are required to be audited in accordance with the Act due to the following statutory provisions:

| Type of Body | Relevant Provision in the Act | No. |
|---------------------------|--------------------------------------|------------|
| Local Authorities | Section 1(1)(c) | 24 |
| Housing Committees | Section 1(1)(d) | 5 |
| Civic Amenity Related | Section 1(1)(d) | 3 |
| Swimming Pool Boards | Section 1(1)(d) | 3 |
| Burial Ground Authorities | Section 1(1)(i) | 17 |
| Total | | 52* |

* Does not include IOM Local Government Superannuation Scheme.

1.3 Reason for these proposals

1.3.1 The Local Government sector continues to raise issues in relation to the proportionality of the requirements placed upon it by the Act and in particular whether those requirements represent value for money for ratepayers.

1.3.2 The total basic statutory audit cost to the sector is currently in the region of £214,000 per annum.

1.3.3 Due to determined efforts by all key stakeholders in the process over the past few years, audit and accounting compliance across the sector is now approaching 100%.

1.3.4 Following a preliminary review of the issue, Treasury is in agreement with the principle that the current financial regulatory requirements placed upon the sector are not proportionate to the level of risk across the sector.

1.3.5 Consequently at its October 2013 meeting the *Audit (Consultative) Committee* agreed for a review and appraisal of the options available to be undertaken prior to the next appointment of Local Government Auditors.

1.3.6 Having considered the matter further, Treasury is now proposing to amend the audit and financial reporting requirements applicable to the sector as outlined herein.

1.4 Statutory mechanism for the implementation of the proposals

1.4.1 It is currently anticipated that the majority of the proposals can be implemented by Treasury using existing statutory powers within the Act.

1.4.2 However for the proposals to be applicable to Burial Ground Authorities it has been identified that primary legislative amendments would be required.

1.4.3 It has also been identified that minor amendments to the Act would also be desirable to better enable the principles being adopted within these proposals.

1.4.4 Consequently in addition to new subordinate legislation being progressed by Treasury it is also proposed to promote a small Audit Act Amendments Bill.

1.5 Objectives of this consultation

1.5.1 To inform Local Government bodies and other interested stakeholders of the proposed introduction of new regulatory measures for the sector.

1.5.2 To seek the views of all stakeholders and request feedback on the proposals.

2. Local Government Audit and Financial Reporting Proposals

2.1 Flexibility in the Implementation of the Audit Act 2006: Subordinate Legislation

2.1.1 The Act includes a number of provisions that provide an element of flexibility in its implementation via the use of subordinate legislation.

2.1.2 The two key subordinate powers that Treasury has that enable flexibility in the implementation of the Act are:

- S1(2)(a) Exemptions: provides Treasury with the power to exempt, by Direction, accounts from being audited.
- S12 Audit & Accounts Regulations: provides Treasury with the power to make regulations that apply to the conduct of audits and prescribe the format of the accounts.

2.1.3 Whilst S12 regulations can be applicable to all bodies audited under the Act, Treasury’s power to exempt is restricted to those bodies audited pursuant to S1(1)(a) to (f) i.e. this means that Treasury currently has no powers within subordinate legislation to reduce the audit regulatory burden upon Burial Ground Authorities who are audited under the Act pursuant to S1(1)(i).

Summary

Treasury is of the opinion that Burial Ground Authorities should be subject to the same Treasury powers to make subordinate legislation in relation to audit exemption.

Question 1: Burial Ground Authorities
Do you agree that Burial Ground Authorities should be subject to the same Treasury powers in relation to audit as other Local Government bodies?

