

HOLDING TO ACCOUNT

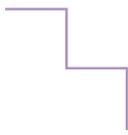
**The Review of Audit and
Accountability for Central Government**

Report by Lord Sharman of Redlynch

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Main Recommendations

The proper and productive use of public money is an indispensable element of any modern, well-managed, and fully accountable democratic state. It is essential that, where Government, and the prime instrument of scrutiny, Parliament, interact, there exists a common understanding of how, and on what terms, public money can be used. Over the last 140 years, increasingly refined techniques for patrolling the boundary between Government and Parliament have been developed. The turn of the new century marks an appropriate time for a further consideration of accountability arrangements.

The Review of Audit and Accountability was established to examine current audit and accountability arrangements for central government and make recommendations. The main recommendations are:

Accountability arrangements

1. All central government bodies should follow the private sector in applying the principles of the Turnbull Report as a basis for ensuring strong **internal controls** and management within the processes of government. This work is already under way and should be pursued vigorously, although it must be recognised that it will take some time before all the necessary processes are in place within departments. The discipline of having a formal internal control statement, signed by the Accounting Officer, is helping departments to systematise and, where necessary, overhaul their internal control systems. To be able to sign the statement, the Accounting Officer will need to take assurance from other senior staff that proper systems and controls are in place. Given this, the Accounting Officer's statement should make clear he has placed reliance on these assurances. This will ensure that the overall accountability of the Accounting Officer is maintained, whilst making clear the responsibilities of other senior officials (paragraph 3.28).
2. All departments should have a formally constituted audit committee. Some basic principles for **audit committees** include that they should:
 - be chaired by a non-executive director, or by a person from outside the department, appointed solely to chair the audit committee, without a wider role within the organisation (with appropriate support to ensure familiarity with the work of the department);
 - if possible, consist solely of independents (or at least have a majority of such people). Committees should not include either the Accounting Officer or the Principal Finance Officer among its executive members, although they should attend the meetings;
 - consider whether all risks faced by the department, not just financial risks, have been properly assessed;
3. All central government bodies should have access to well-resourced and independent **internal audit**, reporting to an audit committee, with its programme and performance against plan reviewed by the committee, and the right to report to the Accounting Officer, and hold private sessions with the Chairman of the audit committee (paragraphs 3.32-3.33).
4. **External audit** of public money is undertaken primarily from the perspective of the 'watchdog' - designed to provide assurance that taxpayers' money has been well spent - but to make the most of the work, auditors should seek to combine this role with that of adviser in ways that do not compromise independence. External audit should be based firmly on the principles of the Public Audit Forum, which emphasise the independence of public sector auditors from the organisations being examined; the wide scope of public audit; and the ability of auditors to make the results of their work public (paragraphs 3.34-3.41).

- approve and review internal audit's work programme and receive internal audit reports;
- involve the external auditor and ensure that he/she receives all papers and is invited to all meetings;
- allow for the Chairman of the audit committee to hold private sessions with the internal and external auditors;
- challenge both external and internal auditors about their assumptions and methodologies; and
- prepare an annual report to the Accounting Officer on their work, which could be published alongside the departmental accounts.

Departments should ensure that staff sitting on, or dealing with, audit committees, have appropriate training (paragraphs 3.29-3.31 and Box C4).

Audit arrangements

5. The arguments for and against the current mix of audit arrangements for **non-departmental public bodies** were debated extensively in Parliament in 2000. The Review was asked to consider the merits of these arguments. In the light of this, it is recommended that, as a matter of principle, the Comptroller and Auditor General (C&AG) be appointed as the auditor, on behalf of Parliament, of all NDPBs, including those where the relevant minister currently appoints the auditor. Use should be made of the provision in the Government Resources and Accounts Act 2000 to allow this to happen as existing contracts expire. At the same time, arrangements should be put in place to ensure that there is no reduction in the level of assurance that is currently provided to departments and the coverage of the audit, and the C&AG's suggestion that he would contract out an equal number of additional audits as are currently awarded by departments to private firms, should be taken up. In the meantime, the C&AG should provide a report to the Public Accounts Committee (PAC) on the major points from the audited accounts and management letters of the executive NDPBs that he does not currently audit (paragraphs 4.9-4.19).
6. The Department of Trade and Industry and the National Audit Office (NAO) should work together to identify how best the current obstacles to the ability of the C&AG to be appointed as an auditor under the Companies Act can be removed. The aim should be for the C&AG to be the auditor of NDPBs which are **companies**, companies owned by a department, or companies which are subsidiaries of a NDPB audited by the C&AG. And he should be eligible for appointment as auditor of companies where a department has a substantial stake or influence (for example, through being able to appoint board members, and influence strategy, or by way of a financial investment of, for example, more than 25 per cent of the shareholding). It seems most appropriate that the above should be public sector or near public sector companies. There may also be cases of other organisations with a 'public interest' role (eg representative bodies, or organisations which play a role in public life) where the C&AG should not be prevented from being eligible for appointment as the auditor, should he be asked to become so. If the C&AG were to become eligible to undertake such work, then such audits would be carried out on behalf of the relevant governing body of the entity, rather than on behalf of Parliament, as is already the case with his international audit work. Similar arrangements should be introduced for the audit of local government, and for the Auditor General for Scotland and the Auditor General for Wales as regards companies in their respective areas of responsibility (paragraphs 4.20-4.33).
7. There are strong grounds for formalising the arrangements for the C&AG's access where it is currently based on negotiated agreement or conventions, and when the matter is considered in the future. The C&AG should, for example, be given **statutory access** to the organisations and information listed in paragraph 4.58, using the order making provision in the Government Resources and Accounts Act 2000. In doing this, the C&AG, the bodies involved, their regulators, and other auditors should produce protocols for the exercise of these new statutory powers. The protocols should be prepared to a fixed timetable and take no longer than six months to produce. A *de minimis* rule could be introduced to prevent undue worry about the C&AG carrying out inspections of small, private sector bodies receiving limited sums of money (with a figure set at perhaps £100,000), unless there are strong grounds for doing so. The C&AG should be given access to the BBC as originally recommended by the Davies Review on the Future Funding of the BBC (paragraphs 4.37-4.61).
8. The move to regular **performance reporting** for departments is a very important step in improving accountability, and there should be external validation of departmental information systems as a first step in a process towards validation of key published data. There is general agreement that a good deal of work needs to be done in preparing for these developments, and the creation of a Treasury-led working group to consider the issues is welcome. There are already strong links between validation and audit work, and in order to ensure a cost-effective process, the C&AG and Audit Commission, as the auditors of the bodies generating much of the data, should be responsible for external validation in their respective areas. They should co-ordinate closely with the Office of National Statistics, the Statistics Commission and other relevant bodies to devise an efficient way of providing Parliament and the public with assurance that published information is reliable. The development of performance validation for central government should be taken forward using a programmed step-by-step approach (paragraphs 4.65-4.72).
9. The PAC could provide further powerful support to improvements in financial management by continuing to **examine themes across central government** as a whole (such as risk management, corporate governance, developments in performance measurement and fraud). In particular, this could be undertaken by holding an annual hearing, examining the main issues set out in a memorandum or report from the C&AG. This could be based on the C&AG's own work, his review of the findings of internal audit, and other sources. As departmental audit committees develop further, the Committee's examination would be able to draw on key themes from their work (paragraphs 4.73-4.80).

10. Recent developments in the PAC's work, and some of the suggested recommendations in this report, could lead to an increase in the Committee's already substantial workload. The Committee should consider its **working arrangements** in the light of this. Developments in the Scottish Parliament and Welsh Assembly (which have established committees broadly along the same lines as PAC) may provide some ideas for further experimentation in the Committee's approach (paragraphs 4.78-4.82).
13. Auditors and other inspectors should continue to seek to **co-ordinate work** where possible in the interests of maximising the benefit of their work and minimising duplication of effort. There are a great many ways that this can be done, ranging from joint studies to sharing information. Where there are a number of inspectorates, audit bodies and regulators working in a particular field, all parties should liaise on a regular basis to identify respective information needs, and co-ordinate information gathering (paragraphs 5.23-5.32).

Making the most of audit

11. In order to make the most of audit activity:
- public auditors should be involved in relevant **government-wide reviews**, and the public audit function should be used, where appropriate, in providing advice and guidance in advance of decisions, but only in ways that do not compromise the ability of auditors to review projects later (paragraph 5.6);
 - there should be further development of **high level overview reports** by NAO and PAC, which draw out lessons from a number of more detailed reports on similar subjects (paragraphs 5.11-5.12);
 - the NAO should look to **publicise its findings** in a wide range of ways in addition to published reports, including, where appropriate, through conferences and seminars, summarised briefings, in newsletters, and using electronic media. There could be scope for a regular seminar of Accounting Officers, hosted by the C&AG to review key strategic issues arising (paragraph 5.13-5.14); and
 - further use could be made of the work of the NAO, for example, by providing the C&AG with the resources to **brief departmental select committees** annually on key financial issues, without in any way undermining the key relationship between the NAO and PAC, or drawing the C&AG and his staff into questioning policy matters (paragraphs 5.15-5.17).

Minimising the cost of audit

12. Auditors have a responsibility to minimise the **cost and burden** of their work, including by refining methods, using IT, making use of existing data, and using outside experts. The C&AG should continue to contract out work to private firms to help encourage competitive tension and benchmark the efficiency of the NAO, working towards a figure of 25 per cent of the resources devoted to financial audit. Recommendation 19 on scrutiny of NAO's financial audit work by the Joint Monitoring Unit will also be important here, as will the scrutiny of costs, efficiency and quality of NAO's work by the House of Commons Public Accounts Commission (paragraphs 5.20-5.22).
14. There should be close **liaison** between departmental internal audit and external audit, based on the code of good practice drawn up by Treasury, NAO and departments, which should be published and disseminated as soon as possible as the basis for developing relationships (paragraphs 5.29-5.31).
15. It is essential that departments continue to improve **risk management** arrangements and that messages contained in recent guidance are embedded in departmental systems and thinking. Encouragement and monitoring of progress could be undertaken by departmental audit committees, and (at a higher level) by the Treasury and Cabinet Office, as well as by the PAC and the NAO. The latter could undertake a follow up study to the C&AG's 2000 report on 'Supporting Innovation'. However, it must be recognised that improvements will only come when risk aversion is treated as a cultural, rather than a structural or technical, issue (paragraphs 5.33-5.39).
16. Although well beyond the remit of this Review, the evidence suggests that the issue of **incentives and rewards** within government is a fundamental one, which merits continuing research as to how best to create a climate in which change and innovation are encouraged and rewarded. Incentives must not be seen purely in monetary terms, but should also include opportunities for recognition, advancement, study and responsibility. The on-going work of the Civil Service Reform Programme is important here (paragraph 5.44).
17. Accountability mechanisms are perceived by some in government as a discouragement to **innovate and change**, but this appears to be only one of a number of complex factors, including a lack of incentives to manage risks, and a lack of commercial decision making skills within departments. Whilst acknowledging this, it is important that auditors recognise the dangers of being perceived as discouraging well managed risk taking, and ensure that their work lives up to the spirit of statements made on attitudes to innovation (paragraphs 5.46-5.48).

18. Many of the obstacles to **'joined up' working** may be internal to government rather than due to external scrutiny. Key success factors for partnership working appear to include the existence of clear responsibilities, the clarity of aims and objectives, and the existence of ring-fenced resources. The examination of 'joined up' working is more complex for auditors, and it seems likely that departments and the PAC will need to be flexible in dealing with such reports by the C&AG, with the PAC perhaps holding several hearings, and departments allowing one Accounting Officer to represent others (paragraphs 5.49-5.61)

Ensuring accountability and quality of audit work

19. The NAO's suggestion that its financial audit work be made subject to regular and routine (perhaps annual) scrutiny by the **Joint Monitoring Unit** is welcome as a significant step in providing an independent and more transparent overview of NAO's work. The idea should be taken forward and the conclusions could be made public (paragraph 5.71).
20. Because of the nature of **VFM work**, it is not subject to the same agreed explicit professional standards as can be applied to financial audit. Instead, the C&AG's reports are subject to several forms of assessment, including by seeking the views of the bodies subject to examination, and external assessment by academic specialists. The use of a panel of acknowledged experts, external to the NAO, is a sensible approach, even though there is an element of subjectivity in it, and the NAO's suggestion that the conclusions of these assessments be made available to audited bodies should be useful as part of a constructive dialogue between auditor and auditee (paragraphs 5.72-5.73).
21. It is a matter for the House of Commons **Public Accounts Commission** what information it decides to publish, but in the interests of transparency, and explaining the arrangements by which the NAO is held accountable, there may be scope for more information to be included in its reports. This might include information arising from the VFM reports on the NAO and from the Committee's annual examination of the NAO's own auditors (paragraph 5.74).

1

Introduction

Background to the Review

- 1.1 Central government spends more than £300 billion a year, and collects a similar amount in revenue. Almost everyone in the country pays some form of tax, or is a recipient of a pension or benefit, or is a user of the roads, schools, hospitals and other facilities provided for in some way out of this money. With so much money and valuable publicly funded assets at stake, how these resources are used and safeguarded are key concerns for a democratic society.
- 1.2 At the end of February 2000 the Chief Secretary to the Treasury announced his intention to set up the Review of Audit and Accountability for Central Government. In his statement, the Chief Secretary said that the Review would recommend suitable audit and accountability arrangements for central government in the 21st century and would cover issues raised by the Committee of Public Accounts during the passage of the Government Resources and Accounts Act, along with a number of other relevant matters. The full terms of reference for the Review are detailed in **Box A1**. Lord Sharman of Redlynch was appointed to lead the Project Team, which undertook its research between September 2000 and January 2001. Details of how the Review was conducted are at Annex A.

A1 TERMS OF REFERENCE

The Review will consider suitable arrangements for the audit and accountability of central government in the 21st century on behalf of Parliament and the public, and make recommendations. The Review will:

- **cover** the issues raised by the Committee of Public Accounts, concerning the roles and powers of the Comptroller and Auditor General, in their report on the Government Resources and Accounts Bill (9th report 1999-2000 HC159), including:
 - audit access (for the Comptroller and Auditor General to discharge his responsibilities efficiently and independently);
 - ensuring accountability in the light of developments in the way public services are delivered; and
 - the scope of audit (including issues of regularity, propriety and corporate governance).
- **cover** other relevant issues such as the role of audit in modernising government, including:
 - performance validation;
 - the audit of joined-up activities; and
 - the implications for attitudes to risk-taking.
- **will have regard to:**
 - the importance of Parliamentary scrutiny and accountability in the round;
 - the costs and burden of regulation;
 - the mechanics of change;
 - the implications of devolution;
 - the wider European context (with particular reference to European directives affecting audit arrangements);
 - possible models from other countries; and
 - the relationship with other audit and regulatory bodies.

1.3 Accountability has been variously defined as 'the quality of being accountable', 'a liability to give account of, and answer for, discharge of duties or conduct' and 'responsibility'. For the purposes of this report it refers to the requirement to provide explanations about the stewardship of public money and how this money has been used. In the United Kingdom, central government accountability is secured in a number of ways. The most important is ministerial accountability to Parliament, for example, through statements, debates and answers to oral questions on the floor of the chamber, appearances before committees, answers to written questions and the laying of documents. But another key mechanism for accountability, and the focus of much of this review, is external audit, the process by which the adequacy of the explanations provided in financial statements is assessed and reported upon by an independent party.

The origins of modern accountability and audit arrangements

1.4 The origins of modern accountability and audit arrangements for central government in the United Kingdom stretch back into the nineteenth century. As part of the reforms of the civil service in the 1860s and 1870s, William Gladstone instituted a more disciplined system of financial administration. As part of this, the Committee of Public Accounts (PAC) of the House of Commons was established in 1861. Five years later, the Exchequer and Audit Departments Act was passed, requiring government departments to produce appropriation accounts for independent audit, creating the post of Comptroller and Auditor General, and establishing the Exchequer and Audit Department to assist him examine the accounts required by the Act. An indication of the strength of this basic framework is that it has endured broadly untouched to this day, and is held in considerably high regard by many observers.

1.5 These reforms laid the foundations of Parliament's scrutiny of public money. Under this, Parliament votes money to the Government, which the Government spends. The Government is responsible for ensuring that arrangements are in place to safeguard these funds, and is then held accountable for how it has used the money. Parliament has assigned to the PAC responsibility for looking in detail at how public money - including voted money, government trading funds, the Consolidated Fund and the National Loans Funds¹ - has been used. The Committee is assisted in this by the Comptroller and Auditor General, who is an Officer of the House of Commons, and the head of the National Audit Office (NAO), which carries out work on his behalf.

¹ The Consolidated Fund is the account through which pass most government payments and receipts. The National Loans Fund is the channel through which pass most of the government's borrowing transactions and some domestic lending transactions.

1.6 These arrangements remain relevant to this day, although there have been important changes along the way. Greater independence in the process of external scrutiny was provided with the establishment of the NAO in 1984, outside of the civil service. In recent decades, the scope of audit scrutiny has extended well beyond the verification of accounts, to encompass value for money examinations assessing the economy, efficiency and effectiveness of government spending. And in 2000, the basis on which government bodies account for public money, set out in the original 1866 legislation, was brought into line with commercial practice and placed on an accruals basis under the Government Resources and Accounts Act. Annex B summarises in more detail key changes in audit arrangements that have taken place.

1.7 In general, these arrangements have worked well for many years. It is widely considered that the rigorous parliamentary scrutiny of public finances (along with, for example, the existence of a non-political civil service) has played a significant part in ensuring low levels of fraud and corruption in central government in the United Kingdom. It has also ensured that, in general, public officials pay appropriate attention to ensuring public money is safeguarded and used with regard to value for money. Whilst such arrangements will never prevent problems arising with projects and programmes, which can result in poor value for money, they have helped to deter wilful misuse of funds. This is a record of considerable importance, and one that provides a firm and continuing platform on which necessary additional improvements and adaptations can be based to meet changing circumstances.

1.8 Audit and accountability arrangements must be seen in context. In recent years, the pace of change in the delivery of government services has intensified in much of the world, with the United Kingdom at the forefront of many of these developments. Whereas once government departments provided most public services directly, the last 20 years have seen considerable diversification in the range and type of service providers. The number of non-departmental public bodies (NDPBs), undertaking important functions of government at 'arms-length' from sponsoring departments, grew after 1945. In the late 1980s, the first Executive Agencies were established within departments to undertake many executive functions of government, and there are now more than 100 such bodies, employing some 75 per cent of all civil servants.

1.9 Also during the 1980s and 1990s, many of the public corporations and nationalised industries (and to a lesser extent, parts of central government departments), which had provided public services, were privatised. In the case of the major public utilities, new bodies (mainly non-ministerial government departments) were set up to regulate the activities of the newly privatised industries.

The 1990s also saw the involvement of many more private sector providers of public services in government, and the Private Finance Initiative has offered new ways of funding hospitals, prisons and a range of other services.

1.10 There is every indication that change will continue in public service delivery. Looking ahead, a number of significant trends in government seem likely to continue. These include that:

- the use of a diverse range of mechanisms for the delivery of public services will continue. Government departments and other public bodies will provide fewer services themselves directly;
- private sector organisations will increasingly play a role in public service delivery. The management of contracts and contractors will thus be of great importance for government bodies;
- partnerships between public bodies, and between public bodies and private and voluntary sector organisations, will continue to develop. Government recognises that solutions to many problems require combined efforts, and new ways of working together are likely to be tried;
- rapid developments in information technology will make available increasing amounts of data on the performance of public bodies and the quality of services to the public, and make it available more quickly. How this material is presented and its reliability assured will be important for public confidence in the data;
- public bodies will continue to use the mechanism of establishing companies to undertake a variety of public services; and
- there is likely to be increased customer focus to the delivery of public services, in the face of continuing demands for more personalised public services, and greater expectations about quality provision.

1.11 All these developments have implications for audit and accountability and, as has been recognised in the United Kingdom and elsewhere, modern arrangements must be able to meet these and other challenges (see **Box A2** for recent consideration of similar issues in three other countries). Developments also look likely to add to the complexity of the ways in which public services are provided and funded. As a consequence, as many of those who have submitted evidence for this Review have commented, the answer to the question 'What is public money?' has ceased to be straightforward. Similarly, in these circumstances, there is no simple answer to such questions as 'How can Parliament and the public be assured that public funds are being well used?' or 'How can the need to provide freedom to innovate in public service delivery be reconciled with the need for transparency and safeguarding of taxpayers' money?'

A2 OVERSEAS CONSIDERATION OF AUDIT ARRANGEMENTS

Other countries have also recognised the implications for audit and accountability arrangements of changes in the ways in which public services are delivered.

New Zealand - in 1998 the Finance and Expenditure Committee of the New Zealand Parliament reported on its 'Inquiry into Audit Office Legislation'. The Committee's report stated that 'Given the extensive reforms to the State sector since 1977 [the date of the legislation governing the structure and role of the Audit Office], we believe that this legislative framework does not adequately provide for the functions, duties and powers of the Auditor-General in the public sector today.' The Committee made a series of recommendations concerning the Audit Office's mandate and the appointment of the Controller and Auditor-General. A Public Audit Bill, taking forward many of these ideas, is currently before the New Zealand Parliament.

Canada - in 1999 the Auditor General of Canada reported on the impact of accountability arrangements on the development of collaborative partnerships in government, and the involvement of private sector and other bodies in delivering services. The Auditor General noted that during the 1990s government had significantly increased its use of external partners in innovative arrangements for delivering services to the public. And he expressed concern that provision for ensuring good governance and accountability to Parliament and the public was very patchy and needed attention.

The Netherlands - in the Netherlands, disbursement of public resources has increasingly been delegated to agencies acting at arm's length to central government. These include private sector bodies and public bodies with statutory tasks (bodies similar to NDPBs in the United Kingdom referred to as RWTs). Since the mid-1990s the audit office has developed its audit of RWTs. The audit office has expressed concern at the ability of many ministries to supervise the RWTs associated with them. It has also requested that the Government and Parliament consider extensions to its powers to enable it to examine the use of public money spent by bodies outside central government. In the coming year, the audit office expects there to be new legislation to give it wider powers with regard to the audit of European Community funds, including allowing access to final beneficiaries.

Scope of the study

1.12 The start of the new century is an appropriate time to examine the audit and accountability arrangements for public money. This report, therefore, examines:

- Scoping the Review - What is public money? (Chapter 2)
- What degree of accountability and audit is appropriate to public money?(Chapter 3)
- Arrangements for the audit and accountability of central government (Chapter 4)
- Making the most of audit and accountability arrangements (Chapter 5)

1.13 This study focuses on central government and organisations providing services to central government. It does not examine audit and accountability in local government, although the relationship between the NAO and the Audit Commission is touched upon. Nor does the Review focus on the arrangements in Scotland, Wales and Northern Ireland, although reference is made to developments in these countries, where relevant.

2

Scoping the Review – What is Public Money?