2.2 Proposed Regulatory Framework: Audit

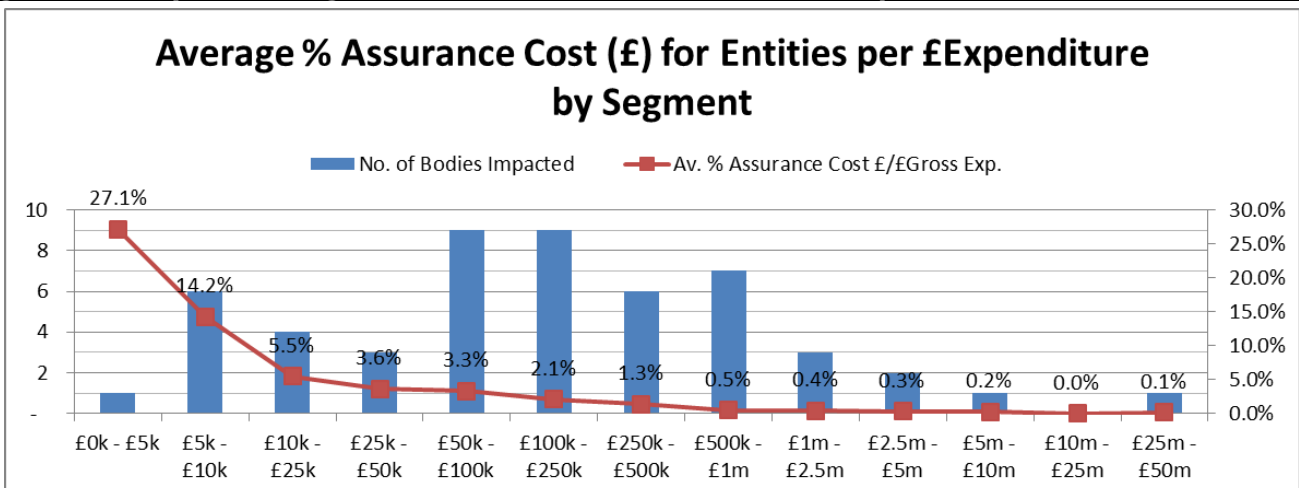
2.2.1 Currently the statutory framework requires all of those Local Government bodies falling within the scope of the Act to be subjected to an annual statutory audit.

2.2.2 The current total basic statutory audit cost to the sector for 2012-13 is approximately £214,000.

2.2.3 A review of the annual financial statements from across the sector indicates that the total annual sector gross expenditure is in the region of £57 million.

2.2.4 It can be seen from *Diagram 1*, that there is a large variance in the ‘financial size’ of the bodies comprising the Local Government sector and that the cost of obtaining this level of assurance is disproportionately burdensome upon the smaller Local Government bodies.

Diagram 1: Analysis showing the cost of audit as a % of the Gross Expenditure audited.



2.2.5 Further analysis illustrating for each size of Local Government body (by gross expenditure segment) the audit cost to the sector alongside the Gross Expenditure and number of entities 'at risk' is included at [Appendix 1](#).

2.2.6 Having considered various alternative approaches Treasury proposes to implement a 3 tier framework to audit examination, primarily based upon turnover thresholds:

| Turnover Threshold | Examination Type | Description |
|----------------------|-----------------------------------|---|
| Up to £100k | Qualified Independent Examination | An independent examination similar to the model used for Manx Registered charities ² whereby accounts are examined by an independent person holding agreed financial qualifications. |
| Between £100k to £1m | Assurance Review | An assurance review performed by a qualified accountant similar to the standard assurance product outlined by the Institute of Chartered Accountants of England & Wales (see Appendix 2). Note, whilst performed by a qualified auditor this is not a 'regulated' audit. |
| Over £1m | Statutory Audit | As currently undertaken in accordance with the Act and undertaken by regulated auditor. |

(Turnover being the higher of annual gross income and gross expenditure.)

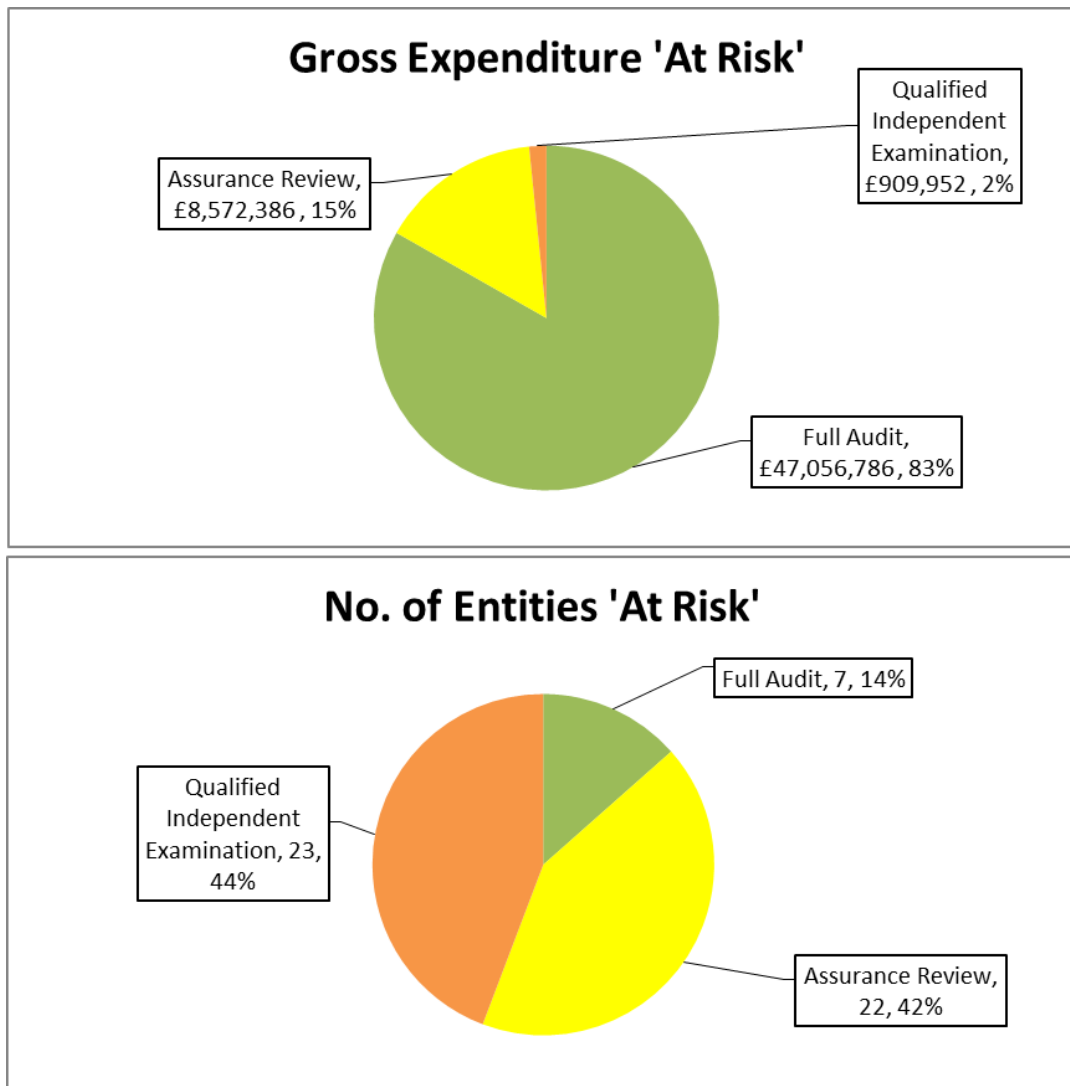
2.2.7 *Diagram 2* illustrates the projected assurance risk impact that the proposed changes would have on the sector by comparing:

- **Gross Expenditure 'at risk'**: The total amount of Gross Expenditure within the sector that would be covered by each assurance level.
 - The impact is relatively minimal in this area. Of the total £56.5m of Gross Expenditure within the sector, £47m (83%) would still be subject to statutory audit and £8.6m (15%) assurance review by a qualified accountant.
- **No. of Entities 'at risk'**: The number of entities within the sector that would be covered by each assurance level.
 - The impact in this area is more significant with a total of 45 (87%) of the entities within the sector no longer being subject to statutory audit. However 22 (42%) would still be subject to a review by a qualified accountant and the remaining 23 (44%) would be subject to an independent examination.

Note: The impact assessment has been modelled on the assumption that Burial Grounds will be able to benefit from the proposed changes. In addition, the model does not include the potential impacts of proposed structural changes to Local Government Housing.

² <http://www.gov.im/lib/docs/registries/courts/independentexaminationguidancema.pdf>

Diagram 2: Analysis showing the impact of the proposal on the sector.