Introduction

2.1 Before considering audit and accountability arrangements, this chapter draws the boundary for the Review by examining the question 'What is public money?'. The Terms of Reference state that the Review will "consider suitable arrangements for the audit and accountability of central government..." An initial assumption might, therefore, be that the answer to the question is all money spent by central government bodies. Indeed, this is the starting point for any examination of this area. However, it is generally recognised that the changes in the mechanisms for delivering public services that have occurred have meant a substantial proportion of public service delivery is now undertaken by organisations not part of central government, or even the public sector.

2.2 Therefore, it is necessary to start by defining what is meant, for accountability purposes, by the term 'public money', so that it can be identified regardless of the type of body spending it. In doing this, the underlying assumption is that, where public money is involved, some level of public accountability is required, regardless of the status of the body handling that money.

Traditional definitions of public money

2.3 Classic thinking on what constitutes public money concentrates on how revenue is raised and on Parliamentary authorisation of expenditure. On the first of these bases, public money will consist of tax revenues and government borrowings, as well as income generated by public bodies from fees and charges. On the second, public money would consist largely of money voted in estimates, but would also cover cases where money was raised under statutory powers (for example, through levies on particular industries).

2.4 These definitions are useful, but not exhaustive. For example, the public expenditure control totals that the Treasury use to control public spending are not coterminous with the amounts voted by Parliament; non-voted expenditure included in the control totals includes lottery money. The move to Resource Accounting and Budgeting (RAB) will mean that more spending by public bodies will be included in the budgeted figures used by the Treasury to control spending, but will also widen the gap between the budgeted figures and the amounts included in estimates. For example, under RAB, departmental budgets will include the total spending of their sponsored non-departmental public bodies (NDPBs), whereas the estimates will continue to show only the amount of grant or grant-in-aid given to the body.

2.5 Yet even the budgeted figures do not provide a full picture. For example, much of the expenditure of self-financing public corporations is excluded. More importantly, however, budgeting measures do not show how public money can be passed down chains of bodies before reaching the final recipient. To do so would, in budgeting terms, lead to double counting, with all the bodies in the chain handling, and so being accountable for, public money.

2.6 None of these existing definitions of public money are, therefore, entirely appropriate for the purpose of the Review. As a result, the remainder of this chapter sets out in greater detail the types of body responsible for spending public money, and the various categories of income and expenditure that the term may include. Based on this analysis, a definition of public money for accountability purposes is proposed.

Who spends public money?

- 2.7 It is a commonly held view that public money has traditionally been spent by government departments and local authorities, and it is only in the past few decades that changes in the mechanisms for delivering public services have meant that a substantial proportion of public service delivery is now undertaken by other organisations.
- 2.8 There is a great deal to this view, particularly given that much service delivery is now in the hands of charitable or commercial organisations (for example, in the case of privately owned and operated prisons). However, it must be recognised that the use of arm's length bodies to deliver public services has a long history, with some NDPBs dating back to the 19th century¹, and an increase in the use of such bodies arising in the period immediately following the end of World War II. Many NDPBs, NHS bodies and, of course, many of the nationalised industries (most of which have since been privatised) date from the late 1940s and early 1950s². Recent decades, therefore, have, at most, seen an intensification of trends that have been noticeable for a considerable period.
- 2.9 **Box B1** shows in diagrammatic form the main categories of bodies that receive public money and the relationships between them. A brief description of each of these types of body and the types of money for which they are likely to be responsible are set out below.

Government Departments (including agencies and trading funds)

There are currently about 50 government departments. Departments include all their executive agencies and trading funds (the staff of which are civil servants or, in the case of some defence agencies, a mix of civil servants and military personnel). The types of money for which these bodies are responsible include:

- amounts voted in estimates;
- amounts paid out as Consolidated Fund standing services;
- amounts passing through non-voted Funds (eg

trading funds, Consolidated Fund, National Loans Fund, National Insurance Fund, etc);

- amounts collected as taxation (including business rates);
- amounts received from the National Lottery licensee;
- European Union monies³;
- amounts received as fees and charges;
- other receipts (eg fines); and
- amounts held by departments on behalf of others (eg by the Child Support Agency and the Public Trust Office - see **Box B2**).

B2 AMOUNTS HELD ON BEHALF OF THIRD PARTIES

A number of departments and agencies hold or have responsibility for money on behalf of third parties as part of their functions. Examples include the Child Support Agency, which receives money from absent parents and passes it to parents with care responsibilities; the Public Trust Office, which administers the assets of persons incapable of managing their own affairs; and the Court Funds Office, which administers amounts paid into Court.

All such money clearly belongs to the (mainly private sector) organisations and individuals on whose behalf the department is holding the money. However, the department has a stewardship role to safeguard and properly manage such monies while they are in its possession, and it is publicly accountable for how it has performed these duties. Therefore, in accountability terms, these monies are 'public'.

1 For example, many of the national museums - The British Museum, The National Gallery and The Natural History Museum - date back to this period.

2 25 (out of 216) of the executive NDPBs in England listed in Public Bodies 1999 are governed by legislation dating back to the 1940s. Given that many NDPBs have over the years merged or had their governing legislation changed it is likely that others could also date their foundation back to this period.

3 The accounting rules for EU payments and receipts are set out in chapter 4 of Government Accounting (1989 edition as amended). In summary the position is:

- Under section 2(3) of the European Communities Act 1972 most payments to and receipts from the EU are charged directly to or paid directly into the Consolidated Fund.
- Certain payments may be made from voted monies, and where monies are received to reimburse payments made from voted money then the receipts may be appropriated-in-aid.
- Certain payments by the EU to private sector bodies and local authorities are made via government departments acting as agents for the EU body. Such payments pass through departmental accounts.

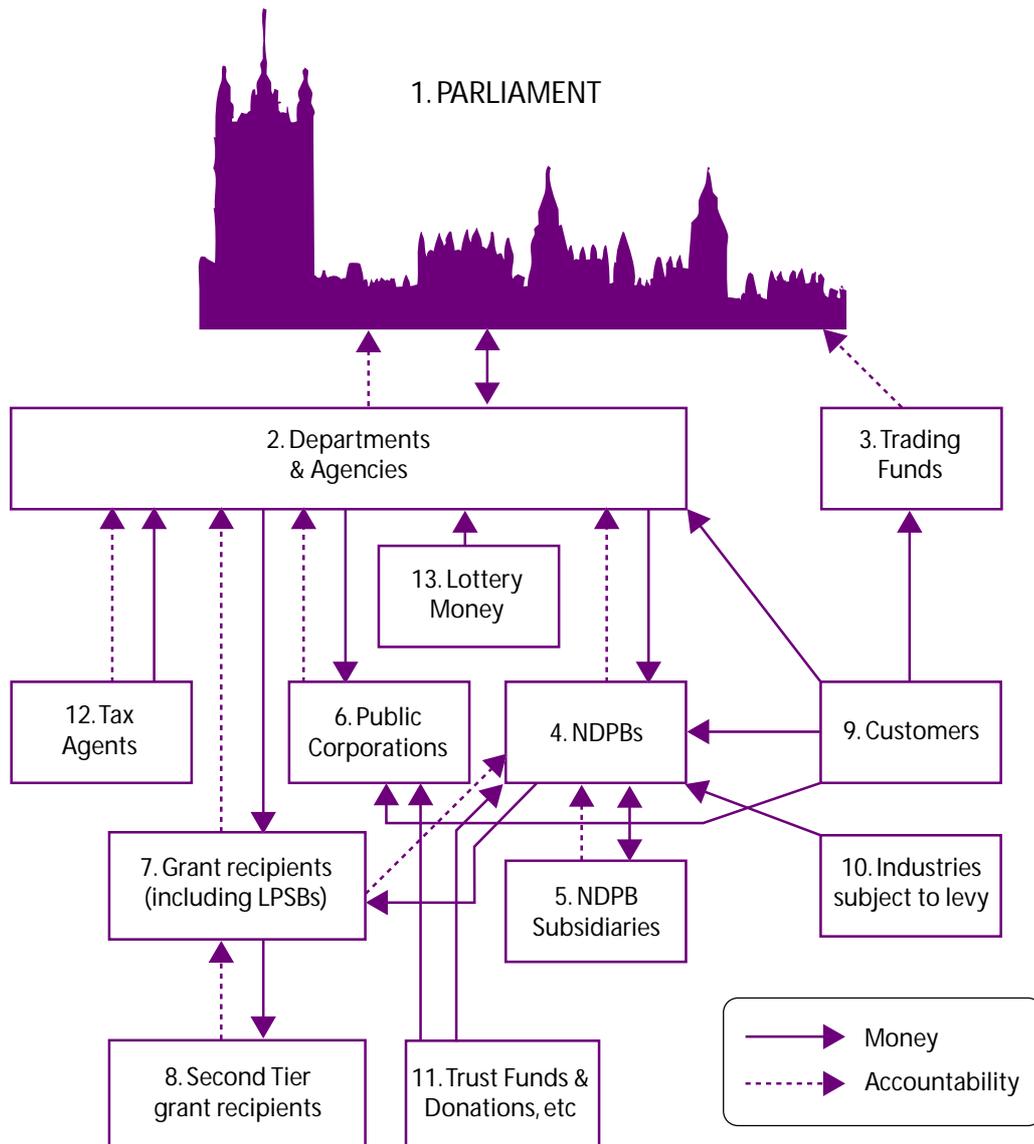
4 Departments can also receive non-voted amounts such as loans from the National Loans Fund (NLF) and Consolidated Fund Standing Services and they have to account for such monies.

5 The normal rule is that any income received by a department should be paid into the Consolidated Fund. Therefore, departments can only keep income up to the amount authorised by Parliament as appropriations-in-aid.

6 In certain circumstances trading funds can receive voted loans from their parent departments or loans from the NLF.

7 The BBC is funded mainly by the TV licence fee. Money raised by the licence fee is paid into the Consolidated Fund and an amount equal to the amount raised by the licence fee is then voted to DCMS, which then pays it (effectively as a grant-in-aid) over to the BBC.

B1



Parliament (box 1) votes money (and resources from 2001/2002) to departments (box 2)⁴. Departments also receive money from providing goods and services (box 9)⁵. Taxes collected by departments (including those elements of tax, such as PAYE and VAT, collected through private sector agents (box 12)) together with other income that cannot be retained by departments, are paid into the Consolidated Fund and cannot be used until authorised by Parliament. Departments are required to account to Parliament for the money received.

Unlike other departments and agencies, trading funds (box 3) do not receive voted money⁶. They are expected to cover their costs through the income received from customers (box 9). However, they are accountable to Parliament for their operations.

NDPBs (box 4) and public corporations (box 6) are financed through a mixture of grants and grant-in-aid from departments (box 2), trading income (boxes 9 and 5), income received as donations or from trust funds (box 11) and, in some cases, from levies on industry (box 10)⁷. All executive NDPBs are required to produce audited accounts that are laid before Parliament and are accountable to Parliament through Ministers.

Both departments (box 2) and NDPBs (box 4) provide grants to various private sector bodies (box 7). In some cases the grant recipients use this money to make grants to other bodies (box 8). In all cases where grants are made the body making the grant should have proper controls in place to ensure that the grant is used in accordance with the condition attaching to the grant.

The lottery operator pays the share of lottery money due to the good causes (box 13) into the National Lottery Distribution Fund (NLDF) controlled by the Department of Culture, Media and Sport (DCMS) (included under box 2). The money in the NLDF is then distributed to the various lottery distribution bodies (all of which are NDPBs - box 4) which in turn pays it as grants to approved projects (box 7).

Parliamentary bodies and those connected with the Monarchy are not included on the diagram due to their specialised nature and their relatively small size in the overall context of the flows of public funds.

Non-departmental public bodies

These are defined as 'bodies which have a role in the processes of national government, but which are not government departments or part of one, and which accordingly operate to a greater or lesser extent at arm's length from Ministers'⁸. The vast majority of NDPBs are non-executive bodies, such as advisory bodies, tribunals and prison boards of visitors⁹. However, the most important NDPBs are those that are classified as executive bodies (described as bodies that 'carry out administrative, regulatory, executive or commercial functions on behalf of Government'¹⁰). There are a wide variety of bodies that are included within this category, ranging from the Environment Agency (with almost 10,000 staff and total expenditure of about £600 million) to the British Hallmarking Council (with no full time staff and expenditure of less than £30,000)¹¹.

The types of money for which NDPBs tend to be responsible include:

- amounts received as grant and grant-in-aid from government departments;
- amounts received as fees and charges or as trading income (including trading income of subsidiary companies);
- amounts received as levies (which count as taxes);
- grants from lottery funds ;
- European Union money;
- donations from private sources; and
- amounts received from associated charitable trusts.

Public Corporations

This is a generic description covering the nationalised industries, statutory public corporations (such as the Bank of England and the BBC), and most National Health Service bodies. All of these bodies are regarded as operating at a greater distance from the Government than NDPBs and are not usually classified as being part of central government¹². However, they are all public bodies and are accountable to both Ministers and Parliament. The type of monies these bodies are likely to receive will be similar to those received by NDPBs. Additionally, the BBC is largely funded by the licence fee, which is classified as a tax (see **Box B3**).

B3 THE FUNDING OF THE BBC

The BBC presents an interesting example of the different ways in which a public body can be funded. It receives three main sources of funding: the television licence fee; income from commercial operations; and direct grant-in-aid.

- The licence fee represents the main source of income (over £2 billion per year) for the Home Service. Under the Broadcasting Act 1990 the BBC itself became responsible for collecting the licence fee (although the Government remains responsible for setting the amount of the licence). Amounts collected for the licence fee are paid into the Consolidated Fund and an amount equivalent to this, less central government costs, is passed to the BBC as a grant from the Department of Culture, Media and Sport.
- The commercial activities of BBC Worldwide, such as sales of programmes, magazines and videos, contribute an increasing percentage of the BBC's Home Service funds.
- The World Service, which is organisationally distinct from the Home Service, is largely funded by a direct grant-in-aid from the Foreign Office.

Devolved administrations

The devolved administrations in Scotland, Wales and Northern Ireland consist of the equivalents of government departments, NDPBs and public corporations. They are likely to be responsible for the same categories of money as those received by both departments and NDPBs/Public Corporations. In the case of the devolved administrations, the main money received will be grants from the UK Parliament.

Local authorities

These include county, district and unitary authorities in all the constituent parts of the United Kingdom. This category also includes other organisations such as the police and fire services. Local authorities will largely be responsible for monies in those categories received by NDPBs/Public Corporations. Most money is received by way of grant from central government and from business rates (collected centrally and then distributed to the local authorities), but in addition have their own tax raising powers.

⁸ Definition taken from Public Bodies 1999.

⁹ 625 out of 841 (figures from Public Bodies 1999 - excluding NDPBs reporting to a devolved administration).

¹⁰ Description taken from Public Bodies 1999.

¹¹ All figures are taken from Public Bodies 1999 (the figures have been rounded).

¹² Public Bodies 1999 notes that three public corporations (The Independent Television Commission, The Radio Authority and The Bank of England) are classified to the central government sector for national accounts purposes.

Parliamentary bodies

These are the Houses of Commons and Lords, the National Audit Office and the Office of the Parliamentary Commissioner for Administration. They are public bodies but are independent of the government, and are funded mainly through voted sums approved in estimates.

Bodies connected with the Monarchy

Funds here include the Civil List and payments to the Royal Household. Civil List expenditure is paid by the Treasury. Grant-in-aid for the upkeep of royal palaces and for transport is paid by the Department of Culture, Media and Sport and the Department of Environment, Transport and the Regions respectively.

Local Public Spending Bodies

Local Public Spending Bodies (LPSBs) is a term adopted by the Committee on Standards in Public Life in its second report published in 1996¹³. The Committee defined LPSBs as: '...not for profit bodies which are rarely elected and whose members are not appointed by Ministers. They provide public services, often delivered at a local level, and are largely or wholly publicly funded.'

Although this definition has no official status, the term has passed into use by the Government (for example, the annual Cabinet Office publication *Public Bodies* now includes basic information on these organisations). LPSBs are not classified as public bodies, but it is clear that, not only do many receive public money, but their activities overall are regulated by government. The main types of bodies included in this category are higher and further education institutions and registered social landlords (RSLs)¹⁴. To the extent that these bodies are publicly financed, it is by way of grants from the sponsoring department/NDPB. Certain LPSBs, for example RSLs, borrow money from commercial lenders on the security of their publicly funded assets.

Other bodies in receipt of public money

Grant recipients

Many private sector organisations receive grants and subsidies from central government bodies. In law, money given as grant ceases to be public money when it is paid to the recipient. However, it is generally recognised that there is a need for public accountability for such monies to ensure that it has been spent properly and value for

money is achieved. In certain cases there may be a continuing public interest (for example, where the grant is used to purchase assets there may be conditions attached to the grant requiring the Exchequer to be reimbursed if the asset is subsequently sold).

Contractors (including under PFI/PPP contracts)

In this context, the term 'contractors' refers to private sector bodies carrying out functions on behalf of departments, as opposed to suppliers who simply have contracts to provide goods or services to departments. Money is paid to such contractors for the performance of the function that the contractor is undertaking (eg running a prison on behalf of the Prison Service). As such, legally it ceases to be public money at the time that the payment is made. However, there is a need for the department to remain publicly accountable to ensure that the operations of the contractor meet the standards expected of public business and represent value for money. There will also be cases (for example, where the government has a reversionary interest in assets operated by the contractor) where there is a continuing public interest.

Core and Periphery

- 2.10 The paragraphs above emphasise the wide variety of bodies that receive public money. This section attempts to draw distinctions between them that affect the extent to which the resources available can be designated public money.
- 2.11 The fundamental distinction is between bodies that are part of the public sector, and those that belong to the independent and private sectors. Where a body is part of the public sector, all the money that it receives is, for the purposes of accountability, public money, regardless of source¹⁵. This recognises that there are greater public expectations regarding accountability for public money and that public bodies, therefore, have a responsibility to exercise proper stewardship over (and as such are publicly accountable for) all monies and assets that they have regardless of the source of funding. This means that, where a public body receives funding from a private source (eg by way of a donation), then that money is as much subject to public accountability as money directly voted by Parliament.

¹³ Second Report of the Committee on Standards in Public Life (1996)

¹⁴ Registered Social Landlords are mainly housing associations which provide low cost rented housing. The other main categories of LPSB discussed in the Nolan Committee's report (Training and Enterprise Councils and Grant Maintained Schools) are no longer in existence.

¹⁵ Both the Accounting Officer Memorandum and the NDPB Accounting Officer Memorandum (both of which are reproduced in Government Accounting) make clear that Accounting Officers are responsible for the overall financial procedures in their body. Paragraph 3 of the NDPB Accounting Officer Memorandum is explicit in stating that 'it is an important principle, that regardless of the source of the funding, Accounting Officers are responsible to Parliament for the resources under their control'.

- 2.12 On the other hand, independent or private sector bodies are not normally subject to the demands of public accountability. Therefore, it is only where a private sector body receives public money (or performs a function on behalf of a public body) that it is subject to public accountability. Even then, that accountability should be limited to that money and to the activities financed publicly, and not to money from other sources or entirely private activities. The main exceptions to this appear to be LPSBs and private bodies raising money under statutory authority, where there may be wider public accountability expectations for the overall financial affairs of the body (see paragraphs 2.16-2.17).
- 2.13 In the context of this review, **public** bodies include government departments (including executive agencies and trading funds), NDPBs, public corporations, the devolved administrations, and local authorities. Any subsidiary companies or other organisations set up by public bodies will also be categorised as public bodies for this purpose. Parliamentary bodies and those connected with the Monarchy are public, but not government, bodies.
- 2.14 Many public bodies receive as funding, or otherwise handle, considerable amounts from private sources. For example, many NDPBs and NHS bodies receive private donations, and in some cases have set up charitable trusts to help fund their activities. This money is used by these bodies to support their public functions and so should be classified as 'public money'. Many public bodies also handle money that belongs to private individuals or companies (see Box B2 above). In such cases the monies involved do not belong to the department, and are not available for it to spend. The department is, however, handling it as an agent, and so has a stewardship role in relation to its proper use, and is publicly accountable for discharging this responsibility. Given this public accountability, it is clear that for the purposes of this review 'private' money handled by public bodies must be classified as 'public money'.
- 2.15 For most bodies in the **independent** and **private sectors** only money received, either by way of a grant or subsidy from a public body, or for carrying out a function on behalf of a public body, would be classified as public money. There are a few cases, such as the lottery operator, where a private body is able to raise revenue under statutory authority. Although for most purposes this money is classified as being private, for the purposes of this Review it must be considered to be public money on the grounds that some form of public accountability to Parliament is appropriate.
- 2.16 LPSBs are not public bodies, but many receive a significant portion of their income by way of grant from public bodies, or are responsible for substantial publicly funded assets. In common with other independent and private sector bodies that receive money from public bodies, the money so received is regarded as 'public money' for the purposes of the Review.
- 2.17 Other monies received by these bodies (eg rent from tenants and fees from students) are private. However, all of these bodies are regulated by government bodies (eg the Housing Corporation in the case of registered social landlords, and the Higher Education Funding Council in the case of higher education institutions) and, because of the public nature of the functions they perform, there is a public interest in the overall financial health of these bodies. Therefore, some public accountability for money from all sources is appropriate.

The continuum of public and private money

- 2.18 The presence of both public and private bodies spending public money, and the existence, in some sectors of government activity, of public money being passed down 'chains' to final recipients, raises the question of when public money becomes private money for the purpose of ensuring proper public accountability.
- 2.19 In legal terms, and for the purpose of public expenditure classification, money ceases to be public when it is transferred to a non-public sector body or individual. In many cases, this will hold good for accountability purposes as well. For example, it would generally be accepted that where a public body pays money to an individual as a salary or a benefit, or to a body in return for goods or services received on normal commercial terms, then, provided that the payments have been correctly made (it may be possible to recover money where overpayments have been made), there is no expectation of public accountability by the recipients of that money for its use.
- 2.20 It is less clear where public accountability ceases when public money is paid out to independent and private sector bodies as grant, or for operating a contracted out service. It is likely that, in practice, the facts of each case will have to be considered individually. As a minimum (for example, where a grant is paid to purchase a particular item and there is no continuing public interest in the item) accountability expectations may cease when it has been ascertained that the grant has been spent as intended. However, in more complex cases (for example, where the government has a reversionary interest in assets operated by a contractor under PFI/PPP arrangements) then there may need to be some level of public accountability throughout the life of the project.

Formulating a definition of public money for accountability purposes

2.21 In summing up the above discussion the following principles are suggested. These are that:

- all money received by a public body, from whatever source, is public money;
- all money received from a public body by a non-public body is public money; and
- additionally, public accountability may exist for private money where that money is either raised under statutory authority, or where the body in question is a local public spending body.

2.22 A definition of public money for accountability purposes is, therefore, proposed as follows:

"All money that comes into the possession of, or is distributed by, a public body, and money raised by a private body where it is doing so under statutory authority".