Summary

The Treasury, having noted the high level of financial compliance now being achieved across the sector, now considers that the existing 'one size fits all' approach is no longer appropriate and so is proposing a revised and more proportionate 3 tier framework to audit/inspection, based upon turnover:

| Turnover Threshold | Independent Audit/Examination Requirement |
|----------------------|---|
| Up to £100k | Qualified Independent Examination. |
| Between £100k to £1m | Assurance Review by a regulated auditor. |
| Over £1m | Full Statutory Audit. |

Question 2 Audit:

- (i) Do you agree that the existing audit framework (i.e. 'one size fits all') is disproportionate and an alternative framework should be implemented?
- (ii) Do you agree that a 3 tier approach to audit/examination is appropriate?
- (iii) Do you agree with the level of audit/examination proposed for each level?
- (iv) Do you agree with the proposed thresholds for each level?
- (v) Do you agree that 'turnover' is the most appropriate financial risk factor to be used to determine the level of independent scrutiny of the financial statements?
- (vi) Do you think that other risk factors should also be used (in addition to turnover) to determine the level of independent scrutiny of the financial statements?

2.3 Clarification of Treasury Powers in relation to Audits

2.3.1 Whilst powers exist that enable Treasury to have an amount of flexibility over the implementation of alternative approaches to audit, the existing powers are worded such that the subsequent subordinate legislation required to do so may prove to be complex.

2.3.2 Clarification of those powers would enable a clearer approach to the subordinate legislation to be adopted in future whilst achieving the same end.

2.3.3 In addition, a key ongoing requirement for any amended Local Government audit regime to be successful is for the power to be retained for Treasury to be able to direct a body to have its accounts subjected to a statutory audit, or specific audit directions (per section 7 of the Act) even if it is generally only required to be subject to a lesser examination. Under the existing statutory framework it is ambiguous as to whether a body effectively exempted from audit (but subject to an alternative accounts examination) could then be directed to be audited or subject to section 7 of the Act.

Summary

Treasury is of the opinion that its subordinate powers under the Act should be clarified to enable the adoption of alternative assurance regimes to audit to be more simply & explicitly implemented.

Treasury is also of the opinion that it is essential that a power should exist to enable it to direct any 'relevant bodies' to be audited by professional auditors if the need arises.

Question 3: Treasury Powers

Do you agree that Treasury's subordinate powers be amended as proposed?

2.4 Proposed Regulatory Framework: Financial Reporting

2.4.1 Under the current statutory framework the applicable regulations covering financial reporting made under Section 12 of the Act are the *Accounts and Audit Regulations 2013*³.

2.4.2 The 2013 regulations (and previously the 2007 regulations) require relevant bodies to also ensure that their financial statements are prepared under 'proper practices' which includes the Statement of Recommended Practice ('the SORP') issued by the Treasury⁴.

2.4.3 The current SORP was issued in 2007 and was based upon the UK equivalent SORP as issued by the Chartered Institute of Public Finance Accountants (CIPFA).

2.4.4 Consequently, the financial reporting framework applicable to the sector has not been amended since the introduction of the Act.

2.4.5 The existing Financial Reporting framework applicable to the sector is set by the gross expenditure/gross income of the body:

- <£40,000 : basic Income & Expenditure accounts.
- >=£40,000 : Income & Expenditure accounts in accordance with the SORP.

³ <http://www.tynwald.org.im/links/tls/SD/2013/2013-SD-0026.pdf>

⁴ <http://www.tynwald.org.im/links/tls/SD/2007/2007-SD-0815.pdf>

2.4.6 Analysis of the financial statements indicates that over 70% of the bodies within the Local Government sector are required to prepare full income and expenditure accounts in accordance with the SORP.

2.4.7 Since 2010 Large Local Councils in England & Wales (those with turnover greater than £1m) are no longer required to produce their financial statements in accordance with the SORP issued by CIPFA and instead adhere to the simpler Financial Reporting Standard for Smaller Entities (FRSSE) and in accordance with additional guidance.

2.4.8 Treasury is of the view that the current two tier approach (threshold at £40k turnover) places an unnecessary financial reporting burden upon Local Government bodies.

2.4.9 The Financial Reporting Council (the body in the UK with overarching responsibility for the establishment of financial reporting standards) has recently revised the accounting standards applicable in the UK. In the light of the changes being progressed in both the UK (and also in International accounting frameworks), the 2007 IOM SORP is now due to be reviewed and updated.