What is so special about 'public money'?

2.23 Having defined what is meant by public money, the question arises as to why this should be subject to any accountabilities over and above those that might be held to apply to private money. A number of answers have been suggested. These are that:

- there is often an element of compulsion involved in raising public money (most is obtained through taxes or through the provision of a service by a monopoly provider). Therefore, it can be argued that there is a special duty incumbent on government to safeguard and make good use of money received;
- public money can only be used for the purposes intended and authorised. The need to ensure that this can be demonstrated imposes a greater degree of accountability than would be expected in the private sector;
- propriety (defined as the expectations as to how public money should be used) also places a greater degree of accountability on the use of public money than would be the case for private money. Public bodies must be able to demonstrate that they have conducted business in accordance with the standards expected of those dealing with public money; and
- most public services are not subject to competition. Greater accountability, therefore, acts as a proxy for the competitive pressures that, in the private sector, drive down costs and improve efficiency.

2.24 These points combine to make it necessary to develop particular accountability and audit structures for public money. The broad definition of public money outlined in this chapter, and the recognition of its special nature, provide the background to a more detailed examination of accountability arrangements. Chapter 3 considers what is meant by accountability, and discusses the scope of audit appropriate for public money.

3

What degree of accountability and audit is appropriate to public money?

Formulating a definition of public money for accountability purposes

- 3.1 Chapter 2 showed clearly that a wide range of bodies - both in the public and private sectors - spend, or are responsible for, 'public money' in the broadest sense. It concluded by drawing attention to the distinctive and special nature of 'public money'.
- 3.2 This chapter turns to considering accountability and audit, subjects described in one submission to the Review as 'pillars of our democratic form of government since the earliest times.' In particular, it considers what is meant by the term 'accountability', and what types of controls and audit are appropriate for public money. It also discusses the principles generally seen as underpinning the audit of public money. In doing so it provides the background to Chapter 4, in which consideration is given to how far these controls should apply to the variety of organisations using public money.

Accountability is a complex concept that goes beyond simply providing information

- 3.3 Accountability is a complex concept, but the basic idea is that an individual or body, acting on behalf of another person or group, should report back on their actions. Accountability is needed wherever there are hierarchical relationships, or where delegation of duties or responsibilities takes place. This is to ensure that those with delegated authority act in ways that their ultimate overseers would wish.
- 3.4 Accountability goes beyond the requirement to provide answers. With delegation comes discretion as to how responsibility will be exercised and resources deployed. Associated with this comes a liability to account for how that responsibility or duty has been discharged. Thus

explanation and possibly justification may be necessary as to what has been done and not done, what is being done, and what is planned. Providing this information allows those delegating responsibility to assess whether responsibilities have been exercised as intended. They may wish to respond on whether their needs have been met, and may wish to impose sanctions or rewards, or require the remedying of faults or further reassurance.

- 3.5 It is helpful to consider further what the notion of accountability entails. One analysis¹ has split it into four aspects:

- **giving an explanation** - through which the main stakeholders (for example Parliament) are advised about what is happening, perhaps through an annual report, outlining performance and activity;
- **providing further information** - where those accountable may be asked to account further, perhaps by providing information (eg to a select committee) on performance, beyond accounts already given;
- **reviewing and, if necessary, revising** - where those accountable respond by examining performance, systems or practices, and if necessary, making changes to meet the expectations of stakeholders; and
- **granting redress or imposing sanctions** - if a mechanism to impose sanctions exists, stakeholders might enforce their rights on those accountable to effect changes.

Accountability is secured in a number of ways in central government

- 3.6 Accountability in central government is based on an intricate web of relationships. Ministers have a duty to account to Parliament, and be held to account for the policies, decisions and actions of their Departments and executive agencies. The convention is that a Minister is accountable to Parliament, in the sense that he/she has a

¹ Barbaris P (1998) 'The New Public Management and a New Accountability' in Public Administration, Autumn. Also Neale A and Anderson B (2000) 'Performance Reporting for Accountability Purposes - Lessons, Issues, Futures' paper at International Public Management Workshop, Wellington, New Zealand

duty to explain to Parliament the exercise of powers and duties, and a duty to give an account of what has been done in his/her capacity as a Minister, or by his/her department. Civil servants are responsible to their Minister for their actions and conduct.

3.7 Within this basic framework, central government organisations are accountable in a variety of ways across a wide range of activities, including for their use of public money. **Box C1** summarises a number of key means by which departments, agencies and NDPBs are held accountable.

3.8 Different forms of accountability are best suited to different purposes (see paragraph 3.5). Thus, published annual reports work well as structured explanations by departments of achievement and progress, but do not have an interactive quality that allows the reader to ask further questions or seek explanations. Parliamentary questions, on the other hand, are ways of seeking specific additional information or eliciting it in different formats. Committee hearings (where those responsible for decisions are actually present) are well suited to seeking justifications and explanations for actions, as well as obtaining agreement to correct or refine practices.

C1 FORMS OF ACCOUNTABILITY

Annual reports

All public bodies produce an annual report in which they describe their work and performance in the previous year. HM Treasury gives guidance on the coverage of departmental annual reports.

Annual accounts

These provide a structured analysis of how funds over which the body has control have been used or safeguarded. Under the Government Resources and Accounts Act 2000 government departments will produce their financial statements on an accruals basis. HM Treasury directs the form of departmental accounts subject, once resource accounting is fully introduced, to the overriding requirements that they show a true and fair view and comply with Generally Accepted Accounting Practice. Accounts are independently audited.

Treasury controls and reporting mechanisms

There are procedures by which departments that propose to give guarantees or indemnities lay before the House of Commons a Minute describing the amount and duration of the guarantee and indemnity, the body or bodies involved, and other relevant information. Other Treasury controls cover gifts given by departments, losses and special payments, contingent liabilities, all of which are reported to Parliament.

Parliamentary questions

Written or oral parliamentary questions can be laid by members of both the Houses of Parliament on almost any matter relating to the activities of public bodies, and are answered by government ministers or the heads of government agencies. Oral questions not answered are automatically given a written response. There may be occasions when responses are not provided on the grounds that questions can only be answered at disproportionate cost. There is also a recognised list of topics on which ministers do not answer questions.

Debates

Debates in Parliament may require ministers to answer questions on their responsibilities. During general debates, any aspects of performance may be the focus of attention, although they may not be the best place for a sustained and detailed examination of performance.

Departmental select committees

Departmental select committees examine the activities and policies of government departments. They allow for scrutiny through sustained questioning of ministers and civil servants during hearings, and examination of departmental papers by committee members. The results of their work are published, and the Government is required to respond to reports.

Committee of Public Accounts (PAC)

The PAC is the senior select committee of the House of Commons. It is responsible for examining, on behalf of the House of Commons, 'the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit...' The committee questions senior civil servants and others on the way in which public funds have been used.

Parliamentary Commissioner for Administration

Cases of alleged maladministration by Government departments and a range of other public bodies are open to investigation by the Parliamentary Commissioner for Administration (the Ombudsman) and his staff.

NDPB quinquennial reviews

NDPBs are subject to review every five years. This examines whether the functions of the body are still required and, if they are, whether the body continues to be the best vehicle for carrying out those functions.

Executive agency framework documents

Executive agencies are governed by Framework Documents agreed with the sponsoring Minister, Cabinet Office and HM Treasury. These identify the functions for which the agencies are responsible, outline the financial arrangements, and establish performance targets. Performance is assessed against these targets.

Recent developments have increased the information available on government performance and activities

3.9 Most of the arrangements described above have been in place for many years, but recent developments in government have important implications for improving the availability of information, and hence enhancing accountability. In particular:

- The Government has stated its commitment to the publication of clear, outcome focused performance targets in Public Service Agreements (PSAs). These encompass around 160 targets, covering key areas of Government. PSAs are intended to be a clear commitment to the public on what they can expect for their money. The Government intends to report regularly on progress in annual departmental reports, so that Parliament and the public can judge whether targets have been delivered. Further discussion is included in Chapter 4.
- Resource accounting and budgeting (RAB) will be introduced fully from the beginning of 2001/02, moving central government budgeting and accounting procedures onto an accruals basis. The existing cash based appropriation accounts will be replaced with resource accounts, which will, as far as it is possible for central government bodies, be prepared in accordance with the same accounting standards and conventions as commercial accounts. On the face of it, this seems a purely technical change, but as **Box C2** shows it should have profound implications for accountability.
- The Government Resources and Accounts Act 2000 provides Treasury with the necessary powers to prepare a Whole of Government Account, and for the C&AG to audit it. The first accounts will cover the central government sector (departments, central funds and non-departmental public bodies), and be expanded later to include all public sector bodies (such as NHS Trusts, local authority bodies, nationalised industries and other public corporations). The Account will provide Parliament and other users with considerably enhanced information on the totality of government income and expenditure, assets and liabilities, and cash flows. All this could help Parliament and others gain a better understanding of the significance of the Government's expenditure, taxation and borrowing plans.

C2 ACCOUNTABILITY IMPLICATIONS OF RESOURCE ACCOUNTING AND BUDGETING (RAB)

Resource accounts contain considerably more information on departments' financial results than traditional appropriation accounts. For example, for the first time ever, accounts will include balance sheets showing the assets and liabilities of the department.

The presentation of resource accounts is a step change from that of appropriation accounts. They are much easier to understand (as they are based on commercial models familiar to many users), and provide scope for departments to present information in clearer and innovative ways (for example, through explanatory notes and diagrams).

The Treasury is developing a framework for analysing resource accounts (equivalent to the analysis used on company accounts). Once again this should aid transparency and rational discussion of the contents of the accounts.

Reliable accounting information is an essential aid to enabling departments to improve management. For example, information produced under RAB will, for the first time, provide departments with data on their working capital and so should enable them to manage it more efficiently.

Adoption of the Accounting Standards Board's accounting standards (adapted as necessary by the Treasury, with the advice of the Financial Reporting Advisory Board) means that new issues that emerge in accounting can be quickly incorporated into the accounts.

Accountability for public money is at the heart of the relationship between Parliament and the Executive

3.10 A fundamental constitutional principle governing accountability for public money is that the Government requests money for specific purposes from Parliament. Parliament may grant it direct from the proceeds of general taxation, or may authorise bodies to collect it in other ways such as levies, or via the lottery. The Government is then required to account to Parliament for its use of public money. Government Accounting², published by the Treasury, provides a synopsis of the basic constitutional position (**Box C3**).

3.11 Parliament authorises most public money to be spent through the supply process. Each year the Government's request for resources is presented in the form of 'supply estimates'. These set out for each broad area of planned activity, the public funds the Government needs to pursue its policies. The estimates are approved by Parliament and formal acceptance is given in the annual Appropriation Act. In return, the Government is accountable to Parliament for the spending. In practice, the Committee of Public Accounts undertakes scrutiny by Parliament of how money has been spent.

² HM Treasury (1989 edition as updated) Government Accounting: A Guide on Accounting and Financial procedures for the Use of Government Departments

C3 THE GRANTING OF SUPPLY

The Crown, being the executive power, is charged with management of all the revenue of the State, and with all payments for the public service. The Crown, therefore, acting with the advice of its responsible Ministers, makes known to the House of Commons the financial requirements of the Government; the Commons in return grants supplies, and the ways and means to meet them through taxes, and the appropriation of other sources of the public income. The participation of the House of Lords is confined to assenting to such financial provisions of the Commons as require statutory authorisation. The withholding of their assent is effective only for a month. Effectively, therefore, the functions of Parliament in matters of financial control are exercised by the House of Commons. Thus the Crown demands the money, the Commons grant it, and the House of Lords assent to the grant. However the Commons do not vote money unless it is required by the Crown; nor do they impose or augment taxes, unless such taxation be necessary for the public service as declared by the Crown through its constitutional advisers.

Source: Government Accounting (1989 edition as amended)

The role of the Accounting Officer

- 3.12 A key element of accountability for public money is the role of the Accounting Officer. The Treasury appoints the most senior official in a department as the Accounting Officer to be responsible for departmental expenditure. This responsibility is for the propriety and regularity of the public finances; for keeping proper accounts; for prudent and economical administration; for the avoidance of waste and extravagance; and for the efficient and effective use of all available resources. Accounting Officers are required to appear before the PAC to provide answers to questions arising from these responsibilities.
- 3.13 The Treasury may, in certain cases, appoint other senior departmental officials as Accounting Officers for defined parts of a department's accounts. In such cases, the head of department will be the principal Accounting Officer and other Accounting Officers will be called additional Accounting Officers. The Treasury also appoints the chief executive of every trading fund as Accounting Officer for that fund. Certain kinds of Accounting Officer appointment are made by relevant departmental Accounting Officers - in particular, the chief executive of agencies, and the chief executive or senior official of an executive NDPB. Within the health service, the senior official in NHS Trusts and health authorities is designated as an 'accountable officer' (with similar roles and responsibilities as Accounting Officers).

Comparisons with accountability in the private sector

- 3.14 Accountability is a concept relevant to both the public and the private sector. In the private sector, the management of a company is expected to act for the benefit of its shareholders. The Chief Executive and other managers are accountable to the board, and the board is accountable to the shareholders. Boards are made up of both executive directors (the most senior operational managers in the organisation) and non-executive directors (generally brought in from outside). The board takes all major decisions affecting the company, and all members of the board are joint and severally responsible for the decisions taken.
- 3.15 This basic structure has been in place for many years. However, a number of reforms have been put in place over the past decade, at least partly in response to a series of scandals in major companies, and have formalised and institutionalised best practice arrangements. The fundamental aim has been to ensure that no one individual or small group can dominate a board and so direct the company's affairs. To this end, the Combined Code recommends a separation in the positions of chairman and chief executive, and a balance between executive directors and independent non-executives. Annex C summarises the key developments in private sector corporate governance.
- 3.16 Overall, there appear to be a number of significant differences between accountability in the public and private sectors. Executive directors are subject to scrutiny by non-executive directors, but the degree of disclosure of information and the level of scrutiny of company boards is generally less than required of ministers and public servants. Nevertheless, behind the scenes directors are subject to considerable shareholder pressure, both direct and indirect. The influence of the commercial market is also strong, and companies face daily assessment of their performance in quite specific and quantifiable terms.
- 3.17 The scope of the accountability is also different. Information sought in the private sector is largely related to matters directly bearing on the company's profitability and the shareholders' return on capital. There is less concern about how outputs have been achieved. Although this focus on profitability is a powerful instrument of accountability, the range of activities for which the private sector managers are held publicly accountable is considerably narrower than that which applies to politicians or senior public servants. Thus, in the public sector, it has been argued 'the absence of a clear 'bottom-line' is more than adequately made up for by a greater variety of accountability mechanisms applied at more points in the decision-making process.'³

³ Mulgan R (2000) 'Comparing Accountability in the Public and Private Sectors' in Australian Journal of Public Administration

The role of the Accounting Officer is of continuing importance

- 3.18 The fundamental importance of the role of the Accounting Officer is a key characteristic of accountability for public funds in central government, and one in clear contrast to arrangements in the private sector. In its submission, the Government suggested that reliance on sole responsibility has a number of implications, and questioned whether a single person at the top of an organisation can reasonably be held responsible for every activity of that organisation, except through the responsibility for setting a risk strategy.
- 3.19 Much of the impetus for strengthened corporate governance in the private sector has come about because of the desire to avoid concentration of decision-making power in one individual. Superficially, this concentration might appear to exist in departments, but it should be recognised that Permanent Secretaries are accountable to ministers, who are in turn subject to collective Cabinet responsibility. Whilst a number of departments appear, at first sight, to be establishing more corporate style boards, the fact that ministers by convention decide policy and officials implement it, means that departmental boards (where they exist) can only have an advisory function. In contrast, in the case of company boards, responsibilities encompass policy, strategy and execution.
- 3.20 In addition, in many ways the concentration of personal authority is not as unqualified as it may sound. In reality, the Accounting Officer delegates responsibilities to other senior staff and is not personally responsible for actions throughout the organisation, even if he is accountable for them. Certain changes to the extent and nature of personal responsibility have been made. In the early 1980s, for example, the personal financial liability of Accounting Officers to repay any losses on their votes (not used for more than 60 years) was removed. In contrast, it is interesting to note the situation in, for example, France, where thousands of public officials with budgetary responsibilities are personally liable for money entrusted to them, and take out insurance to protect themselves until discharged following audit.
- 3.21 Instead, it seems the traditional Accounting Officer model provides a powerful focus for accountability for public money in central government. In discussions, there was strong continuing support for the Accounting Officer role. Permanent Secretaries themselves were strongly of the opinion that the Accounting Officer designation provided them with great strengths, both in their relationships with ministers, and in respect of their ability to control their departments. Accounting Officers have a particular responsibility to see that appropriate advice is tendered to ministers on all matters of financial propriety, regularity and value for money. In this context, the role was seen as a

personal responsibility to safeguard the interests of the taxpayer. In addition, the personal nature of an Accounting Officer's accountability for public money - a unique situation for civil servants in being accountable in their own right, rather than as representatives of ministers - was also seen as helping to produce the necessary incentives to ensure that departments conducted themselves with due regard to propriety, regularity and value for money.

- 3.22 From the parliamentary perspective too, the singular responsibility of the Accounting Officer was seen as essential to proper accountability. In his submission, the Chairman of the Public Accounts Committee stated that one of the strengths of the PAC process was the certainty of arrangements, in particular, the clear accountability of the Accounting Officer. He emphasised the importance of the most senior official being present at Committee hearings albeit, where necessary, with other officials to provide additional information.

Departmental boards and the use of non-executive directors

- 3.23 In view of this, there should be no question of diluting the role and accountability of the Accounting Officer. However, a number of departments are moving to a fully collegiate board structure. Departmental boards made up of senior officials have a number of major attractions. In particular, they can act as the main source of advice to the Accounting Officer, potentially improving the decision making capabilities of the department. They also make it clearer to senior officials other than the Accounting Officer that they are accountable for performance in specific areas. And boards help to facilitate the involvement of high calibre non-executive directors.
- 3.24 The appointment of non-executive or independent directors to sit on departmental boards is a welcome development. The aim has been to bring in experience and expertise from outside the civil service to bolster the position of executive directors. As part of this role, non-executives can help by providing a constructive challenge to accepted wisdom within organisations, as well as alerting them to risks and opportunities. They are not responsible for decision-making (unlike non-executives within companies, who share legal responsibility with executive directors), but in several departments, a non-executive chairs the audit committee, enhancing the independence of that function. Some concern was expressed that departments might find it difficult to attract suitable non-executives. In general, departments advised that they had not had problems recruiting high quality non-executives, including chief executives of major companies. Nevertheless, departments may need to widen the pool from which they draw potential candidates.

3.25 The existence of non-executive directors on a departmental board should not be seen as a challenge to the authority of the Accounting Officer, but rather a valuable source of advice and guidance in helping them fulfil their responsibilities. Nevertheless, the independence of non-executive directors is crucial, as is their willingness to raise issues that may be uncomfortable for departments. Problems have occurred in the commercial sector where non-executives have suffered from conflicts of interest, or are not truly independent. In many parts of the public sector (eg NDPBs and the NHS) the appointment of non-executive directors is subject to the rules on public appointments. However, these do not apply to departments and, in order to be seen to be maintaining independence, departments may need to institute formal procedures, if they have not already done so, for the appointment of independent non-executive directors.

Characteristics of a sound accountability regime for public money

3.26 Before turning to consider the audit arrangements suitable for public money, it is appropriate to summarise the principles and characteristics of accountability that should be displayed. Chapter 2 referred to the special nature of 'public money', and there is no doubt that there are greater expectations (in Parliament, Government and amongst the public) of openness and transparency when dealing with public, rather than private, funds and assets. Any consideration of changes to accountability arrangements in future should, therefore, acknowledge the following principles:

- Because of the special nature of public money, the obligations attaching to accountability in the public sector are likely to be more demanding than apply to private money. This does not mean that efforts should not be made to minimise this burden, but it does recognise that accountability and the provision of information have a price.
- Public reporting is the principal means by which an organisation discharges its accountability. This does not mean that everything a public body does should take place in the glare of publicity, but it does mean that there are expectations of openness about decision making and performance, which extend beyond those in the private sector.
- Accountability in the public sector will stretch across a broader range of objectives and activities than in the corporate sector. This emphasises that in most cases in public sector bodies, there are a range of objectives and targets to be met and less singular concern for the 'bottom line'.

- Accountability goes beyond simply providing information, and must encompass expectations of scrutiny, and the prospect for revision or redress.
- Accountability arrangements should aim to be proportionate to the amount of money involved and the degree of risk associated with the activities under consideration.
- Accountability mechanisms in place should be cost effective, avoiding duplication and distorting effects by excessive demands for information.
- Accountability arrangements should seek to provide effective incentives within public bodies to encourage high class performance and not stifle change and innovation.

The sound control of public money depends on a combination of robust internal controls and independent external audit

3.27 Ultimate responsibility for safeguarding public funds rests with the management of the bodies receiving the money, who are responsible for putting in place effective arrangements for control. Such arrangements include sound internal controls and corporate governance regimes. Increasingly public bodies are incorporating audit committees within their arrangements, and strengthening the role of internal audit. Allied to these controls, wide-ranging external audit acts as an incentive for sound governance and as a key element in public accountability. This section considers the principles and characteristics of control appropriate to public money.

Internal controls

3.28 The requirements of Parliamentary accountability and the duties of Accounting Officers to ensure regularity, propriety and value for money within their departments have meant that central government has traditionally been concerned with ensuring that proper internal control mechanisms are in place. In recent years, departments have adapted many of the requirements on internal control produced by the various working parties that have examined corporate governance arrangements in listed companies. Thus, departments have been required for the past two years to include a Statement of Internal Financial Control in their accounts, and from 2001/02 a Statement of Internal Control will replace this. This development is of considerable importance, although it must be recognised that it will take some time before all the necessary processes are in place within departments.

Recommendation

All central government bodies should follow the private sector in applying the principles of the Turnbull Report as a basis for ensuring strong internal controls and management within the processes of government. This work is already under way and should be pursued vigorously, although it must be recognised that it will take some time before all the necessary processes are in place within departments. The discipline of having a formal internal control statement, signed by the Accounting Officer, is helping departments to systematise and, where necessary, overhaul their internal control systems. To be able to sign the statement, the Accounting Officer will need to take assurance from other senior staff that proper systems and controls are in place. Given this, the Accounting Officer's statement should make clear he has placed reliance on these assurances. This will ensure that the overall accountability of the Accounting Officer is maintained, whilst making clear the responsibilities of other senior officials.

Audit Committees

3.29 Another welcome development is the formation of audit committees within central government bodies. The purpose is to give advice to the Accounting Officer on the adequacy of audit arrangements (both internal and external), and on the implications of assurances provided in respect of risk and control in the organisation. Currently, audit committees in central government are very variable in both format and performance. Guidance given to

agencies and NDPBs some years ago appears to have ensured a quicker pace of development amongst these bodies than central government departments.

3.30 The arrangements for committees differ across central government. Some are chaired by the Accounting Officer and are mostly made up of senior officials from the department. Others (for example, the audit committee at the Department of Social Security) are headed by an independent person. In this case, a majority of the members are from outside the Department. **Box C4** recommends some key characteristics to be followed in the setting up and operation of audit committees.

3.31 Audit committees work best if they act as a source of independent advice and warning to the Accounting Officer, and it should be recognised that, at times, the questioning of an audit committee may be uncomfortable for executive staff. Fully developed, audit committees could help to identify and focus attention on common problems and themes. By doing this, they might help to screen out minor and repeated problems that occur across government, and which, on occasions, might result in hearings of the PAC. To do this, they should, for example: pay particular attention to the organisation's risk management strategy, and the adequacy of the department's project management skills; ensure that appropriate action is taken to deal with key issues identified by the department's own internal and external audit; and review the department's vulnerability to more widespread problems identified across government, for example, by Treasury, the Cabinet Office, NAO/PAC and others. They would, for example, have a particular role to

C4 RECOMMENDED KEY CHARACTERISTICS OF AUDIT COMMITTEES

All departments should have a formally constituted audit committee. Some basic principles for audit committees include that they should:

- be chaired by a non-executive director, or by a person from outside the department (*), appointed solely to chair the audit committee, without a wider role within the organisation;
- if possible, consist solely of independents (or at least have a majority of such people). Committees should not include either the Accounting Officer or the Principal Finance Officer among its executive members, although they should attend the meetings;
- consider whether all risks faced by the department, not just financial risks, have been properly assessed;
- approve and review internal audit's work programme and receive internal audit reports;
- involve the external auditor and ensure that he/she receives all papers and is invited to all meetings;
- allow for the Chairman of the audit committee to hold private sessions with the internal and external auditors;
- challenge both external and internal auditors about their assumptions and methodologies;
- prepare an annual report to the Accounting Officer on their work, which could be published alongside the departmental accounts.

Departments should ensure that staff sitting on, or dealing with, audit committees, have appropriate training.

(*) Where an external person is appointed solely to chair the audit committee, the department may need to provide additional support to ensure familiarity with the organisation. However, it should be remembered that independents are recruited for their wider expertise, rather than specific knowledge of the department.

play in asking questions (at a high level and an early stage) about IT related projects or major business change initiatives in the light of the Cabinet Office's recent work in this area.

Internal audit

3.32 Another key element of control is internal audit. Over the years, internal audit in central government has tended to be very broad-based. This has meant that it has covered all operational aspects of a department and not just financial control. Evidence suggests that there has now been a shift back towards internal audit playing a greater role in looking at financial systems. All central government bodies should have access to well-resourced and independent internal audit, reporting to an audit committee.

3.33 The independence of internal audit is a crucial issue. To be effective it must be able to report to the Accounting Officer, and it is important that undertaking work commissioned by sections within an organisation does not compromise internal audit's independence. A close relationship between internal and external auditors helps strengthen the internal audit function by bolstering the latter's independence, and providing additional justification for management taking internal audit concerns seriously. This relationship is considered in more detail in Chapter 5.

Recommendation

All central government bodies should have access to well-resourced and independent internal audit, reporting to an audit committee, with its programme and performance against plan reviewed by the committee, and the right to report to the Accounting Officer, and hold private sessions with the Chairman of the audit committee.

External audit has a wide range of purposes

3.34 The functions described above are internal to the organisation. A crucial element of public accountability is independent, external scrutiny. One submission to the Review commented that '[external audit] strengthens accountability, both upwards to the elected or appointed members who provide resources, and outwards to the consumers and beneficiaries, taxpayers and the wider community at large'.

3.35 There are several purposes to external audit of public money. Suggestions made in evidence submitted to the Review or in recent statements by the Public Audit Forum (PAF)⁴ include:

Supporting democratic government

- The Auditor General for Scotland has suggested⁵ that 'Audit can and must play a central part in the working of a modern democracy with claims to be open, transparent and accountable.'

Holding the executive to account

- More specifically, financial statements provide an important means by which Parliament holds the Executive accountable for the way money has been spent. External audit is a means of providing assurance to Parliament that public money has been properly spent.

Helping public bodies to improve their performance

- Public audit adds value not merely by analysing and reporting what has happened after the event, but also by looking forward, identifying lessons to be learnt, and by disseminating good practice. External public auditors thereby have a direct and positive influence on the way organisations and people in the public service discharge their responsibilities (Public Audit Forum).

Ensuring standards of public conduct

- Public audit has a key part to play in safeguarding public money, ensuring proper accountability, upholding proper standards of conduct in public services, and helping public services achieve value for money (Public Audit Forum).

Establishing and maintaining public confidence

- Public audit is also deemed to be a key element in establishing public confidence that public money is properly spent. Whilst few people ever read published accounts or audit reports, the fact that auditors report publicly acts as an important element of reassurance.

⁴ The Public Audit Forum (PAF) was created in 1998, following a suggestion made in the Government's response to the second report of the Committee on Standards in Public Life, to build on the existing co-operation between the national audit agencies in the United Kingdom. A consultative forum, including representatives from Government, local authorities, the NHS, CIPFA and the private sector accountancy firms was also established.

⁵ Auditor General for Scotland (2000) 'Supporting Democratic Scrutiny by Public Audit' Public Management and Policy Association.

The external auditor should seek to combine the roles of watchdog and adviser

- 3.36 A number of those providing evidence commented on what they saw as a conflict in the position of the external audit function between a role as 'watchdog', and a more advisory role. The watchdog was seen as acting on behalf of the public, providing assurance that taxpayers' money was well spent, and that information was available on which to judge performance. The advisory role was deemed to focus more on promoting learning, encouraging change, possibly through internal mechanisms, and helping those responsible to improve services.
- 3.37 Perhaps the simplest line to espouse and, conversely, the hardest to follow in practice, is that those undertaking audits of public money should seek to combine both roles. No system that discouraged auditors from reporting areas for improvement or weaknesses identified during work, or providing advice on the basis of experience gained, would be making the most of the audit function. In saying this, it should be made clear that the external auditor of public money is auditing, in the first place, from the perspective of the watchdog. Because of the nature of public money, the accountability element to the work underpins the focus, conduct and execution of the audit. That being said, in order to make the most of the work, the auditor must also seek to maximise the benefits derived from insights obtained by close inspection of public bodies, an issue examined in Chapter 5.

The principles of public audit

- 3.38 Considerable thought has been given in recent years to the principles and characteristics of the audit of public money. The PAF's statement on 'The Principles of Public Audit'⁶ provides a sound basis for future thinking on audit arrangements, which is endorsed here. The key principles that have been expounded are:
- The independence of public sector auditors from the organisations being audited.
 - The wide scope of public audit, that is covering the audit of financial statements, regularity (or legality), propriety (or probity) and value for money.
 - The ability of public auditors to make the results of their audits available to the public, and to democratically elected representatives.

Independence

- 3.39 It has been argued that, to maintain confidence, auditors must be independent to avoid improper influence and allow work to be carried out freely. Independence is considered to encompass the methods of appointment of auditors, the financial relationship between auditor and auditees, discretion in the amount of work necessary, the ability to follow up the implementation of recommendations, and the ability to have access to information in the custody of the audited body necessary for the work.

The wider scope of public audit

- 3.40 The second key principle emphasises that public audit involves not just providing an opinion on accounts, but also covers other issues such as regularity, propriety and value for money. By doing this it helps to contribute to corporate governance arrangements of public bodies. The terms are defined as follows:

- **Regularity** - Public audit must ensure that financial transactions comply, where appropriate, with the legislation that authorises them; regulations issued by a body with the power to do so; Parliamentary authority; and Treasury authority.
- **Propriety** - The concept of propriety is closely connected with public and Parliamentary expectations as to the way in which public business is conducted; for example, in relation to standards of conduct and behaviour. Public audit helps to ensure that public bodies meet their statutory and ethical duties to the public and other stakeholders in an open and even-handed manner.
- **Value for money** - Those who use or pay for public services, either through taxation or charges, have a reasonable expectation that public bodies make the best use of the resources at their disposal. Public audit must therefore include examinations of the economy, efficiency and effectiveness in the use of public resources, including the evaluation of service quality and the measurement of performance.

External reporting

3.41 The final principle is external reporting. It is argued that to be effective, there must be appropriate reporting arrangements so that public auditors can report the results of their work to the representative of the public responsible for funding the activities or directly to the public themselves where it is in the public interest.

Recommendation

External audit of public money is undertaken primarily from the perspective of the 'watchdog' - designed to provide assurance that taxpayers' money has been well spent - but to make the most of the work, auditors should seek to combine this role with that of adviser in ways that do not compromise independence. External audit should be based firmly on the principles of the Public Audit Forum, which emphasise the independence of public sector auditors from the organisations being examined; the wide scope of public audit; and the ability of auditors to make the results of their work public.

4

Arrangements for the audit and accountability of central government

- 4.1 External audit provides a key means by which Parliament, on behalf of the taxpayer, scrutinises how Government uses the money voted to it, and holds the Government to account. As noted in Chapter 1, there is a long history of central government audit in the United Kingdom, which has successfully accommodated many changes in the way government organises itself.
- 4.2 During consideration of the Government Resources and Accounts Bill in 2000, concerns were expressed in Parliament that some of these changes had led to a reduction in the powers of scrutiny and accountability over public money. The Government agreed that developments over the years had implications for central government audit that needed to be examined, and this was one reason for setting up this Review.
- 4.3 This chapter considers the arrangements for the audit of central government funds. It starts by highlighting the roles of the audit bodies in the United Kingdom. It then considers a range of issues related to audit arrangements for those types of bodies identified in Chapter 2.

The public audit bodies in the United Kingdom

- 4.4 Throughout the world, the audit of central government finance is undertaken by national audit bodies, established to examine the use of public funds and report their findings. The precise organisational arrangements, and the nature and scope of audit practices differ from country to country, but the general principles underpinning the work remain the same. These include fundamental requirements, such as the organisational independence of the audit office, its ability to decide its own work programme and to employ the staff it needs, and the right to report freely.
- 4.5 In the United Kingdom, the C&AG has performed this role (assisted initially by the Exchequer and Audit Department and, from 1984, by the National Audit Office) for more than 130 years. Northern Ireland has had a separate

Comptroller and Auditor General since 1921. As a result of recent devolution changes, there is now an Auditor General for Scotland and an Auditor General for Wales with distinct responsibilities. **Box D1** summarises the key features of these arrangements. It is not the intention of this report to cover arrangements in Northern Ireland, Scotland and Wales, except to provide comparisons with those at Westminster.

Arrangements for the audit of central government funds

- 4.6 Chapter 2 described categories of bodies through which public money passes. There was an underlying assumption that, where public money is involved, some level of public accountability is required regardless of the status of the body handling that money. Annex D summarises the accounting and audit arrangements for each type of body.
- 4.7 Arrangements for the audit of central government funds have grown up over time. One of the key issues that the Review was set up to consider was whether current audit arrangements were appropriate. This section examines the arrangements for central government departments and agencies, executive non-departmental public bodies, public sector companies, and public corporations. It also considers arrangements for access where the C&AG is not the auditor of particular types of bodies.

Central government departments and agencies

- 4.8 In its submission, the Government noted that there is little dispute about the accepted arrangements in respect of those bodies that are responsible for the great majority of public expenditure. Departments and executive agencies are directly accountable to Parliament, and this is reflected in the appointment of the C&AG as auditor. The C&AG has a statutory right of access to documents and information held by these bodies. The passing of the Government Resources and Accounts Act 2000 has superseded the

D1 AUDIT ARRANGEMENTS IN THE UNITED KINGDOM

The Comptroller and Auditor General

The Comptroller and Auditor General (C&AG) is appointed by the monarch, on a motion of the House of Commons, to work on behalf of Parliament. He is the head of the National Audit Office (NAO), a body of some 700 staff. All statutory powers and rights governing the audit of central government finances are vested in the C&AG, and the staff of the NAO undertake work on his behalf. The independent status of the C&AG is protected by a series of safeguards, including his ability to determine his own work programme, and decide how to conduct his work. He can only be removed by a vote of both Houses of Parliament.

The role of the C&AG and the NAO is to provide independent assurance and advice to Parliament on the proper accounting for, and regularity and propriety of, central Government expenditure, revenue and assets. It is also to provide independent reports to Parliament on the economy, efficiency and effectiveness with which Government departments and other bodies use their resources. These reports form the basis for hearings of the Committee of Public Accounts of the House of Commons, which are held twice a week when Parliament is sitting.

The C&AG is responsible for the audit of a total of some £600 billion revenue and expenditure each year, along with assets of much greater value. The C&AG audits the accounts of some 600 bodies and prepares around 50 value for money reports a year. The National Audit Office receives a budget of about £50 million, which is voted by Parliament.

Northern Ireland Comptroller and Auditor General

There has been a separate C&AG for Northern Ireland since 1921, responsible for auditing Northern Ireland departmental and certain other expenditure. Under direct rule, the Northern Ireland C&AG reported to Westminster. Under the devolution settlement, he reports to the Northern Ireland Assembly. The Northern Ireland C&AG is supported by the Northern Ireland Audit Office (NIAO). The UK C&AG retains responsibility for the audit of functions retained by the Northern Ireland Office, although the NIAO carries out the audits on behalf of the NAO.

The Auditor General for Scotland

The Scotland Act 1998, which established the Scottish Parliament, created the post of Auditor General for Scotland to audit the accounts of bodies funded by the Scottish Parliament. The Auditor General for Scotland reports to the Audit Committee of the Scottish Parliament. A new body - Audit Scotland - has been created which employs all the staff formerly employed by the Accounts Commission and the National Audit Office in Edinburgh. It is a service organisation, supporting the Auditor General and the Accounts Commission. The C&AG will continue to audit matters in Scotland that remain 'reserved' to the UK Government, including defence, foreign affairs, central government taxation and social security. He also retains the power to report on any cross-border public authority.

The Auditor General for Wales

The post of Auditor General for Wales was created by the Government of Wales Act 1998 to audit the accounts of the Welsh Assembly and its sponsored bodies. Currently, the Auditor General for Wales is supported by the National Audit Office in Cardiff. He reports to the Audit Committee of the Welsh Assembly. In Wales, the C&AG retains access rights to the Welsh Assembly and public bodies in Wales for the purpose of reporting to Parliament.

Exchequer and Audit Departments Act 1866 in providing the basis for the C&AG's powers, making him the auditor of the departmental resource accounts, as well as other departmental accounts. These arrangements, as updated, remain sound.

Executive non-departmental public bodies

- 4.9 Executive Non-Departmental Public Bodies (NDPBs) are an important part of central government. The amount of public funds spent by them has more than doubled from £8.5 billion in 1979 to £18 billion in 1999 (at constant prices), which means that they spend some 10 per cent of all money voted by Parliament. The Treasury's guide 'Government Accounting' states that an NDPB is:

'A body which has a role in the processes of national government, but it not a government department or part of one, and accordingly operates to a greater or lesser extent at arm's length from Ministers.

Conferring functions on an NDPB involves recognition that a degree of independence from Ministers in carrying out those functions is appropriate - otherwise those functions should be carried out by a government department or Next Steps agency. However, the Minister remains answerable to Parliament for the general manner in which it discharges its functions.'

4.10 In its submission, the Government noted that it has long been recognised that NDPBs are close to central government. Ministers appoint Board members and the Accounting Officer of the sponsoring department has responsibility for ensuring that the NDPB has satisfactory systems of financial control. NDPB accounts are laid before Parliament and NDPB Accounting Officers, appointed by the sponsoring department, are answerable to the PAC for their stewardship, usually alongside the Accounting Officer of the department. The activities of NDPBs are usually clearly linked to departmental aims, and much of their income comes from their department. They may hold substantial assets purchased from government funds. And sponsor departments often exercise significant influence over their activities and management. **Box D2** summarises the roles played by a selection of key NDPBs.

D2 EXAMPLES OF EXECUTIVE NDPBs

The Environment Agency: responsible for protecting and improving the environment in England and Wales through regulation of pollution, management of water resources and flood defence duties in relation to conservation, fisheries, navigation and recreation.

The Arts Council of England: as national funding body for the arts in England, responsible for fostering the arts through the distribution of public money from central government and revenue from the National Lottery.

Teacher Training Agency: responsible for boosting recruitment to the teaching profession, funding the provision of teacher training in England, and improving the quality of teacher training.

Higher Education Funding Council for England: responsible for advising the Secretary of State for Education and Employment on the funding needs of higher education, and distributing available funds.

4.11 There are two main models for the audit of NDPBs that are not companies (for those that are see paragraphs 4.20 - 4.33). In some cases (56 in 2000), the sponsoring minister appoints the external auditor. The Government states that this emphasises the NDPB's line of accountability to the minister. In the second main model (some 135 NDPBs in 2000), the legislation setting up the NDPB appoints the C&AG as external auditor. The Government states that this emphasises a direct accountability to Parliament, separate from the line of accountability to the minister. In a small number of cases (currently some 15), the auditors are appointed by the audited body itself (see, for example, **Box D3**).

D3 LEVY-FUNDED NDPBs

Most of the NDPBs that appoint their own auditors are bodies entirely funded by levies. Levy-funded bodies are bodies financed by compulsory levies on the members of a particular industry¹. In most cases, the organisation provides services (training, research, marketing etc) that are deemed to be of benefit to all members of the industry. Providing these services through a statutory body, financed by a statutory levy, ensures that all members of the industry participate and avoids the problem of 'freeriders'. In most cases, sponsoring departments consider these NDPBs to be very much at arm's length and to exist principally to provide a service to the industry.

4.12 In their report on the Government Resources and Accounts Bill (9th Report 1999-2000 HC159), the Committee of Public Accounts expressed concern at the number of bodies voted funds by Parliament whose finances were audited by auditors appointed by, and reporting to, Ministers, rather than Parliament's own officer - the Comptroller and Auditor General. These include major bodies such as English Heritage, the Environment Agency, English Partnerships and the Housing Corporation. They stated that their arguments for appointing the C&AG to audit all executive NDPBs were based on the requirements of accountability to Parliament. In response, the Government stated² that, whilst it accepted that current arrangements were a 'hotch potch', it did not accept that the C&AG should automatically be appointed the auditor of all executive NDPBs.

4.13 An analysis of the characteristics of the NDPBs that are audited by the C&AG and those that are not, does not throw up any particular trends. The C&AG (using either the NAO or private sector auditors) audits many of the largest NDPBs and many of the smallest. It is not clear that those he does audit are any more or less technically complex than those he does not. And different arrangements for NDPBs exist within the same government department. That being said, the C&AG's submission noted that there had been a more consistent approach to appointments in recent years, in that the present Government has appointed the C&AG as auditor of all new executive NDPBs created since 1997. This has been justified in Parliament on the grounds of openness and transparency.

¹ The official publication 'Public Bodies 1999' identifies 14 such NDPBs. These are: Construction Industry Training Board; Engineering Construction Industry Training Board; Pensions Compensation Board; Northern Lighthouse Board; Trinity House Lighthouse Service; Policyholders Protection Board; Horserace Betting Levy Board; Apple and Pear Research Council; British Potato Council; Home-Grown Cereals Authority; Horticultural Development Council; Meat and Livestock Commission; Milk Development Council; Sea Fish Industry Authority.

² Treasury Minute on the Fourth and Ninth Reports from the Committee of Public Accounts 1999-2000 (Cm 4695)

- 4.14 The arguments for and against the current mix of audit arrangements were debated at length during the passage of the Government Resources and Accounts Act. The main concern expressed about altering current arrangements - so that the C&AG is appointed as auditor of NDPBs he is currently prevented from auditing - was that these bodies would not receive the same level of assurance from the C&AG as they received from private sector auditors appointed by the Secretary of State. In discussions with the Housing Corporation and its sponsoring department, for example, officials stated that, by commissioning extra work from the external auditor, they believe departments are able to use the external audit process to help provide assurance to the department's Accounting Officer that the NDPB has satisfactory financial systems in place.
- 4.15 The Government considers that if the C&AG were to be appointed as auditor of the NDPBs from which he is currently excluded, 'then arrangements should be established that ensure there is no reduction in the level of assurance that is currently provided or in the quality of audit.' They suggest that to provide such assurance a concordat between the sponsor department and the C&AG to accompany the use of the order making power in the Act might be appropriate.
- 4.16 In his submission, the C&AG stated that if appointed as auditor of those NDPBs which he is currently not able to audit, he would consider (as he does for those NDPBs he already audits), in consultation with the sponsoring department, for each of the bodies, whether it would be more appropriate for the NAO or a private sector firm to carry out the work on Parliament's behalf. He would also ensure that the sponsoring departments continued to receive the same type and quality of assurance they currently receive from private firms. In addition, the C&AG has stated that he would initially contract out at least an equal number of additional audits as are currently awarded to the private firms by departments. The C&AG has recently contracted out, for example, the audits of the Coal Authority and the Strategic Rail Authority.
- 4.18 In view of the arguments outlined above (and taking account of the extensive discussions in Parliament during 2000), as a matter of principle³, the C&AG should be appointed the auditor, on behalf of Parliament, of all executive NDPBs. Within that general principle, however, the needs of each NDPB and its sponsoring department should be taken clearly into account in deciding how the audit will be conducted and who will carry it out. The consultation outlined in the C&AG's submission, along with agreement by way of a protocol on the coverage of the C&AG's work, would be an important part of this, as would the continuing use of private sector auditors, where appropriate. The C&AG's suggestion that the conduct and quality of the NAO's financial audit work be made subject to regular and routine scrutiny by the Joint Monitoring Unit (see paragraph 5.71) would also be relevant here in providing departments with further assurance.
- 4.19 It has been suggested that fully levy-funded NDPBs might merit separate treatment. Given that they are public bodies financed by public money (the levies are classified as taxation) there seems to be no particular reason why the general principle of the C&AG being appointed as the auditor should not apply. Nevertheless, the status of some of these bodies is clearly anomalous given that their main role is seen to be supporting the industry through a marketing and research role. Consideration might be given to reviewing whether it is still appropriate for these bodies to be classified as NDPBs.

Recommendations

The arguments for and against the current mix of audit arrangements for NDPBs were debated extensively in Parliament in 2000. The Review was asked to consider the merits of these arguments. In the light of this, it is recommended that, as a matter of principle, the C&AG be appointed as the auditor, on behalf of Parliament, of all NDPBs, including those where the relevant minister currently appoints the auditor. Use should be made of the provision in the Government Resources and Accounts Act 2000 to allow this to happen as existing contracts expire. At the same time, arrangements should be put in place to ensure that there is no reduction in the level of assurance that is currently provided to departments and the coverage of the audit, and the C&AG's suggestion that he would contract out an equal number of additional audits as are currently awarded by departments to private firms, should be taken up. In the meantime, the C&AG should provide a report to the Public Accounts Committee on the major points from the audited accounts and management letters of the executive NDPBs that he does not currently audit.