Summary

Having considered various alternative approaches Treasury proposes to implement a 3 tier framework to financial reporting requirements linked to the proposed audit examination thresholds:

| Turnover Threshold | Financial Reporting Requirement |
|----------------------|--|
| Up to £100k | Receipts & Payments Accounts (cash accounting) based upon a fixed template. (Income & Expenditure accounting as an option.) |
| Between £100k to £1m | Basic Income & Expenditure accruals accounting based upon a fixed template (with the option for full FRSSE based Income & Expenditure accounting). |
| Over £1m | Full Income & Expenditure accruals accounting based upon the FRC Financial Reporting Standard for Smaller Entities (FRSSE). |

Question 4 – Financial Reporting

Do you agree that:

- (i) The existing 2 tier financial reporting audit framework is disproportionate and an alternative framework should be implemented?
- (ii) It would be more appropriate to adopt a 3 tier approach to financial reporting?
- (iii) The financial reporting levels should be linked to those proposed for audit/examination?
- (iv) Introducing fixed templates for smaller entities will assist transparency and comparability for users?
- (v) Cash accounting should be introduced for the smallest bodies?
- (vi) The current 2007 IOM SORP needs review and updating?
- (vii) The FRC FRSSE would be a more appropriate standard than the CIPFA SORP on which to base any revised IOM Treasury issued 'proper practices'?

2.5 Auditor Appointment

2.5.1 The Act requires that statutory auditors are appointed by The Treasury. Currently Treasury appoints a single auditor for the entire local government sector and this contract is due for tender from the commencement of the next financial year (2014-15).

2.5.2 The existing arrangements provide a single point of contact that enables an ongoing dialogue to be maintained between the auditors and Treasury's Audit (Consultative) Committee. This has undoubtedly contributed to the vastly improved accounts & audit compliance that is now being maintained across the sector.

2.5.3 Treasury is of the view that central procurement of Audit/Assurance services also enables competitive prices to be obtained with the minimum of administrative overhead.

2.5.4 However Treasury is of the view that the smallest entities should have more flexibility in the appointment of their proposed 'independent examiners' subject to the examiners having appropriate financial expertise and independence.

2.5.5 Treasury is considering introducing a fixed fee for Independent Examiners proportionate to the size of the body.

Summary

Having considered various alternative approaches Treasury proposes that the auditor/examiner contracts be fulfilled as follows:

| Audit/ Examination Type | Estimate of Number of Bodies Affected | Fulfilled By |
|--|--|---|
| Qualified Independent Examination | 23 | Individual bodies to be able to appoint their own examiners subject to their having certain qualifications and meeting key independence criteria. Examination Fee payable to be on a scale fixed by the Treasury. Examiners to be subject to oversight by the Treasury appointed auditors. |
| Assurance Review | 22 | To be undertaken by the Treasury appointed auditors. |
| Statutory Audit | 7 | To be appointed by the Treasury (as per existing provision). |

It is proposed therefore that the aim of the forthcoming Local Government Audit Contract tender shall be to appoint a single auditor for undertaking both Statutory Audits and Assurance Reviews across the sector.

Question 5 – Auditor/Examiner Appointment

Do you agree that:

- (i) The smallest bodies should be permitted to appoint their own Independent Examiners?
- (ii) Independent Examination fees should be fixed by the Treasury?
- (iii) A single point of contact should be maintained for medium & large Local Government bodies? i.e. a single Treasury appointed auditor should undertake all Assurance Reviews and Audits.