Finding a way forward

- 4.17 The Government Resources and Accounts Act 2000 includes provision to enable the Treasury to provide by order that an NDPB should be audited by the C&AG, even if the C&AG is currently prevented by statute from auditing it. An order could remove the restrictions in the statute setting up the NDPB that prevents the C&AG being appointed auditor. The Review was asked to consider whether any changes should be made in respect of the audit of NDPBs.

³ It has been suggested that a counter-principle is that, since ministers are responsible for NDPBs, they should have the right to appoint the auditors of these bodies. This is an entirely valid argument in theory, but there is no evidence that it has ever been followed in practice. Indeed the main objection to the principle that the C&AG should audit all NDPBs has been an argument that this would be inflexible and that decisions on each audit should be on a case by case basis taking account of the individual needs of each body.

The audit of companies established by central government bodies

- 4.20 In recent years government departments, NDPBs and trading funds have set up companies to carry out important tasks on their behalf. They vary considerably in size, from small trading operations at national museums to bodies that are major NDPBs in their own right. There are also significant differences in the amount of central government funds they receive in the forms of grants, set-up capital, tangible assets (eg buildings and equipment) and intangible assets, such as intellectual property rights.⁴
- 4.21 In a small number of cases, the amounts of public money involved are substantial. The C&AG's submission notes, for example, that the New Millennium Experience Company has received more than £500 million, whilst in setting up the English Sports Council Trust Company Limited, the English Sports Council gifted it assets worth more than £40 million. **Box D4** describes a few of the public sector companies established.

D4 EXAMPLES OF COMPANIES ESTABLISHED BY CENTRAL GOVERNMENT

New Millennium Experience Company - The Company is responsible for the delivery and operation of the Millennium Dome. It is a limited company with authorised share capital of 1,000 ordinary shares of £1. It is a NDPB and has one shareholder, who is a nominated Minister of the Crown.

Remploy Ltd - Remploy provides productive employment in a supportive environment for severely disabled people who are seeking work. It is a NDPB set up as a company limited by guarantee, with no share capital. The members of the company are the directors.

National Consumer Council - The Council is a NDPB established as a company limited by guarantee without share capital, which acts as the independent voice of consumers throughout the United Kingdom, and promotes and safeguards the interests of consumers of goods and services of all kinds.

Student Loans Company Limited - The Company receives about £25 million of public funds each year, and administers the student loans scheme within the policy context set by the Government and the legislative framework of the Education (Student Loans) Act 1990 and the Education (Student Loans) (Northern Ireland) Order 1990 and associated regulations. The Company is owned by the Government.

- 4.22 Public bodies set up companies for a number of reasons. These include the desire to establish activities on a more commercial footing, as well as administrative convenience, in the absence of space in the Government's legislative programme to set up an organisation on a statutory basis. However, bodies established as limited companies are still subject to Government Accounting rules. Sponsor departments have a duty to ensure that financial and other management controls applied over these companies are appropriate and sufficient to safeguard public funds, and comply with requirements of regularity, propriety and value for money. Departments or NDPBs must ensure that directors manage such companies in a responsible fashion, and that they have sufficient information about their activities.
- 4.23 Currently, the C&AG cannot be appointed as auditor of a company established by a public sector body, even where he audits that body. And the order making power included in the Government Resources and Accounts Act 2000 does not cover those NDPBs established as companies. In their report on the Government Resources and Accounts Bill, the PAC stated that it was unsatisfactory that UK companies regulations prevented the C&AG from auditing NDPBs established as companies, even though he employed staff that were qualified to do so. In response, the Government said it had undertaken to consider separately the possibility of legislating to make the C&AG a Companies Act auditor in the review of the Companies Act being conducted by the Department of Trade and Industry. But it also stated that the issues are not straightforward.
- 4.24 The reason the C&AG is excluded is that under the Companies Act 1989 only a registered auditor can audit a body established as a limited company. The legislation does not allow for the C&AG to become registered, even though many of his staff meet the necessary education and training requirements and so could become registered and qualified to audit limited companies in their own right.
- 4.25 Although the direct source of applicable law is the United Kingdom Companies Act, European law in the form of the Eighth Company Law Directive (84/253/EEC) is also relevant here. The main purpose of the Directive is to harmonise the qualifications required of persons entitled to carry out the statutory audits of accounting documents and, as part of this, to ensure that such persons are independent and of good repute, including by imposing certain minimum education and training requirements. The United Kingdom is bound to implement the Directorate properly, and the Eighth Directive will colour and, ultimately, govern the proper implementation of the 1989 Act in the event of any ambiguity.

⁴ A figure of over 200 such companies was suggested to the Review Team. However, these figures appear to include 68 TECs and 81 Business Links. TECs were not set up by a central government body (although they were reliant on contracts with DfEE for their income) and are now in any case virtually defunct. Likewise, although Business Links is a Government supported initiative, the local Business Link companies have not been set up by or owned by the Government. Of the remaining companies the majority are either NDPBs or the trading arms of NDPBs.

4.26 Whilst the relevant United Kingdom legislation clearly prevents the C&AG at present being appointed as auditor of companies established by public sector bodies, it seems unlikely that the Act, and the European Directive were deliberately designed to have this effect. When they were introduced in the 1980s, there were very few companies established by public sector bodies. Both were clearly attempting to deal with arrangements in the private sector. It also seems unlikely that the position of the C&AG and his equivalents elsewhere was in the minds of those drafting either piece of legislation. And it is arguable that times have changed, with the NAO now resourced, as it was probably not then, with staff with experience of auditing companies.

4.27 In addition, as a matter of principle, it does not seem appropriate that the form of the organisation created by Government should prevent the C&AG undertaking his work on behalf of Parliament (see **Box D5** for an example of the consequences of this). The C&AG advised that this view had been endorsed by representatives of all 15 European Union state audit offices during a recent meeting of the heads of these bodies.

4.28 The Eighth Company Law Directive applies right across the European Union. The use of overseas comparators is difficult in view of the different administrative and auditing arrangements, but there are a few cases where other audit offices seem able to either audit public sector companies, or else carry out their normal audit activities within public companies, despite their status (although there are others with legislation that does not appear to allow it). **Box D6** summarises the position in Ireland and Portugal.

4.29 Outside the European Union in New Zealand, a parliamentary inquiry held in 1998 into the adequacy of audit office legislation noted that many public sector entities were conducting large parts of their business through subsidiary companies or through other related entities such as unincorporated joint ventures or trusts. These could be created or acquired simply by executive action, and result in the conduct of activities that might otherwise have been carried out by the parent entity itself. The report noted that, whilst most legislation in which Parliament appointed the auditor of the parent entity stated that the same auditor should audit any subsidiary company, inclusion of such a provision was on a case-by-case basis. Public sector entities could thus avoid the level of external scrutiny that would otherwise apply. **Box D7** explains what action is being taken in New Zealand.

D5 RESOURCE: THE COUNCIL FOR MUSEUMS, ARCHIVES AND LIBRARIES

The Department of Culture, Media and Sport set up Resource: The Council for Museums, Archives and Libraries as a NDPB in 1999 by merging two existing NDPBs, both of which had been audited by the C&AG. However, due to lack of legislative time, the Council was established as a company rather than by specific statute. This change in status meant that the C&AG could not continue as the auditor of the merged body. The Department has now introduced legislation to place the Council on a statutory footing, at which point it is intended to once again make the C&AG the auditor.

D6 THE AUDIT OF PUBLIC SECTOR COMPANIES

In Ireland - where the audit legislation follows arrangements in the UK very closely, having been originally covered by the Exchequer and Audit Departments Act 1866 - the Comptroller and Auditor General is able to audit companies. The Companies Act 1963 specifically exempted the C&AG from any provisions regarding qualifications, and all subsequent legislation, including after the Eighth Directive, has confirmed this exemption.

In Portugal, article 2 of Law 98/97 on the Jurisdiction and Functions of the Court of Auditors states that the Court's audit powers extend to include: public companies; companies formed under commercial law by the state, by other public entities or by both in association; companies formed under commercial law where the public sector has direct control of the respective management; and concessionaires companies for the management of public companies.

D7 AUDITING PUBLIC COMPANIES IN NEW ZEALAND

In New Zealand most government-owned bodies and local authorities have the power to establish subsidiary companies. The power to establish a subsidiary company will be either stated expressly in the entity's establishing legislation or be a result of its general statutory powers (e.g. many statutory bodies are given all the powers of a natural person or a body corporate - by definition that includes the power to set up a trust or company).

Under existing law, the Controller and Auditor-General (CAG) only audits a subsidiary company if the establishing legislation of the parent body allows it. For example, the Energy Companies Act 1992 states expressly that the term 'energy company' includes a subsidiary, so the CAG has the audit mandate by virtue of being the auditor of 'every energy company'.

However, the Public Audit Bill, which is currently before the New Zealand Parliament, seeks to introduce a principles-based control test by providing that a 'public entity' (which is the term used in the Bill to describe what the CAG audits) includes an entity controlled by one or more public entities. It is part of the Government's objective with the Bill to ensure that whatever is consolidated into an entity's financial statements, or is otherwise owned or controlled by it, will be audited by the one auditor (ie the CAG).

- 4.30 It seems highly likely that, as part of the modernisation initiative in the United Kingdom, Government bodies will continue to establish companies in the future. In these circumstances, the current obstacles to the C&AG becoming auditor seem outdated and in need of modernisation. On the basis of an examination of the relevant Act and Directive, it seems unlikely that these pieces of legislation were designed to prevent the C&AG being the auditor of major organisations spending large amounts of public money, or companies set up by organisations of which he is already the auditor.
- 4.31 It also seems clear that the C&AG has the independent status required, and that he has staff who are qualified to, and have experience of, auditing private sector companies. Given the existence of these staff, one possibility would be for the NAO to form an audit firm consisting of staff qualified to conduct company audits. This firm could then become a registered auditor and so be eligible to be appointed the auditor of public sector companies. The C&AG may wish to consider this course of action.
- 4.32 However, the disadvantages of this may well outweigh the advantages. Although made up of NAO staff, appointing such a firm as the auditor would not be the same as appointing the C&AG, thereby failing to meet the main objective of those seeking to allow the C&AG to audit companies. There could also be issues of liability that may potentially damage both the financial and professional standing of the NAO. And the firm would be subject to professional regulation under the terms of the Companies Act and so, ultimately, review by the Department of Trade and Industry, which could cause concerns about the independence of the NAO from Government. Such a firm would also be in direct competition with the private firms, which could damage relations between the NAO and these bodies.

Finding a way forward

- 4.33 Many public sector companies are clearly undertaking their work on behalf of central government bodies. Therefore, while accepting the difficulties faced in amending European legislation (if this is what is needed), the Department of Trade and Industry should consider how best to remove the obstacles to the C&AG being the auditor of companies as part of its review of the Companies Act. The aim should be to ensure that the C&AG's remit keeps pace with changes in the delivery of public services. It is not the objective that the C&AG - as Parliament's auditor - should seek to compete for the audit of wholly commercial private sector organisations, and it is hard to envisage that Parliament would wish him to do so.

Recommendations

The Department of Trade and Industry and the NAO work together to identify how best the current obstacles to the ability of the Comptroller and Auditor General to be appointed as an auditor under the Companies Act can be removed. The aim should be for the C&AG:

- to be the auditor of NDPBs which are companies, companies owned by a department, or companies which are subsidiaries of a NDPB audited by the C&AG; and
- to be eligible for appointment as auditor of companies where a department has a substantial stake or influence (for example, through being able to appoint board members, and influence strategy, or by way of a financial investment of, for example, more than 25 per cent of the shareholding).

It seems most appropriate that the above should be public sector or near public sector companies.

There may also be cases of other organisations with a 'public interest' role (eg representative bodies or organisations which play a role in public life) where the C&AG should not be prevented from being eligible for appointment as the auditor, should he be asked to become so. If the C&AG were to become eligible to undertake such work, then such audits would be carried out on behalf of the relevant governing body of the entity, rather than on behalf of Parliament, as is already the case with his international audit work. Similar arrangements should be introduced for the audit of local government, and for the Auditor General for Scotland and the Auditor General for Wales as regards companies in their respective areas of responsibility.

The National Health Service

- 4.34 There has been some discussion in recent years about audit arrangements for one group of key public bodies - those in the National Health Service. It has been argued by some observers that these bodies are subject to the attentions of too many auditors - particularly given that both NAO and the Audit Commission have audit responsibilities within the NHS.
- 4.35 The division of audit responsibilities for the National Health Service reflects the existence of both national and local elements to the service. Most of the funding for the health service is provided by the Department of Health, which produces an account subject to audit by the C&AG. The Audit Commission is responsible for appointing external auditors to all health authorities, special health authorities and NHS Trusts. These auditors provide audit opinions on the annual accounts. The Department of

Health and the NHS Executive summarise these accounts, which the C&AG audits. The summarised accounts, and the accompanying report, provide Parliament with an overview of the finances of the National Health Service. The C&AG is able to report on trends and issues across the service as a whole, including, for example, financial performance, fraud, internal controls and accounting matters.

- 4.36 Some have raised concerns about the potential for duplication and overlap in this area. Whilst there may be a risk of this, the Audit Commission and the NAO have clearly defined roles at local and national level respectively, and continue to work together to ensure that these roles provide an efficient audit of the NHS.

The BBC

- 4.37 The question of what access the C&AG should have to the BBC has also been raised in recent years. The current situation is that, with the exception of a few specific areas, the C&AG has no access to the BBC for either financial audit or value for money purposes. The only area where the C&AG has significant access rights is to the World Service (which is largely funded by grant-in-aid from the Foreign and Commonwealth Office). In addition, he can examine the BBC's arrangements for collecting and enforcing the licence fee (a value for money study was underway in this area at the time of the Review).
- 4.38 The BBC's Royal Charter requires it to be audited by an auditor eligible for appointment as a Companies Act auditor. As discussed in paragraph 4.24 this requirement excludes the C&AG from being appointed as the BBC's financial auditor. The C&AG cannot carry out value for money studies into the main activities of the BBC because he is specifically excluded from doing so by schedule 4 of the National Audit Act 1983 (this also excluded the C&AG from the other public broadcasters and from the nationalised industries). This exclusion was decided upon because the then Government believed that it was inappropriate for commercially focussed public corporations to be subject to public audit arrangements. The Government continues to believe that this is the case. Furthermore, it is concerned that the editorial independence of the BBC could be compromised by value for money studies as it considers it would be difficult to separate expenditure decisions from editorial decisions.

- 4.39 In its August 1999 report the panel on the Future Funding of the BBC⁵ (chaired by Gavyn Davies) recommended that the Royal Charter should be amended to give the NAO inspection rights to carry out periodic financial audits of the BBC's accounts and its fair trading arrangements. They further recommended that such audits should focus only on administrative efficiency, and on proper financial management and accounting, and not question policy objectives and programming issues and matters of editorial or artistic judgement. The Government accepted the need for greater transparency and improved financial reporting by the BBC, but did not agree that the C&AG should be involved. Instead, the Government has appointed independent firms of accountants to carry out this work. However, transparency and accountability would be enhanced if the C&AG were given access to the BBC on behalf of Parliament, as originally recommended by the Davies Review.

Recommendation

The C&AG should be given access to the BBC as originally recommended by the Davies Review on the Future Funding of the BBC.

Access to bodies of which the C&AG is not auditor

- 4.40 Auditors in both the public and the private sectors must obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their audit opinions. The ability to decide what information is required in order to form an opinion is at the heart of the independence of the external auditor. In its submission, the Auditing Practices Board stated that the independent powers of auditors to obtain information on the use to which public money is put, contributes to accountability, transparency and public confidence.
- 4.41 In his submission, the C&AG also emphasised that public and parliamentary interest in funds raised by the state did not cease simply because funds are not spent directly by departments, their executive agencies, or NDPBs. He stated that he needed access to those bodies spending public money beyond those he audited himself, in order to provide Parliament with independent assurance that this money had been spent properly and in accordance with Parliament's intentions.

⁵ "Review of the Future Funding of the BBC" (August 1999).

- 4.42 The ability to obtain access to information for the purposes of the audit of government departments is well understood. Under current arrangements, as well as being the auditor of over 650 government accounts, the C&AG has the right to inspect and report to Parliament on the accounts and Government funded activities of a large number of other bodies. These include over 500 health bodies, 440 Further Education Colleges, 130 higher education institutions, and around 1,700 miscellaneous bodies that receive grants from Government departments. He also has access to the Royal Household for the purpose of examining the grants-in-aid used for the upkeep of the occupied royal palaces and royal transport⁶.
- 4.43 In many cases, such access is provided on a statutory basis. Thus, under the Further and Higher Education Act 1992, for example, the C&AG has had statutory powers to visit colleges of further education, although he is not the auditor of these colleges. In other cases, the access is by agreement with the Treasury or the department responsible, as in the case of registered social landlords (or housing associations). The C&AG has also used access by agreement to report to Parliament on contracts under the Private Finance Initiative.

Arrangements for access in other countries

- 4.44 Arrangements exist in many other countries to allow auditors to inspect how public funds have been used. Usually, the national audit office has the ability to examine a wide range of public and private sector bodies in receipt of public money. The breadth of the arrangements vary, and in many cases there are qualifying criteria relating to the amounts of money involved. **Box D8** provides a number of European examples.

Access arrangements

- 4.45 In evidence to the Review, the Chairman of the Committee of Public Accounts reiterated his committee's view that it was unacceptable that the C&AG had to negotiate in some cases with the relevant body to obtain access to new types of service deliverer. The Chairman referred to his committee's report⁸ that stated that over the years, gaps, anomalies, constraints and delays in Parliamentary assurance had arisen from the unsatisfactory nature of the C&AG's powers.

D8 OVERSEAS EXAMPLES OF ACCESS ARRANGEMENTS FOR NATIONAL AUDIT OFFICES⁷

In **France** all private bodies that receive money from public funds can be examined by the Cour des Comptes. Where public funds exceed 50 per cent of turnover all funds can be examined; only public funds can be examined at bodies receiving less than 50 per cent.

In **Germany** the Bundesrechnungshof is able to examine the financial management of private entities that receive grants or guarantees. These audits can also cover the proper and sound management of the use of funds, and, for grants, can extend to recipients' other resources.

In **Denmark** the Rigsrevisionen has a statutory right of access to bodies that receive grants, loans or other financial support from the state, and has complete or partial access to limited liability companies' accounts. In addition, the Auditor General has access to local government accounts if expenditures are reimbursed by the state.

In the **Netherlands** the rights of the Algemene Rekenkamer were extended under 1989 legislation to enable it to examine both the regularity and performance aspects of public limited companies and private companies whose share capital was held by the state, corporate entities and partnerships in which the state has given grants, loans or guarantees, and corporate bodies performing a function regulated by statute and funded wholly or partially by receipts from levies instituted by statute.

- 4.46 In his submission, the C&AG stated that negotiating the terms of access rights on an individual basis meant that he had to rely on the department or funding bodies agreeing that the circumstances of each case merited access. He then had to rely on them negotiating access with the contractor or other body and writing appropriate terms into the contract or terms and conditions of funding. He considered this was administratively burdensome and diminished his independence. He said that there was also a risk that important contracts and grant arrangements might slip through the net.

Case examples: Registered social landlords and universities

- 4.47 In considering the issue of access, we examined the case of registered social landlords (more widely known as housing associations), which has been a matter of considerable discussion during the 1990s. Access to housing associations is by agreement between the NAO and the Housing Corporation and the Department of Environment, Transport and the Regions. We also examined access under statutory powers in the case of universities.

⁶ The C&AG has access to information for the purpose of examining the costs of the upkeep of the occupied royal palaces and royal transport, but not payments under the Civil List.

⁷ National Audit Office (1996) 'State Audit in the European Union', as updated for revised 2001 edition.

⁸ Committee of Public Accounts (2000) The Government Resources and Accounts Bill 9th Report 1999-2000

4.48 In many ways, the arrangements in these two important sectors are quite similar. Housing associations and universities are both private sector bodies that receive (and have received) considerable sums of public money - in both cases measured in terms of billions of pounds. Both have been encouraged to diversify their funding streams, and both assert strongly their independence of Government. Both are overseen by funder-regulators (the Housing Corporation and the Higher Education Funding Council respectively). **Box D9** summarises the position with regard to access to registered social landlords.

D9 ACCESS TO REGISTERED SOCIAL LANDLORDS

Current arrangements for access by the C&AG to Registered Social Landlords (RSLs) are based on a letter sent by the then Department of the Environment to the NAO in 1994. They have not been subject to formal agreement. In practice, no difficulties have arisen in agreeing access to housing associations for VFM studies. However, the letter does not cover the question of how access should be granted in cases of queries relating to the regularity and propriety of spending in a RSL.

According to the NAO and the PAC the informal nature of the access has caused some problems. Negotiations lasting about six months (between NAO asking for access and the visit taking place) were required to arrange access in the case of work by the C&AG into irregularities at Focus Housing Association. In this case, the Department and Housing Corporation stated that they were concerned that NAO access might get in the way of other investigations. They also stated that they had been surprised that NAO had sought access, having previously said it was unnecessary. For its part, the NAO expressed concern that its investigation for Parliament was hampered, and advised that it had ensured that a Serious Fraud Office investigation was completed before starting work. The case was the subject of a hearing of the PAC in 2000.

4.49 It was clear from discussions that the main players have strongly held views about access, although this was not so much as to whether the C&AG should have access at all, but the form that this should take. The Department opposes the C&AG having assured rights of access because it believes it would duplicate the Housing Corporation's powers and regulatory arrangements. It also considers it would blur lines of regulatory responsibility and increase costs. The Housing Corporation feared that the C&AG could become an alternative source of regulation of the sector.

4.50 From its perspective, the NAO stated that it required access to inform its work on the Corporation and to provide independent assurance to Parliament that public money passed to these bodies had been spent in accordance with Parliament's wishes. It stated that it had no desire to be an alternative regulator, but considered it

was only possible to gather independent evidence on how efficiently and effectively the Corporation had discharged its regulatory responsibilities by visiting a sample of RSLs. The NAO and PAC were concerned that without statutory access, the general principle that the auditor's access rights should be independent of the audited body was broken.

4.51 A different situation appears to arise in the case of higher education institutions. In this sector, the C&AG has statutory powers of access. In recent years, he has undertaken a number of institution specific reports, sometimes following up concerns about poor use of public funds within universities highlighted by Members of Parliament, as well as a higher-level value for money examination approximately every two years - for example, on university procurement in 1999.

4.52 In its submission, the Higher Education Funding Council for England stated that accountability regimes could be lightest when all sides trusted each other and where there was a respect for the competence of those who deliver services. It suggested the burden of scrutiny could be minimised by various parts of government working with each other, so avoiding duplication, and where organisations' internal processes could be used to provide external assurance. The Council noted, for example, it worked with the NAO and other auditors, respecting each other's independence, but avoiding costly duplication of activity by sharing information. **Box D10** provides further details. These examples emphasise the importance of clarity in arrangements.

D10 ACCESS TO HIGHER EDUCATION INSTITUTIONS

The C&AG and the NAO have sought to keep inspections at universities to a minimum, whilst ensuring that, where necessary, they exercise their rights in order to obtain independent evidence. The NAO advised that where it is asked to investigate the use of public money within a higher education institution, it first contacted the Higher Education Funding Council Internal Audit Service in order to draw on its knowledge and ensure that concerns raised with the NAO were not already being investigated. In turn, the Funding Council could consult with internal auditors within universities. On occasions, these auditors had agreed to investigate particular issues on behalf of the NAO as part of their programme of work. The NAO was thus often able to obtain assurance it needed in this way without visiting universities. Consequently, the C&AG had exercised his statutory right to visit to universities relatively infrequently, and mostly for the purposes of sector-wide VFM studies, where small samples of universities were drawn on to examine particular subjects, and allow the NAO to examine the performance of the sector as a whole. Nevertheless, the statutory access rights held by the C&AG provide the ability to visit universities if he considers this necessary.

Costs and burden of access

- 4.53 One of the concerns expressed during the passage of the Government Resources and Accounts Act was that providing the C&AG with statutory powers of access would add to the costs and burdens of audit on a range of public and private sector bodies. Such concerns mirror the wider debate in recent years about the expansion of regulation, inspection and audit more generally in government⁹.
- 4.54 Inevitably, audit visits for evidence collection and requests for information do incur costs, both for auditors and those audited. Chapter 5 considers further how auditors can seek to minimise such costs. However, the concerns about the cost and burden under statutory arrangements are less convincing when it is recognised that the C&AG already has (and exercises) access by agreement to many of the bodies involved. Whether the C&AG has access by agreement or under statutory powers should not influence the cost of that work. Indeed, there seems merit in the C&AG's argument that providing powers in legislation would reduce the costs to the taxpayer since there would not need to be protracted negotiations about issues of principle.
- 4.55 Some concerns were also expressed that statutory rights of access would mean that the staff working for the C&AG would arrive unannounced at bodies spending public money. The Review Team were assured that this does not happen at the moment under existing statutory powers (for example, the National Audit Act 1983), and no evidence was presented that this was the case. It was also suggested that the C&AG would exercise his powers excessively. Again there is no evidence that the C&AG deliberately exercises his rights of access to no particular end, and indeed there is plenty of evidence that he has used statutory rights of access sparingly. As with any other organisation, the NAO has limited resources, thus influencing the targeting of its audit work.
- 4.56 Finally, it was suggested that private sector companies involved in conducting government business might be put off by the costs associated with NAO and PAC scrutiny. Whilst the sample examined was small, it did include major companies that had been the subject of several NAO examinations and PAC hearings. Those interviewed did not consider the costs of replying to NAO requests for information or preparing to give evidence at a PAC hearing unreasonable, and regarded such scrutiny as inevitable given the work they were carrying out for government.

Finding a way forward

- 4.57 The Government Resources and Accounts Act 2000 provides for the Government, by order, to enable the C&AG to have additional rights of access to documents and bodies for the purposes of auditing departmental accounts. The Government has suggested that to allay concerns about the burdens of additional access, it might be helpful if the use of the order making power were accompanied by an agreement or concordat about the manner in which the rights would be exercised. The Government suggests that the agreement might include assurances from the C&AG that, for example, he would consult the body and relevant department beforehand and take account of their views, would seek to minimise any additional burdens, and would normally expect to test only a small proportion of transactions tested by departments.
- 4.58 In his submission, the C&AG has suggested that in sectors where he does not presently have statutory access, he would develop protocols with the bodies in receipt of public money and other regulatory bodies, covering arrangements for liaison and co-operation, and the manner in which his rights would be exercised. Such protocols should be drawn up, recognising the statements of the Public Audit Forum that auditors should seek to make use of the work of others in order to limit the amount of direct access needed to contractors and others. The C&AG has mentioned (as illustrative examples rather than an exhaustive list) the need for statutory access to grant recipients, registered social landlords, train operating companies, and private finance initiative contractors.
- 4.59 There are strong grounds for formalising the arrangements for the C&AG's access where at present it is based on negotiated agreements and conventions, and when the matter is considered in the future. Although in many cases these are adequate, the uncertainty and delays that have occurred on occasions do not sit well with the principle of the independence of the auditor. Firm arrangements also provide the basis for the kind of trust that the Higher Education Funding Council quite rightly identified as crucial to light touch accountability regimes. Thus, whilst essential that access rights are clear and founded in statute, it is also entirely proper that rights are exercised in a measured manner. Such powers would also satisfy those who have been concerned in the past that the C&AG's statutory powers of access are significantly weaker than those enjoyed in the United Kingdom by the European Court of Auditors, the auditors of the budget of the European Community.

⁹ See, for example, Power M (1997) *The Audit Society*

- 4.60 Granting statutory rights of access to the C&AG would, as a result of the existing section 6 (3) (c) of the National Audit Act, also give a right to conduct value for money studies in these bodies. Where the C&AG already has access to a body by agreement, as in the case of many grant recipients, this would have no practical effect because in such cases he already has the right to carry out VFM studies under section 6 (3) (d). Where the C&AG does not currently have any access to a body (as with train operating companies), granting statutory access for the purpose of auditing the sponsoring department's accounts would allow the C&AG to carry out VFM examinations.
- 4.61 Whilst the C&AG's ability to undertake VFM examinations would therefore be broadened, it seems unlikely that, as the head of an organisation with such wide responsibilities, he will wish to undertake detailed examinations on, for example, individual grant recipients, unless there are compelling and broader reasons for doing so. It is also unlikely that Parliament would consider this an appropriate use of NAO resources, at a time when there is growing support (discussed in Chapter 5) for more high-level and thematic investigations. Moreover, the National Audit Act states that where the C&AG's access (under an agreement or under statute) is restricted to particular activities or funds, then his VFM rights must be correspondingly restricted¹⁰. It seems appropriate, therefore, that if there is concern that the C&AG might undertake studies of small private sector bodies, this issue could be a subject for discussion in drawing up the recommended protocols.

Recommendations

There are strong grounds for formalising the arrangements for the C&AG's access where it is currently based on negotiated agreements and conventions, and when the matter is considered in the future. The C&AG should, for example, be given statutory access to the organisations and information listed in paragraph 4.58, using the order making provision in the Government Resources and Accounts Act 2000. In doing this, the C&AG, the bodies involved, their regulators, and other auditors should produce protocols for the exercise of these new statutory powers. These protocols should be prepared to a fixed timetable and take no longer than six months to produce. A *de minimis* rule could be introduced to prevent undue worry about the C&AG carrying out inspections of small, private sector bodies receiving limited sums of money (with a figure set at perhaps £100,000), unless there are strong grounds for doing so.

Whole of Government Account

- 4.62 Another significant development is the proposed creation of a Whole of Government Account (WGA), as a consolidated account for the public sector. Initially, under the Government Resources and Accounts Act 2000, the C&AG will audit the Account and determine whether, in his opinion, it is true and fair. The new Act provides the C&AG with access to the working papers of the auditors of bodies included within the WGA where he is not the auditor, but does not provide him with access to the bodies themselves.
- 4.63 In their 9th Report 1999-2000, the PAC argued that the C&AG should have such access and that this was necessary to enable him to collect all the necessary audit evidence. The Government believed that this was unnecessary as the vast majority of bodies not audited by the C&AG, which will be included within the consolidation, will either be audited by another public audit body (for example, the auditors appointed by the Audit Commission or the Auditor General for Scotland), or will be bodies to which the C&AG already has access.
- 4.64 The WGA is a major development and it is important for the credibility of the account that the C&AG is able to conduct a full audit. The limitations on the C&AG's access appear relatively minor once bodies audited by other public auditors are taken into account. Given this, it appears that the best way forward is for all the parties concerned, particularly the NAO and the Treasury, to agree a protocol as to how the audit of WGA will be carried out. This should be done as part of current discussions between the NAO and the Treasury.

Performance measurement

- 4.65 One area which has received growing attention during the last couple of decades has been the measurement of public sector performance. Performance measurement is the use of measures and targets to assess objectively the performance of a body. It is now well established as an important means of improving performance and reinforcing accountability. Performance measures assist organisations to communicate their objectives and priorities, measure what they have delivered, and report publicly on what they have achieved. They also help Parliament and the public to assess how well public money is being spent and what is being achieved with it. Box D11 shows key developments in the UK in recent years.

¹⁰ The significance of this is that, for example, where the C&AG has access to a grant receiving private sector body for the purposes of checking the use of public money, his rights do not extend to examining other aspects of the body's activities.

D11 DEVELOPMENTS IN PERFORMANCE MEASUREMENT IN THE UK

The origins of modern performance measurement in central government date back to the early 1980s and the drive to increase the productivity and quality of public services. Key developments include:

- In 1979 the Efficiency Unit was set up to carry out narrowly focused departmental reviews of efficiency. In 1982 the more wide-ranging Financial Management Initiative was introduced, emphasising the need for departments to measure outputs and performance. One of its aims was the establishment of systems to enable managers to have a clear view of their objectives and the means to measure performance in relation to these objectives.
- In 1988 the Executive Agencies programme was launched. Responsibility for managing and delivering many functions of government was transferred to newly formed agencies. This brought clearer definition of objectives and targets, together with greater freedom for managers to determine the means of service delivery. There are now more than 100 executive agencies, which are set annual targets for key areas of their performance.
- In 1991 the Citizen's Charter was introduced, aimed at improving the quality of public services and making government more directly accountable to the consumers of services, by setting a range of targets for quality service, and by finding more effective and efficient ways of organising and delivering services.
- In the late 1990s more systematic arrangements for measuring the achievements of central government were introduced in the form of public service agreements (PSAs). The PSA for each government department sets out its aims and objectives, the resources made available to it, the outputs and outcomes it is working to deliver, and its performance targets. Each department reports annually to Parliament and the public on performance against its public service agreement. The second round of public service agreements covering 2001/04 has recently been announced, with fewer, more focused targets.
- In 1999 the Government published its White Paper on Modernising Government. This increased further the focus on performance measurement. As part of its drive for better public services, the Government made a commitment 'to monitor performance closely'. Public sector managers are increasingly required to demonstrate what they have achieved and measures of performance are crucial to evaluating the success of programmes.

4.66 There have also been significant developments in performance measurement in local government, where the Audit Commission has responsibility for inspection of, and reporting on, Best Value Performance Plans. And developments in the United Kingdom have been mirrored abroad. A number of countries have recognised that financial information alone is not sufficient for Parliament and others to assess performance fully, and that additional information is needed. Performance measurement systems have been in place for some time, for example, in Canada and New Zealand.

Validation of performance information

4.67 The Government has highlighted the importance of Public Service Agreements (PSAs) for accountability, and is committed to reporting regularly on progress against targets. Technical details of how targets will be measured and assessed were published at the end of 2000. These help to show the variety of sources from which data is drawn, including National Statistics, local authority data, private sector sources and departmental systems.

4.68 There is widespread recognition that the involvement of external parties is crucial in providing credibility to information published by public bodies. An important issue of debate at present appears to be whether the subject of validation should be the underlying data collection systems, or the data. The Government has stated that it is committed to ensuring data systems that underpin PSA targets are reliable, and believes that some form of independent validation would help provide assurance on the quality and integrity of these data systems. It notes that some of the data already has National Statistics status, so that the systems already meet a number of criteria to safeguard quality. In other cases, data systems are not currently subject to external validation.

4.69 A number of those submitting evidence advocated validation of the performance data itself, for which examination of data collection systems would be one key element. For example, in its submission, the Audit Commission emphasised that the comparison of performance relies on robust information and informed analysis and interpretation. It stated that it is important, therefore, that performance information published by central government departments and agencies, as well as compliance with Public Service Agreement targets, is subject to external scrutiny and review and validated in order to give that data credibility. The Commission considers that public audit should play a role in this process, reviewing both the validity of the measures selected and the robustness of reported information. A similar view was taken by the NAO, which stated that without some form of external validation, a significant part of the performance measurement process may be undermined and inaccurate information may be reported.

4.70 Whilst, as **Box D11** shows, performance reporting has a history in the UK, there is also general agreement that systematic departmental reporting is a significant step forward and will take care and time to introduce. The Government's submission states that a good deal of work needs to be done before firm proposals can be made on who would conduct the validation process, what standards departments should be assessed against, and how often the validation would occur. It is also important that validation work proceeds in step with departments' ability to provide information to an auditable standard. This view is supported by other parties. A Treasury-led working group has been established to consider these issues further and come up with options later in 2001.

4.71 At the same time, it is clear that there is experience to build upon within the Audit Commission, the NAO, and the private sector. The Audit Commission has been responsible for validation work in local government for more than a decade, and the NAO has undertaken validation of performance data for executive agencies and NDPBs on request for a number of years. It also recently published a report on good practice in this area¹¹. Both organisations have been working with the Treasury and Cabinet Office to develop the Government's performance information strategy. The existence of several overseas examples also provides a basis for drawing on established good practice.

4.72 In these circumstances, there is a strong case for pursuing performance validation vigorously now. One approach might be for the development of performance measurement and validation work on similar lines to that used for the introduction of resource accounting. This went forward in stages, with a 'trigger point' process to monitor progress, and with external audit involvement to provide advice and guidance as systems were bedded in. Thus, a first stage might be to address the systems used to generate performance data. Once there was general confidence in the systems, work could move on to providing further assurance on the published data itself in ways that are not overly burdensome or expensive (for example, validators would rely on the work of others where possible, and look to carry out minimal levels of substantive checking). This seems a measured approach.

Arrangements for parliamentary scrutiny of the use of public funds

4.73 Chapter 3 referred to the processes for parliamentary scrutiny of the use of funds by Government. Examination of the use of public money in Parliament is primarily the responsibility of the Committee of Public Accounts, which plays a key role in holding Government to account. This part considers the Committee's work.

The role of the Committee of Public Accounts

4.74 The Committee of Public Accounts is an all-party committee of 15 Members of Parliament. Its role is to examine whether public money voted by Parliament has been spent in accordance with Parliament's intentions, and with due regard to issues of regularity, propriety and value for money. The Committee's remit covers all central Government departments, executive agencies and NDPBs. It also covers the National Health Service and a wide range of other public bodies. The Committee carries out its investigations based on the accounts, reports and memoranda presented to Parliament by the C&AG. It examines senior public officials responsible for the expenditure or income under examination, and produces its own reports. The Government responds to the recommendations of the PAC's reports in Treasury Minutes.

4.75 In its submission, the Government stated that the reputation that the Committee of Public Accounts (supported by the C&AG) has built up over many years for holding Accounting Officers to account is an enormous strength of the British system and has played an important role in stimulating high standards of regularity, propriety and value for money. This view was echoed by several senior officials, who felt that the seriousness with which hearings of the Committee were taken within departments helped them to impose financial discipline on their organisations. In part, this was felt to be the case because appearing before the PAC was the only occasion on which Accounting Officers were held publicly accountable in their own right, rather than as representatives of their ministers.

Recommendation

The move to regular performance reporting for departments is a very important step in improving accountability, and there should be external validation of departmental information systems as a first step in a process towards validation of key published data. There is general agreement that a good deal of work needs to be done in preparing for these developments, and the creation of a Treasury-led working group to consider the issues is welcome. There are already strong links between validation and audit work, and in order to ensure a cost-effective process, the C&AG and Audit Commission, as the auditors of the bodies generating much of the data, should be responsible for external validation in their respective areas. They should co-ordinate closely with the Office of National Statistics, the Statistics Commission, and other relevant bodies to devise an efficient way of providing Parliament and the public with assurance that published information is reliable. The development of performance validation for central government should be taken forward using a programmed step-by-step approach.

4.76 At the same time, some concerns were expressed about the effect of the PAC process, or perhaps more precisely, the effect of perceptions about the Committee. To some officials, the PAC was seen as too critical. Many believed the Committee disliked new developments in government, and were critical of any failures, however small, even when considering projects that were generally successful. Some suggested that fear of such censure discouraged officials from considering innovative projects (an issue to be considered further in Chapter 5), although no specific examples were provided. Others - both within government and the private sector companies - regarded this as 'a red herring', and noted that public bodies continued to undertake numerous highly innovative and risky activities.

4.77 Several suggestions were made as to how the PAC could best have a beneficial impact. Some considered that the work of the PAC was most valuable where it was focused on broad issues and outputs, and was not concerned with minor matters and processes. Thus, they argued that, whilst it was appropriate for the C&AG to investigate quite specific issues, it might not be necessary for the Committee to hold hearings on them. This was linked to the concerns of some observers that there were many other areas of government that appear only rarely to receive PAC attention. It was also given as a reason to support the recent development of PAC producing high-level reports drawing out lessons from a range of specific cases (see Chapter 5).

The Committee's own arrangements

4.78 In his evidence, the Chairman of the Committee of Public Accounts emphasised the importance of the relationship between the Committee, and the C&AG and NAO. He stated that the existence of an independent officer of the House of Commons, supported by a body of qualified and experienced staff, provided a supply of thorough and reliable reports. He also felt that the close relationship helped to ensure that the resources of the NAO were well employed in preparing work of value to Parliament.

4.79 The arrangements by which the PAC undertakes its work are well established, and generally involve a single evidence taking session based around a report by the C&AG and the appearance of a single Accounting Officer. However, the Committee has altered this approach on occasions and the Chairman highlighted in his evidence that:

- although Accounting Officers from departments, agencies and NDPBs were the main witnesses, the Committee on occasions examined representatives of the private sector organisations that had performed work under contract to government departments;

- where deemed necessary, the Committee had taken evidence over more than one hearing, as in the case of examinations of the National Insurance Recording System, and the privatisation of the Rolling Stock Leasing Companies;
- the Committee had recently sought to draw on the knowledge and experience of retiring Accounting Officers by starting to hold 'valedictory' hearings to discuss with them lessons learnt from a series of reports covering their period of responsibility;
- the Committee had asked former Accounting Officers to give evidence, where appropriate, as in the case of the hearing on the Passport Agency in 1999;
- the Committee had taken the opportunity in 1999 of visiting several European Union institutions responsible for the management and oversight of the Community Budget; and
- the Committee had produced several overview reports - that had drawn on lessons learnt from previous PAC and NAO reports.

4.80 These developments are acknowledgements of changing circumstances and an indication of a desire to make the most of the material available to them. The PAC is in a strong position, as perhaps the original 'cross-cutting' committee, to consider many of the initiatives that stretch beyond the boundaries of individual departments, and also to take a strategic view of the major risks to public money. The Committee's remit is also sufficiently broad to allow it to consider a wide range of the issues discussed earlier, such as corporate governance, performance measurement and developments in accounting arrangements.

4.81 How it operates is a matter for the Committee itself. Nevertheless, the recent developments outlined above, and some of the suggested recommendations in this report, could lead to an increase in the Committee's already substantial workload. The Committee should consider its working arrangements in the light of this. In doing so, the Committee has the opportunity to observe variations in the way a parliamentary audit committee can conduct its business. Under devolved government arrangements, the Scottish Parliament and the Welsh Assembly have both established audit committees that bear strong resemblance to the Westminster model.

4.82 In both cases, the committees are still developing their practices, but there have already been certain departures that may or may not be deemed desirable for PAC. For example, on one occasion, the Scottish Parliament's Audit Committee took evidence on a report on the Scottish Ambulance Service by visiting ambulance stations in order to see first hand the demands on the service. In Wales, the Audit Committee hearings are divided up so that each area of questioning is handled in turn, and then drawn to a close before moving on to the next subject.

Recommendations

The PAC could provide further powerful support to improvements in financial management by continuing to examine themes across central government as a whole (such as risk management, corporate governance, developments in performance measurement and fraud). In particular, this could be undertaken by holding an annual hearing, examining the main issues set out in a memorandum or report from the C&AG. This could be based on the C&AG's own work, his review of the findings of internal audit, and other sources. As departmental audit committees develop further, the Committee's examination would be able to draw on key themes arising from their work.

Recent developments in the PAC's work, and some of the suggested recommendations in this report, could lead to an increase in the Committee's already substantial workload. The Committee should consider its working arrangements in the light of this. Developments in the Scottish Parliament and Welsh Assembly (which have established committees broadly along the same lines as PAC) may provide some ideas for further experimentation in the Committee's approach.

5

Making the most of audit and accountability arrangements

- 5.1 In recent years, successive governments have made increased use of external verification to provide independent assessments about performance and assurance on the reliability of published information¹. Where auditors have been involved, this has been a departure from their more traditional role. There have also been calls from outside Government for improvements in the way in which Parliament scrutinises the activities of the executive². Amongst proposals for reform have been suggestions that the C&AG and the NAO should be used in new or different ways.
- 5.2 Common to all these developments is a desire to get the most from independent external scrutiny, and a belief that it can help to assess and improve performance. At the same time, however, concerns have been expressed at what has been described as the development of an 'audit society', one overly concerned with checking and measuring. And some have suggested that the prospect of inspection and audit discourages innovation and a willingness to change, and contributes to what has been described recently as 'the culture of blame' that has become a 'national pastime'.
- 5.3 The issue of how audit and accountability arrangements can be of most value in the future is, therefore, of considerable significance. This chapter considers:
- how the benefits of audit and accountability can be maximised;
 - how the costs can be minimised;
 - the relationship between audit and risk taking and innovation in government;
 - audit and 'joined up' working; and
 - ensuring accountability and quality of audit work.

The aim is to highlight appropriate arrangements for making the most of audit and accountability in the future.

Maximising the benefits of audit and accountability mechanisms

- 5.4 Auditors in both the public and private sectors have a privileged position with regard to information. They are provided with powers of access and can seek answers from senior management about decisions and actions. They can choose when to examine specific subjects, and when or if to report. Such powers enable them to gain insights into what makes for successful performance, or to identify weaknesses and problems within organisations. With this privileged position comes certain responsibilities. A simple one is to undertake their work to professional standards and with integrity. Another less fundamental, but nevertheless important, responsibility is to make the most of the information and insights gained, and to seek to maximise the benefits and value for money derived from audit work.
- 5.5 Much of the value of external audit comes from its independence from those it is examining. Auditors are thus able to stand outside an organisation and offer advice from a detached position. In his evidence, the Auditor General for Scotland emphasised that 'The first issue for auditors, if the potential of public audit is going to be achieved, is the safeguarding of auditor independence.' Within this constraint, however, there is much that auditors, given their privileged access, can and should offer.

Playing a full role

- 5.6 It is important that Government draws on the knowledge and experience of auditors and makes the most of the external audit resource. This can take a variety of forms. There is, for example, considerable benefit for all parties to be gained from staff from NAO, the Audit Commission, and private

¹ For example, several statutory inspectorates, including the Audit Commission, now have a responsibility to inspect the Best Value reviews conducted by local government bodies. In central government too, since 1997, the Government has seen value in involving the C&AG in examining the assumptions upon which the Budget is prepared.