3. APPENDIX 1: Local Government Sector Financial Analysis

3.1 Financial Risk Indicator: Gross Expenditure (less audit fees)

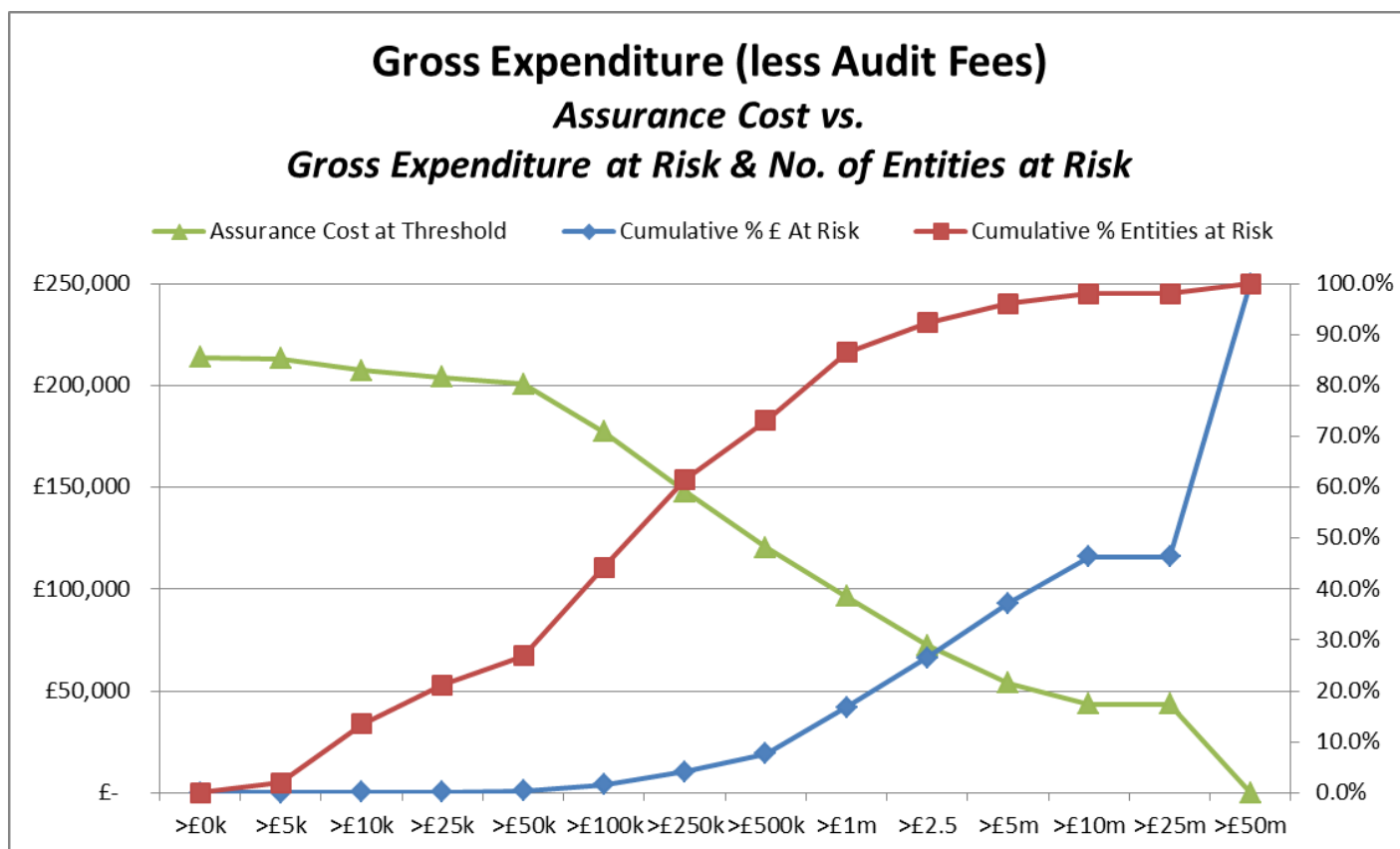
3.1.1 The financial data from 52 individual bodies within the Local Government sector currently required to be audited in accordance with the Audit Act 2006 were included within the review, including:

- Local Authorities;
- Housing Committees;
- Swimming Pool Authorities;
- Civic Amenity Sites;
- Burial Ground Authorities.

3.1.2 Whilst several financial risk factors have been reviewed, for the purposes of considering alternative frameworks applicable to audit and financial reporting, focus has been retained upon 'gross expenditure' which is one of the factors currently used within existing regulations to determine financial reporting thresholds.