² (House of Commons Select Committee on Procedure 6th Report 1998-99) 'Procedure for Debate on the Government's Expenditure Plans'; (Hansard Society 2000) 'Parliament and the Public Purse: Improving Financial Scrutiny'; (Edward Davey MP 2000) 'Making MPs work for our money: Reforming Parliament's Role in Budget Scrutiny'; (Fabian Society 2000) 'Paying for Progress: A New Politics of Tax and Public Spending'; (Andrew Tyrie MP 2000) 'Mr Blair's Poodle: An agenda for reviving the House of Commons'.

accountancy firms being seconded to government departments, as has occurred for some time. It is also valuable that experienced audit staff participate in government reviews where they can make a contribution. Recent examples mentioned by the NAO include participation in the Performance and Innovation Unit's 'Accountability and Incentives for Joined-Up Government' project, and the Cabinet Office's ministerial review of Major Government IT Projects.

- 5.7 At a lower level, of course, feedback following audit visits is vital, particularly through management letters or, for example, as part of VFM examinations, where much of the very detailed information may not find its way into a published report. Where auditors have undertaken large-scale surveys, there may be merit in them providing departments with the raw data for further analysis should they wish to use it. And, as mentioned in Chapter 3, external auditors should attend audit committees as a matter of routine, and not just when external audit matters are being discussed.
- 5.8 There are other ways in which auditors can provide advice and guidance on a range of matters without compromising their independence. Examples include:
- the recent preparations for the introduction of resource accounting, which showed the scope for considerable auditor input and advice, including through secondments;
 - the scope for auditors to provide advice on accountability issues, particularly to newly established bodies, or organisations which involve people new to the public sector; and
 - advice to help audited bodies improve their financial systems and reduce the risk of error and fraud, without being involved in the design or redesign of the systems.
- 5.9 A number of those giving evidence were also keen for the audit function to be involved earlier in the decision-making processes of government, although others expressed concerns at such developments, fearing that it might compromise the auditor's independence. The example of the London Underground PPP contract may prove a useful case study in how the NAO can play a role in advance of decisions being taken. Traditionally, of course, audit has been seen as a backward looking activity, but on this occasion the C&AG reported in December 2000 so that the results of his examination were available ahead of the final negotiations leading up to the eventual decisions and the closing of any deal. The benefits of this kind of input will need to be examined.

Auditors should look to make as much as possible out of findings from their work

- 5.10 Much of the C&AG's work leads to two main outputs. He provides an opinion on over 650 sets of financial statements and publishes 50 value for money reports each year. These are core outputs, for which there are well-established handling arrangements. In addition, however, audit work provides scope to generate other outputs.
- 5.11 A number of those submitting evidence saw considerable value in the publication, by the C&AG and PAC, of overview reports, drawing on previous, more detailed reports, to disseminate wider lessons. The Government, in its submission, noted that NAO and PAC had, from time to time, published reports on thematic subjects. It described them as 'useful outputs', which provided opportunities to learn lessons and disseminate good practice. The Government suggested that the NAO and PAC were probably in a unique position to produce such studies, and encouraged them to develop this approach further. **Box E1** lists recent reports of the kind suggested.

E1 RECENT PAC AND NAO OVERVIEW REPORTS

- Getting value for money in Privatisations (PAC report)
- Getting Better Value for Money from the Private Finance Initiative (PAC report)
- Improving the Delivery of Government IT projects (PAC report)
- Good Practice in Performance Reporting in Executive Agencies and Non-Departmental Public Bodies (NAO report)
- Examining the Value for Money of Deals under the Private Finance Initiative (NAO report)
- Supporting Innovation: Managing Risk in Government Departments (NAO report)
- Modernising Procurement (NAO report)

- 5.12 Published reports are by no means the only way in which audit findings and recommendations can be disseminated. Indeed, all parties have recognised that a pro-active approach is also needed to draw lessons to the attention of potential users. The Government's evidence encourages NAO to run seminars to disseminate good practice from reports. These could be in addition to (but not perhaps on the same scale as) the major conferences that NAO has already organised in the last year or so to highlight key findings from certain value for money reports³. Clearly such events are not appropriate for every published report, but they are a valuable development for the future.

³ These related to the C&AG's reports on Government on the Web (where speakers included the Government's e-Envoy), Medical Equipment, The Management and Control of Hospital Acquired Infection (where over 500 practitioners and managers from the NHS heard speeches from the C&AG and the Minister of State for Health and discussed practical solutions to the problems highlighted in the C&AG's report), and Hip Replacements: Getting it right first time.

5.13 There is also scope for audit findings to be disseminated in other ways. A number of people suggested that the C&AG might organise a regular seminar for Accounting Officers at which the most important issues from audit work could be discussed (a development perhaps of existing Principal Finance Officer level meetings). Another means is through auditor involvement in conferences and seminars organised for practitioners by external bodies and companies, already a feature, for example, of the NAO's work on PFI and health. There is also much to be gained from summarising key findings, perhaps in brief leaflet form, for those who do not have the time to read full reports. The NAO highlighted steps in this direction with the publication of the first *'Health Service Chief Executive Briefing'* in 2000, summarising key findings from recent health reports and drawing attention to recommendations for NHS managers. It also pointed to the revamping of the NAO newsletter *'Focus'*, which highlights recommendations and issues arising from recently published audit work, and is circulated to departments. Both provide scope for further development.

5.14 The Internet also provides great opportunities for ensuring that reports are easily accessible to more people. The most recent audit reports of the NAO and PAC are now available on their respective websites. Simple actions such as linking reports to departmental websites, and ensuring they are noted on 'What's New' pages can help to bring them to the attention of staff in organisations who might not otherwise have access to the report in paper format.

5.15 A much more substantial development in the use of audit findings would be for House of Commons committees other than the PAC to make use of them. How parliamentary committees conduct their business is a matter for parliamentarians to decide, but several suggestions were made in evidence to the Review. These included that NAO reports not used by the PAC might be the basis for departmental select committee work; that some of the resources of the NAO might be made available to other committees; or that the NAO might provide departmental committees with an annual briefing on financial issues, drawing, for example, on the accounts and supply estimates.

5.16 The latter idea may be the most attractive and, with the recent introduction of resource accounting, the current time may be a very suitable one for taking it forward. Many observers have argued that departmental select committees do not scrutinise departmental expenditure as well or as often as they could. If the NAO were given the resources to brief departmental select committees annually on the main issues arising from departmental resource accounts (and other key financial documents), this could provide the basis for a well-informed hearing - perhaps with the senior official and/or the Secretary of State - which would enhance Parliament's scrutiny of public expenditure.

5.17 Any such development should be designed to extend the use made of the NAO by Parliament, rather than replace some of the work already handled by the PAC. In order that this work did not detract from NAO's core work, an appropriate amount of additional money could be ring-fenced. Given the NAO's current role, the extra work needed to provide suitable briefings should not be too significant; much could be gained for relatively limited input. It is also essential that a protocol for this work is agreed to make clear that the NAO's role in providing briefing must not be allowed to draw the C&AG and his staff into questioning policy matters.

Recommendations

To make the most of audit activity, arrangements should include:

- involving auditors in relevant government-wide reviews;
- involving auditors early in providing advice and guidance in ways which do not compromise their ability subsequently to review projects and activities independently;
- further development of high level overview reports by NAO and PAC, which draw out lessons from a number of more detailed reports on similar subjects;
- the C&AG organising a regular seminar with Accounting Officers, to discuss key strategic issues arising from audit work;
- publicising audit findings in a wide range of ways other than published reports, such as NAO conferences and seminars, summarised briefings, in newsletters, and using electronic media; and
- further use for the work of the NAO, for example, by providing the C&AG with the resources to brief departmental select committees annually on key financial issues, without in any way undermining the key relationship between NAO and PAC, or drawing the C&AG and his staff into questioning policy matters.

Keeping the cost of audit and accountability to a minimum

5.18 Accountability is not free. The requirement to provide information - for example, in the form of an Annual Report, answering correspondence, responding to parliamentary questions, preparing for select committee hearings - incurs costs for those providing the information. During the debates on the Government Resources and Accounts Bill, ministers made a number of references to the costs and burdens of audit. Others have raised similar points. In a recent report⁴, the Environment, Transport and Regional Affairs Committee expressed alarm at what it saw as the impact of a developing culture of over-inspection in the public sector.

5.19 There is relatively little information on the costs of scrutiny work generally, although a recent study⁵ put a figure of £1 billion per annum on the total direct costs of government inspectors, regulators, ombudsmen, and statutory auditors. This does not include 'compliance costs', which relate to the time staff in public bodies spend on activities linked to audit and inspection, such as attending meetings, clarifying issues and providing information. These tasks often involve input from senior staff within an organisation. The same study suggested such compliance costs 'are likely to dwarf the direct costs of the regulators themselves.' This underlines the importance of those involved in oversight work of all kinds seeking to minimise the costs that result from their work.

There are a number of ways in which auditors can minimise the cost of their work

5.20 Auditors have a responsibility to review their work to improve its focus and make it more efficient. This also helps to minimise the burden imposed on audited bodies. Examples of ways of minimising this burden might include:

- refining financial audit methodologies - financial audit methodologies should be kept under continual review and compared with best practice. The NAO highlighted that in 1999 it had introduced changes to its approach, drawing on the latest thinking and developments in risk-based audit. The revised approach has an increased focus on assessing key risks and controls. Taking assurance from an organisation's controls reduces the amount of substantive testing needed to meet audit objectives. The changes are expected to lead to more efficient audits, which are less burdensome and add more value to audited bodies;

- reducing sample sizes - on both financial and value for money audit, auditors should look to examine the smallest sample that will allow them to draw statistically valid conclusions (unless there are particular reasons for taking larger samples);
- using information technology - developments in IT provide scope for productivity gains through the use of computer packages allowing standard audit tests to be completed efficiently. They facilitate on-line review, improved and quicker reporting to clients, and greater standardisation of work. In addition, through the Internet auditors have access to a huge amount of material not previously publicly available, making familiarisation and information gathering easier and quicker, and reducing the need for direct contact with audited bodies;
- feasibility and piloting work - piloting work on value for money studies is important to ensure that attention is given to the right issues and that work is likely to add value. Elements of fieldwork (for example, questionnaires) can also be tested before rolling them out more widely;
- making use of existing data - wherever possible for value for money studies information should be used that has already been collected by audited bodies, or by other auditors or inspectors; and
- using experts - experts can help increase auditors' knowledge of particular sectors, meaning they are better informed when dealing with audited bodies. NAO regularly use reference panels of experts to help ensure VFM studies are relevant and focused, and employ specialists to work as part of study teams.

5.21 Drawing on the skills of private sector auditors is also important for keeping costs down. The C&AG currently contracts out to private sector firms some 17 per cent of the total resources applied to his financial audit work⁶. In doing so, he remains responsible for signing off the accounts and ensuring that the work is undertaken in a consistent manner, according to the expectations of Parliament. Contracting out provides him with the opportunity to test NAO's efficiency through a comparison of costs and methodology, ensure an element of competitive tension, and secure additional skills. Currently, the NAO has five-year framework agreements with a number of firms, and individual work assignments are awarded according to agreed procedures.

⁴ House of Commons Environment, Transport and Regional Affairs Committee, Tenth Report 1999-2000.

⁵ (Hood et al 1999) Regulation inside Government: Waste-Watchers, Quality Police and Sleaze-Busters

⁶ National Audit Office Annual Report 2000

5.22 The C&AG should continue to contract out work to private firms, working towards a figure of 25 per cent of the resources devoted to financial audit. There is also merit in ensuring that there is rotation in the audits that are undertaken by private sector firms. In addition, the recommendation outlined in paragraph 5.71 (for regular and routine scrutiny by the Joint Monitoring Unit of the quality of NAO financial audit work) will provide additional assurance about the consistency and quality of financial audit work, whether undertaken by the NAO or private sector firms. Issues of the cost, efficiency and quality of the audit work will also remain important matters to be considered annually by the Public Accounts Commission, set up specifically to oversee the NAO's performance.

Recommendation

Auditors have a responsibility to minimise the cost and burden of their work, including by refining methods, using IT, making use of existing data, and using outside experts. The C&AG should continue to contract out work to private firms to help encourage competitive tension and benchmark the efficiency of the NAO, working towards a figure of 25 per cent of the resources devoted to financial audit. Recommendation 19 on scrutiny of NAO's financial audit work by the Joint Monitoring Unit will also be important here, as will the scrutiny of costs, efficiency and quality of NAO's work by the House of Commons Public Accounts Commission.

Where possible, auditors should rely on the work of others

5.23 An important aspect of keeping costs down is relying on the work of other auditors and inspectors. The Public Audit Forum publication on 'What public sector bodies can expect from their auditors'⁷ includes a section on making use of the work of others. The paper states that:

"It would neither be cost effective nor fair and reasonable for all the bodies in the spending chain...to be constantly subject to several layers of audit...[E]fficiency requires that public auditors seek to maximise...the use they make of the work of others such as internal auditors, regulators and external auditors of related bodies."

5.24 Using the work of other auditors and experts is the subject of three auditing standards⁸, and guidance on the application of auditing standards to the central government sector is given by the Auditing Practices Board in Practice Note 10⁹. The Note recommends that, in the interests of efficiency and reducing the audit burden, external auditors should adopt a co-operative approach

when considering the extent to which they can use the work of others and reduce their own audit procedures.

5.25 Because of the division of labour between the NAO and the Audit Commission, the National Health Service is one area where reliance on the work of others is important, as was noted most recently by the Select Committee on the Environment, Transport and the Regions (**Box E2**).

E2 AUDITING THE NATIONAL HEALTH SERVICE

In its submission, the Audit Commission emphasised that it had established working arrangements whereby, each year, in accordance with professional auditing standards, the NAO uses the work that the Commission's auditors undertake at health service bodies, and also at local authorities in the certification of government grant claims, in its audit work on the consolidated National Health Service accounts and departmental appropriation accounts.

The NAO's work, therefore, concentrates on a review of the opinions, reports and main findings of the appointed auditors, an assessment of the Audit Commission's quality reviews, an audit of the summarisation process carried out by the NHS Executive, and investigation of anomalies and key issues. The C&AG also draws on the work of the appointed auditors on issues of regularity and propriety. A number of sessions of the Committee of Public Accounts have been based on the NAO's review of the findings of the auditors appointed by the Audit Commission.

There has been growing recognition of the need to co-ordinate audit

5.26 In the 1997 White Paper 'The Governance of Public Bodies'¹⁰, the Government suggested that the four national audit agencies set up a forum to provide a focus for developmental thinking in relation to public audit. The Public Audit Forum was established in 1998, with a remit to build on the existing co-operation between national audit agencies in order to enhance the efficiency and effectiveness of public audit, to provide a strategic focus on issues cutting across their work, and to help develop common standards for public audit. The Forum is supported by a consultative forum with representatives from key stakeholders in the audit process, including audited bodies and the auditing profession. The Forum has published a series of reports, highlighting issues of common interest.

7 Public Audit Forum (2000) 'What Public Sector Bodies can expect from their Auditors'

8 SAS 500 'Considering the work of internal audit', SAS 510 'The relationship between principal auditors and other auditors', and SAS 520 'Using the work of an expert'.

9 A new practice note is expected to be published in early 2001.

10 The Governance of Public Bodies (February 1997).

5.27 There are a number of ways in which auditors can co-operate. Some have expressed concern about a lack of reports produced jointly by the NAO and Audit Commission. Further development of this type of work would be valuable, but there are other ways in which the objectives of maximising the benefits derived from audit work and minimising the risk of duplication and overlap can be achieved, which recognise the needs of different audiences. Thus, two audit bodies producing complementary reports, or one organisation contributing information to another should be seen as equally valuable.

Box E3 suggests a number of forms of co-operation.

E3 FORMS OF CO-OPERATION

- Sharing data already collected for the reports of another body.
- Undertaking fieldwork for others in respective areas of responsibility.
- Complementary reports - wherever possible, launched together.
- Joint advisory groups for reports.
- Consultation on strategic planning for future work programmes.

5.28 The growth in the number of government inspectorates and regulators underlines the importance of those in any particular field talking to each other, and there being a clear understanding of the respective requirements and responsibilities of all parties. In its submission, the Higher Education Funding Council highlighted recent work it had commissioned on the accountability burden in the higher education sector. Following research, it had established a higher education forum, where those bodies involved, including the NAO, can meet to discuss issues of mutual concern. Such an approach - involving a review to identify the exact nature of the 'burden' and the needs of various interested parties - might be appropriate in other fields, for example, the criminal justice system, health, and social security. However, any proposals for joint-working between bodies must take account of the distinctive perspectives of the individual bodies, which may limit the ability of particular inspectorates to participate in specific joint studies.

Recommendations

Auditors and other inspectors should continue to seek to co-ordinate work where possible in the interests of maximising the benefit of their work and minimising duplication of effort. There are a great many ways that this can be done, ranging from joint studies to sharing information. Where there are a number of inspectorates, audit bodies and regulators working in a particular field, all parties should liaise on a regular basis to identify respective information needs, and co-ordinate information gathering.

Co-operation between internal audit and external audit

5.29 Another important area for co-operation is between internal and external audit. Traditionally, it appears the relationship has not been as close as might have been expected in central government, in part because the focus of internal audit has tended towards non-financial areas, making its work of less value to those auditing financial statements. However, the balance seems to be being restored, holding out the possibility of external audit increasing reliance on internal audit work, where it is satisfied, for example, about quality.

5.30 Recently, the Treasury and the NAO (in conjunction with departmental representatives) prepared a good practice guide on 'Co-operation between internal and external auditors'. This is very welcome and should be published and circulated as soon as possible as the basis for developing relationships between NAO and internal audit throughout government. The guide considers possible areas of co-operation, including sharing information about work programmes and reports. **Box E4** draws on the guide to highlight a number of key success factors for co-operation.

E4 CO-OPERATION BETWEEN INTERNAL AND EXTERNAL AUDIT

The achievement of effective co-operation can be assisted in various ways.

Structural

- Senior management actively encourage and support co-operation.
- There is an appropriately constituted audit committee taking active interest in internal and external audit issues and encouraging co-operation.
- Opportunities for co-operation are identified from respective audit plans and documented along with agreed procedures for co-operation.

Behavioural

- There is regular and structured dialogue between interested parties, particularly internal and external audit teams.
- Both sets of auditors adopt an active role in seeking opportunities for co-operation.

Source: (NAO and HM Treasury) Co-operation between Internal and External Auditors: A Good Practice Guide

5.31 The guide also highlights the importance of building co-operation, based on commitment, consultation, communication and confidence. Those consulted emphasised there must be genuine commitment to improvement, and mutual respect for the roles and responsibilities of each party. Both internal and external auditors emphasised that strong internal audit functions with considerable independence give external audit confidence in the work on which they might rely. Close co-operation with external audit also helped to strengthen the position of internal audit within an organisation.

Recommendation

There should be close liaison between departmental internal audit and external audit, based on the code of good practice drawn up by Treasury, NAO and departments, which should be published and disseminated as soon as possible as the basis for developing relationships.

Co-ordination between the various national audit bodies

5.32 The creation of new audit arrangements in Scotland and Wales presents new risks as well as opportunities. The main risks are that there will be uncoordinated approaches to issues affecting all areas of the United Kingdom that result in the loss of an ability to draw comparisons between different regions, and that there will be wasted effort as the different audit bodies 're-invent the wheel' in developing separate audit methodologies for similar subjects. To guard against this the various audit bodies should ensure that they have arrangements in place to enable them to draw on each other's methodologies. There should also be scope for audit work with combined teams - for example, to compare performance in different parts of the United Kingdom - and the possibility that one body might wish to engage another to undertake fieldwork on its behalf.

Audit, accountability and risk management

5.33 Government bodies are responsible for a broad range of activities, many of which involve a degree of risk. Because of their size, complexity and nature many government projects are highly risky. Risks might include unexpected events or circumstances arising that prevent completion of projects on time, or an inability to cope with external developments. Risk is not a new problem for government departments, who have long been responsible for handling financial risks, managing the threat of impropriety and malpractice, or safeguarding public assets.

5.34 More recently, however, the growth of new forms of service delivery, such as under the Private Finance Initiative, has highlighted the importance of identifying key risks and allocating responsibility for managing them to the most appropriate party. In addition, the Modernising Government programme has encouraged departments to adopt well-managed risk taking where it can lead to sustainable improvements in service.

The civil service has traditionally been risk averse

5.35 The culture of the civil service has traditionally been considered risk averse, although this partly meant that risks have not always been appreciated or understood. A Cabinet Office report¹¹ on *Professional Policy Making for the 21st Century* commented that 'we found a widespread view that civil service culture does not welcome new thinking or change.' Thus, departments associate risk taking with increasing the possibility of something going wrong, and of project failure or financial loss, which could lead to Parliamentary and public censure. Few are considered to have suffered in the civil service for failing to take opportunities, but considerable damage to careers and reputations can be done by being seen to have failed.

5.36 In these circumstances, risk aversion in the civil service appears to include:

- a failure to take opportunities to deliver better and more cost effective public services;
- slow progress in taking advantage of technological advances;
- a reluctance to try to adopt new organisational structures and ways of working;
- a lack of experience in risk management;
- an unwillingness to abandon tried and tested methods of service delivery; and
- an inability to respond to, or to manage, changed circumstances.

Government has shown growing interest in risk management but still has some way to go

5.37 Risk management has been defined¹² as a corporate and systematic process for evaluating and addressing the impact of risks in a cost effective way, and having staff with the appropriate skills to identify and assess the potential for risks to arise. In recent years, a number of important developments have taken place in government (**Box E5**).

¹¹ (Strategic Policy Making Team, Cabinet Office 1999) *Professional Policy Making for the 21st Century*

¹² Comptroller and Auditor General (2000) *Supporting Innovation: Managing risk in government departments*

E5 DEVELOPMENTS IN RISK MANAGEMENT IN GOVERNMENT

The Modernising Government White Paper, published in March 1999, encouraged departments to improve their approaches to managing risk and delivering services in innovative ways. All departments are to prepare framework documents setting out their procedures for reaching decisions on the risks for which they are responsible.

From 1998-99 onwards there has been a Treasury requirement for central government bodies to include in their accounts a statement by the Accounting Officer on the system of Internal Financial Control. As part of the C&AG's audit of these bodies, he reviews whether the statements comply with Treasury requirements, and whether the statement is misleading or inconsistent with other information he is aware of arising out of his audit of the financial statements.

In September 1999 the Turnbull Committee issued its report 'Internal Control: Guidance for Directors on the Combined Code'. Aimed principally at the boards of listed companies, the report provided guidance on the implementation of internal control requirements. Subsequently, the Treasury consulted departments and the NAO on how the principles could be translated and applied to central government.

In February 2000 the Treasury issued a consultation draft on 'Management of Risk - A strategic overview', which poses questions for departments to ask themselves about their management of risk, and sets out the key components of an effective risk management system.