(The indicator currently used is within regulations is actually the greater of gross income or gross expenditure, which is also referred to as 'turnover' within comparative frameworks within the UK).

| | |
|--|---|
| Gross Expenditure (less audit fees) within the year. | Used primarily as an indicator of the turnover of cash within each year. However audit fees (as prescribed by the 2010 fees order) have been removed so as to avoid distortion in relation to the audit framework considerations. |
|--|---|



4. APPENDIX 2: ICAEW Assurance Review



**AUDIT &
ASSURANCE
FACULTY**

ASSURANCE OPTIONS: ASSURANCE REVIEW

icaew.com/assurance

A CREDIBLE CHOICE FOR YOUR FINANCIAL STATEMENTS

These options are open to any small company (as defined by the Companies Act). Medium and large companies are required by law to have an audit. Large charities are required to have an audit, but all medium-sized and some small charities can choose between an audit and an independent examination. If you are in any doubt about your options, check your status with a qualified accountant.

What is it?

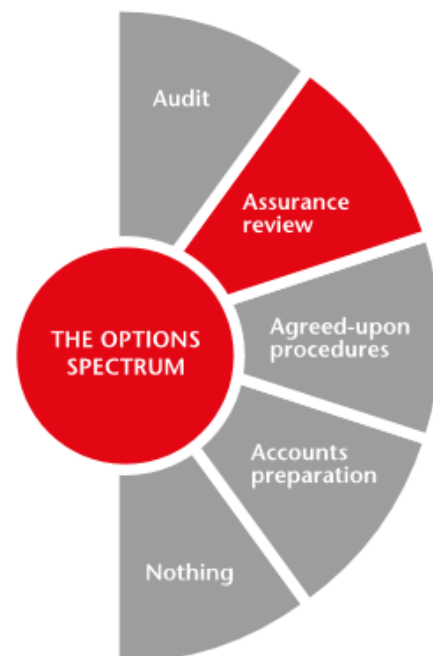
During an assurance review a qualified accountant will review your accounts and investigate any areas of concern. This includes analysing changes from one year to the next and may include further testing of the underlying information if something comes up in the review that catches their attention.

The accountant considers: does anything they have seen during the review suggest a problem in the financial statements that needs further checking to sort out?

A conclusion is presented in a report which is appended to your financial statements so that everybody who reads them can see that an independent review has taken place.

Take care!

Unlike an audit, an assurance review is not necessarily a regulated service. The quality of the engagement depends on the skill, integrity, and experience of your accountant. There is no law to enforce quality control, so it is important that you make sure you are talking to a qualified professional accountant.



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|------------------------|
| Overview |
| Audit |
| Assurance review |
| Agreed-upon procedures |
| Accounts preparation |

PRESENTED BY

ASSURANCE OPTIONS: ASSURANCE REVIEW

You may need an assurance review if...

- As a business owner you would like to have a professional accountant review your accounts, check they agree to the underlying records and investigate anything thrown up by the review.
- Your business does not have an experienced finance team and you would like a second pair of eyes cast over your accounts to assure the quality of the information in your financial statements.
- You would like to reassure lenders and investors about the quality and integrity of your financial statements. Your bank has access to other information, particularly on your cash situation, but a business angel or venture capitalist might appreciate the independent review on your accounts.
- Your organisation is high profile in your local community and you are aware that your accounts may be widely read. Extra credibility for your financial statements would be helpful.
- You want assurance that is less intensive and more flexible than an audit.
- You want assurance but would rather not bear the cost and time burden of a full audit.

A different option may prove better if...

- You have chosen to outsource your finance function and do not want to gain any further confidence over its operation.
- Your accounts have been prepared by a qualified professional accountant and you have full confidence in their quality and integrity.
- You have some other way of providing assurance to interested people outside your business. For example, open book contracts might mean that your key customers have no need for further assurance over your accounts as they can visit and obtain what they need directly.
- If you are more comfortable with a regulated service, you may prefer an audit. An audit can only legally be performed by a qualified professional accountant, who must also be registered as an auditor.
- Due to your circumstances, an audit would not cost significantly more than an assurance review. An audit gives the highest level of assurance.
- Audited accounts are a contractual requirement in order to win work from a key customer. Local government contracts, or contracts with some larger entities, may include a requirement of this kind.
- You would rather pay more for a consistent, regulated service (an audit) than less for a flexible and less regulated one. In either case the quality of the work depends on the skill and experience of a professional expert, but audit is subject to stricter quality control requirements.
- You are looking for a very high number of other services from your accountant at the same time. Much of the value of an audit or review comes from the fact that the professional accountant providing it is seen to be independent.