The Government now intends that current statements of Internal Financial Control should be widened to cover the whole system of internal control, in line with Turnbull. The NAO will review the statements, with the change taking effect for accounting periods starting in 2001.

5.38 Recent research suggests that currently the quality of risk management varies considerably in government. The *Professional Policy Making* report highlighted a widespread lack of risk assessment and management in departments. This was confirmed by a NAO¹³ survey of risk management arrangements in 257 departments, agencies and NDPBs, which, amongst other things, identified some of the reasons for risk aversion. These included: cultural factors within the organisation; lack of expertise in risk management; little information about the risks facing departments and what is appropriate risk taking; unclear responsibilities for the management of risks; the status and activities of public bodies limiting the risks departments can take with public services; time and funding constraints, and fear of project failure reducing the scope for innovation.

5.39 It is essential that departments continue to improve risk management arrangements to help overcome these difficulties. There is a growing literature of guidance which

has been added to recently by the C&AG's report mentioned above, and the Treasury's paper 'Management of Risk: A Strategic Overview'. It is, therefore, important now that the messages contained in the guidance become embedded in departmental systems and thinking, and that progress is encouraged and monitored, including by:

- departmental audit committees, which should pay particular attention to risk management arrangements within their organisations (informed by the work of internal audit);
- the Treasury and Cabinet Office, which should continue to monitor the developments;
- the PAC, which could include risk management in the annual review recommended in Chapter 4; and
- auditors, possibly by the NAO undertaking a follow up study in three years time to review progress in risk management across government, and as part of the routine audit work conducted in those public bodies it audits.

However, it must be recognised that improvements in the ability of departments to manage risks will only come when risk aversion is treated as a cultural, rather than a structural or technical, issue, and the work already under way in government on incentives should be pursued (see below).

Audit and risk management

5.40 Risk management has been the subject of several recent NAO reports - for example, *The Cancellation of the Benefits Payment Card project*, and *The Passport delays of summer 1999*. The PAC's report on *Improving the Delivery of Government IT Projects* also highlighted the problems associated with not identifying and planning for the unexpected.

5.41 However, some observers have suggested that the audit and accountability processes themselves discourage public officials from innovating and trying new approaches to service delivery - in effect, making them risk averse. More specifically, it has been suggested that the NAO/PAC process can act as a barrier to change, claims that have also been made about the impact of audit in local government. This issue was raised during the passage of the Government Resources and Accounts Act, when the Economic Secretary stated:

'There is a perception - opinions vary on whether it is a reality - that current scrutiny arrangements inhibit some risk taking in Departments. It is argued that the NAO is critical when Departments try to do anything new, which encourages officials to play safe... We would be very concerned if enhanced scrutiny simply led to embedding very traditional ways of doing things and closed down innovation and modernisation in Government.'

- 5.42 In evidence to the Review, there were mixed views on whether there was substance to these claims. A number of senior government officials dismissed them as a 'red herring', emphasising that their work was inherently risky, and in making decisions about whether to go ahead with a particular project, the prospect of NAO and PAC interest was not a primary consideration. Some observers saw the auditor as a convenient 'whipping boy', when the real problem was timidity amongst officials. Others - including within organisations responsible for a number of groundbreaking initiatives - suggested that, whilst fear of audit attention had not, to date, prevented highly innovative developments taking place, this situation might alter if such projects went wrong and they were criticised in the future.
- 5.43 However, to other observers, officials in some organisations did seem to regard the possibility of problems becoming the subject of external scrutiny as a matter that influenced their thinking. One private sector representative commented that he had heard concerns about the possibility of PAC interest voiced in organisations undertaking PFI/PPP projects for the first time, although he noted that amongst those with a track record, the matter had never surfaced in contractual talks. Another senior official suggested that fear of failure and consequent PAC criticism was an important factor for many civil servants. This was less about specific cases, and considered to be more a generalised concern that influenced the actions of many officials.
- 5.44 More generally though, much of the evidence suggests that the issue of whether scrutiny arrangements affect innovation and change should be seen as part of a much broader issue about the incentives and penalties that exist within the public sector. Several people suggested that the rewards for successful innovation by public sector employees are either non-existent or are very small, whereas the perceived penalties for failed projects - in terms of damage to career prospects and censure in public - are real. Others suggested that many aspects of the way in which the civil service operated - its pay structures and incentives, the continuing policy/operations division, and inadequate management information - all worked against risk taking. The issue of rewards and performance management is currently being examined as part of the Civil Service Reform Programme.
- 5.45 One concern raised has been whether the demands of accountability are actually putting off bidders for government contracts. Although very difficult to prove either way, no evidence was presented that audit scrutiny discouraged bids or that companies were put off by NAO access to contractors. Whilst the possibility of involvement in a critical PAC hearing was considered unpleasant, representatives of private sector companies interviewed did not consider the accountability process was a

deterrent, and expressed no concern about NAO access to papers. Those interviewed in the private sector considered it very unlikely that decisions would change because of these requirements, and said they fully understood the need for transparency. Of greater concern were the costs of bidding for work, and the complexity of regulations, although central government work remains attractive to the private sector.

- 5.46 Notwithstanding this, it is important that auditors are aware of the potential impact of their work and how it can be perceived. Awareness that audit is seen by some as discouraging risk taking and change has encouraged auditors to make public pronouncements on the issue (**Box E6**). Against this background, the NAO highlighted recent reports that had supported innovative approaches - for example, on the National Savings deal with Siemens Business Systems and on the transfer of the DSS Estate to the private sector. The NAO also noted that the C&AG's reports were often critical where bodies had failed to modernise, where risks had not been managed sensibly, or where failings had been repeated over a number of years.

E6 STATEMENTS BY AUDITORS ON RISK TAKING

In 1997, before the first examination of a PFI project, the NAO explained publicly that it recognised that PFI was new and meant departments had to take risks. It emphasised it would, in its audit work, support risk taking and innovation, provided it was well thought through.

In 1999 the Public Audit Forum set out its position of supporting well thought through risk taking in a paper on the *Implications for Audit of the Modernising Government Agenda*. This encouraged auditors to respond constructively and positively to Modernising Government initiatives and support worthwhile change, for example, by examining how the innovation has worked in practice.

In 1999 the NAO published its own response to the Modernising Government White Paper. This emphasised that, in the spirit of the Public Audit Forum's statement, 'we shall give careful attention to the efforts departments have made to identify risks before committing themselves. If a department or other public body has taken steps to identify its risks, so that it can evaluate how it is doing, but something comes out of the blue which could not have been planned for and causes the project to fail, we should not criticise officials for being at the receiving end of what could not be predicted; our focus will be on the lessons that can be drawn.'

5.47 These statements have been welcomed by the Government, but at the same time, the Performance and Innovation Unit of the Cabinet Office commented in *'Wiring it Up'* that 'Actions, of course, speak louder than words, and officials in departments, agencies and delivery organisations will be looking for signs that the PAF statement is actually affecting the way auditors behave. Officials do not expect to avoid criticism when they have failed to act sensibly. But only when a carefully calculated risk has not worked out as hoped, will they start to gain enough confidence to take further risks.'

5.48 This view - repeated in interviews for the Review - underlines the importance of audit bodies being aware of how their work is perceived, and ensuring that their work is balanced and constructive. It also highlights the significance of regular liaison between departments and the NAO to ensure mutual understanding, and of departments ensuring that staff are fully aware of the role, remit and responsibilities of the auditor. Auditors may also be able to counter the perception by ensuring that key findings and lessons learnt are widely disseminated in easily accessible ways, as recommended earlier in this chapter.

Recommendations

It is essential that departments continue to improve risk management arrangements and that messages contained in recent guidance are embedded in departmental systems and thinking. Encouragement and monitoring of progress could be undertaken by departmental audit committees, and (at a higher level) by the Treasury and Cabinet Office, as well as by the PAC and the NAO, which could undertake a follow up study to the C&AG's 2000 report on 'Supporting Innovation'. However, it must be recognised that improvements will only come when risk aversion is treated as a cultural, rather than a structural or technical, issue.

Although well beyond the remit of this Review, the evidence suggests that the issue of incentives and rewards within government is a fundamental one, which merits continuing research as to how best to create a climate in which change and innovation are encouraged and rewarded. Incentives must not be seen purely in monetary terms, but should also include opportunities for recognition, advancement, study and responsibility. The on-going work of the Civil Service Reform Programme is important here.

Accountability mechanisms are perceived by some in government as a discouragement to innovate and change, but this appears to be only one of a number of complex factors, including a lack of incentives to manage risks, and a lack of commercial decision making skills within departments. Whilst acknowledging this, it is important that auditors recognise the dangers of being perceived as discouraging well managed risk taking, and ensure that their work lives up to the spirit of statements made on attitudes to innovation.

Audit and 'joined up' working

5.49 In recent years, there has been increasing recognition that individual departments cannot always solve problems on their own, and that users of many services face problems caused by organisational boundaries between different services. Public bodies have responded in some cases by working in partnership with others in the public and private sectors (see **Box E7**). A key conclusion of the 1998 Government's Comprehensive Spending Review was that dividing responsibility for overlapping policy areas between several departments could make government intervention less effective. This led to the creation of a number of cross-departmental budgets for areas that needed to be tackled.

E7 EXAMPLES OF DIFFERENT TYPES OF PARTNERSHIP WORKING

Conflict Prevention Review

As part of Spending Review 2000, the Foreign and Commonwealth Office, Ministry of Defence and the Department for International Development carried out a review on how to improve the effectiveness of the United Kingdom's contribution to conflict reduction. This informed the development of the Public Service Agreements for each of the departments and has led to the setting up of a joint budget to finance conflict reduction programmes.

Sure Start

The Sure Start programme works to promote the physical, intellectual and social development of young children (particularly those who are disadvantaged). Sure Start reports to both the Secretaries of State for Education and Employment and for Health, and operates through a Sure Start Unit with its own PSA and ring-fenced budget. The Head of the Sure Start Unit is the Accounting Officer. At a local level, Sure Start operates through partnerships that bring together local authorities, health authorities and trusts, local and national charities and parents.

Working Links

This is a joint venture company set up by the Employment Service, Ernst & Young, and Manpower PLC to manage and operate Employment Zones to provide help to get the long term unemployed into sustainable employment. Each of the partners has equal representation on the Board of the company.

British Trade International

British Trade International (BTI) is a joint body of the Department of Trade and Industry and the Foreign and Commonwealth Office, tasked with co-ordinating export promotion work. The Chief Executive of BTI reports to both the Foreign Secretary and the Secretary of State for Trade and Industry. He is Accounting Officer for BTI's programme expenditure, while administrative costs continue to be borne on the votes of the parent departments.

- 5.50 Partnerships provide opportunities to improve public services and solve problems caused by organisational divisions, but they also raise accountability issues. Some have suggested that partnerships can be less accountable than the individual partners would be, and it may be unclear as to who is responsible for service delivery and for safeguarding public money.
- 5.51 In its submission, the Government highlighted the Performance and Innovation Unit's report '*Wiring it Up*', which suggested that departments might be reluctant or unable to contribute to a cross-cutting initiative once budgets have been allocated to other departmental priorities, and the traditional focus and perception of audit and VFM may have led to departments concentrating on the improvement of their own internal performance and financial controls, rather than the Government's overall performance by working with others. It also noted that the report had warned that cross-cutting work might be considered 'risky' because relationships and lines of responsibility may be more complicated.
- 5.52 This is a complex area, meriting further examination, but on the basis of discussions, it seems that many of the obstacles to 'joined up' working may be internal to government, rather than due to external scrutiny. Some relate to accounting conventions whereby each estimate can only have a single principal Accounting Officer. There was also a suspicion that in some cases the desire to protect existing structures was a discouragement to entering into partnerships. Again this raises the issue of what incentives exist to encourage organisations and individuals to enter into partnerships, where doing so requires those involved to take risks and consider new ways of working.
- 5.53 Those providing evidence emphasised several key success factors for partnership working (which were not too dissimilar from points identified elsewhere - see **Box E8**). The most important factor was the existence of clear responsibilities for activities, regardless of how they are constructed. Partnership working undoubtedly adds to the complexity of accountability arrangements. Without clear allocation of responsibilities and clarity about aims and objectives, the possibilities for confused accountability increase considerably, and with it the danger of disputes between the partners leading in turn to failure to achieve the objectives.
- 5.54 Where departments were entering into a partnership, the existence of a ring-fenced budget was also seen as crucial to protecting the ability of the partnership vehicle to deliver its objectives. Without this there was concern that the departments involved in the partnership would cut back on expenditure on areas of joint-working in order to protect 'core' programmes in the event of spending pressures emerging in the course of a year. In discussions, it was also noted that joint-working is likely to be most successful

where all the parties involved have a strong interest in the issue. This enables the joint-working arrangements to be carried out with the full support of all the parties. Sure Start is an example of this. Conversely joint-working will be less successful where one or more of the bodies involved consider the initiative to be a higher priority than others. Likewise, where two or more of the bodies involved each think that they are already in the lead on the issue, joint working may prove difficult.

E8 ACCOUNTABILITY OF COLLABORATIVE ARRANGEMENTS IN CANADA

In Canada the federal government, other levels of government, and organisations in the private and voluntary sectors are establishing collaborative arrangements to provide public services. In 1999 the Auditor General of Canada reported on *Collaborative Arrangements: Issues for the Federal Government*, noting that whilst such arrangements had the potential to be an innovative, cost-effective and efficient way of delivering programs and services, effective accountability for them was more complex. The Auditor General suggested that key elements of strong accountability for collaborative arrangements were:

Clear and agreed expectations: agreement in writing on common objectives and public policy purposes, as well as key results sought, is critical. Operational matters, including on sound procedures and practices for financial management and control, must also be agreed.

Clear roles and responsibilities: these should be clear from the outset and reflect the interests and capabilities of each partner, as well as common interests. Decision-making processes, and co-ordination arrangements (consisting perhaps of designating a lead department, having a central agency or establishing a specific management structure) must be agreed upon.

Balanced expectations and capacities: a balance must be struck between expectations and the capacity of each partner to deliver.

Credible reporting: adequate provision for reporting in agreements, leading to credible and timely reporting of plans, activities and overall results, is essential for accountability in collaborative arrangements.

Reasonable review, program evaluation and audit: partners need to agree on a mechanism for monitoring the progress of collective activities and evaluating performance and results.

- 5.55 One way to clarify responsibilities suggested in evidence to the Review was for a mechanism such as a code of practice to identify when there is a partnership in place, which would then require that a lead officer and a lead finance officer were identified for all such activities. A clear statement of their duties and responsibilities would be part of this. Accountability and audit arrangements would then tend to follow the lead finance officer.

5.56 However, accountability issues and solutions will depend on the form of the arrangement. Where, for example, a public body is investing in a partnership - as in the case of the Employment Service investing in Working Links - it is clearly responsible for the protection of the public investment in the partnership body. This will generally be done by ensuring that it has adequate representation on the Board of the body, and that these directors ensure that the commercial strategy of the entity is sound and that appropriate corporate governance and risk management arrangements are in place.

5.57 In a case such as Sure Start, however, where the department is operating through a large number of unincorporated local partnerships, which are themselves made up of many individual bodies, it is likely that the department will wish to institute detailed reporting requirements to ensure accountability. For Sure Start these involve that:

- each organisation in the partnership is audited and has to identify Sure Start expenditure separately in its accounts;
- an account is prepared for each partnership and these are audited;
- NAO audits Sure Start's account and has access to the partnerships; and
- in addition, there is monthly monitoring by the Sure Start Unit of each partnership and quarterly milestones are set for achievement of the PSA targets.

Auditing joined up activities

5.58 The development of joined up activities will require greater flexibility from auditors. The NAO stated that it had responded to changes in government in 1999 by reorganising itself internally to bring together, for example, the teams working on education, employment, tax and social security issues. It also suggested that one of the concerns - that parliamentary procedures might act as an impediment to the scrutiny of policies cutting across departmental boundaries - was not a problem for the PAC as it could already examine every department, and could call witnesses from a range of bodies.

5.59 However, the creation of partnerships and joined up working does raise a number of issues for auditors. In particular, it increases the need on occasions for different audit bodies to work together. It also presents challenges for the organisation and focus of VFM examinations, which in recent years have tended to concentrate on individual departments. It also increases the importance of careful liaison throughout the duration of the project between all parties, and is likely to make the 'clearance' of the report, through which the NAO confirms the facts and their presentation with departments, a more demanding exercise.

5.60 The establishment of joined up activities is still in its early days and so there are relatively few examples to date of audit work examining their performance. However, the C&AG issued a report on the Criminal Justice System (in 1999), and will shortly publish reports on Obesity (a subject touching on the responsibilities of five departments), and Non-Medical Education and Training (which involves both higher education institutions and the National Health Service). In each case the teams preparing the reports stated that the studies could not have been undertaken properly by focusing simply on one department or body.

5.61 Parliament is just beginning to consider the issue of accountability for cross-cutting activities. At the moment the PAC is unusual (although not unique, of course, given the existence, for example, of the Environmental Audit Committee and the Public Administration Committee) in having a remit that enables it to look across departments. One major issue affecting PAC when dealing with cross-cutting issues is that of which Accounting Officers to call. It is too early to suggest any guidelines for this, but it seems clear that departments, NAO and the PAC will have to be flexible in handling this issue. In some cases, it seems one department may have to be willing to be represented by another, and in other cases the PAC may need to hold several hearings on the same subject to enable all the interested parties to appear before it.

Recommendation

Many of the obstacles to 'joined up' working may be internal to government rather than due to external scrutiny. Key success factors for partnership working appear to include the existence of clear responsibilities, the clarity of aims and objectives, and the existence of ring-fenced resources. The examination of 'joined up' working is more complex for auditors, and it seems likely that departments and the PAC will need to be flexible in dealing with such reports by the C&AG, with the PAC perhaps holding several hearings, and departments allowing one Accounting Officer to represent others.

Auditing environmental issues

- 5.62 Towards the end of the Review, the Environmental Audit Committee of the House of Commons issued a report covering its activities during the current Parliament¹⁴. A major conclusion of this report was that the Committee as currently constituted could not adequately audit the Government's performance against its environmental targets and that an independent environmental audit facility, reporting to the Committee, should be established to fill this gap. The Committee proposed that this environmental audit function should be set up within the NAO under a new post of Environmental Auditor General (perhaps at Deputy C&AG level). Under this proposal the environmental audit arm of NAO would enjoy a similar relationship to the Environmental Audit Committee as the NAO has with the PAC.
- 5.63 This is clearly an important proposal which merits further consideration. However, it may not be the most effective way of achieving the Environmental Audit Committee's aims. The proposal has potentially significant implications for both the relationship between NAO and PAC, and for the management, organisational, and resource requirements of the NAO. There is also a risk it could compromise the NAO's independence of considerations of policy. It could also add major new audit requirements onto departments and other public bodies. These would have to be carefully integrated with more traditional audit functions in order to avoid 'audit overload'. All of these issues will require considerable thought by the Government, NAO, PAC and the Environmental Audit Committee. It does not seem to be within the terms of reference of the Review to comment substantively on these proposals except to note that it is likely that the Review's proposals regarding performance validation, making the most of audit, and minimising the cost of audit are likely to be as applicable to environmental audit activities as they are to more traditional audit.

Ensuring accountability and quality of audit work

- 5.64 It is important that there are arrangements in place to ensure the accountability and quality of audit work, and that those involved have confidence in them. This final section considers the accountability and quality control arrangements for the NAO.

Accountability of the NAO

- 5.65 The basic constitutional position is that the Comptroller and Auditor General, as an Officer of the House of Commons, is accountable to Parliament. The performance of the NAO is overseen by the Public Accounts Commission, a committee of Members of Parliament, established under the National

Audit Act 1983. This is distinct from the examination of the output from the NAO's work, which is the responsibility of the Committee of Public Accounts. Parliamentary scrutiny of the NAO's use of its resources and its performance is summarised below (**Box E9**).

E9 PARLIAMENTARY OVERSIGHT OF THE NAO

- The C&AG appears before the Public Accounts Commission twice a year, firstly when the Committee considers the NAO's Corporate Plan, and also when it examines the NAO's own Supply Estimate.
- The C&AG appears before the Committee of Public Accounts to be examined on the NAO Estimate.
- The PAC meets annually to discuss the NAO's work programme. Under the National Audit Act 1983, the C&AG is required to consult with the PAC on subjects for examination.
- The annual accounts of the NAO are presented to Parliament.

- 5.66 As well as high-level accountability, the NAO emphasised that its programme of work received twice-weekly scrutiny when Parliament was sitting, when its reports were the subject of PAC hearings. The Chairman and members of the Committee may comment on the report, which provided informal feedback. There has also been extensive media coverage of NAO reports for many years, some of which focused on the way work had been undertaken, as well as growing interest from academics and other commentators. The PAC also holds an annual debate, based on its reports (and thus the work of the NAO).
- 5.67 The NAO publishes a Corporate Plan and an Annual Report, which is distributed to audit clients and other interested parties. The NAO's annual accounts are audited by private sector auditors, appointed by the Public Accounts Commission. The NAO's auditors also carry out value for money studies on the Office, the results of which are presented to the Public Accounts Commission, although not currently published.
- 5.68 In addition, the NAO noted that its own performance indicators appear in its Annual Report. The main ones are the amount of identified financial savings arising from the NAO's work compared to the cost of the NAO; the proportion of PAC recommendations accepted by Government; and the number of recommendations accepted by departments. Measurement of the effect of audit work is difficult, but the range of indicators used seems appropriate, reflecting the impact of the NAO's work.

¹⁴ Select Committee on Environmental Audit, First Report 2000/2001 'Environmental Audit: The First Parliament'.

5.69 Some have questioned how robust the figures for financial savings are, but NAO noted that they are agreed with departments, and are counted on a conservative basis to avoid the risk of exaggeration. There are also explicit rules governing the length of time over which specific savings could be counted towards the corporate total. The NAO also pointed out that the deterrent effect of the NAO and PAC's work - described by some as perhaps the greatest impact - could not be quantified and so was not included in the overall total. Qualitative improvements and non-quantified impacts were also recorded, but again not reflected in the savings total.

Professional quality control arrangements

5.70 As well as formal accountability arrangements, it is also important that the work of the NAO is subject to professional quality control arrangements. The technical quality of the C&AG's work is probably not something that parliamentary committees are best placed to comment on, and it is, therefore, appropriate that NAO arranges for this to be assessed by suitably qualified, independent examiners.

5.71 In its submission, the National Audit Office stated that it currently assures the quality of its financial audit work through a systematic process of peer review. It suggests that additional assurance could be provided to clients and Parliament from submitting its work to external assurance procedures and is currently discussing the possibility of NAO audit being subject to review by the Joint Monitoring Unit¹⁵ from 2001/02.

5.72 The C&AG's VFM reports are also subject to quality assurance arrangements. These include self-assessment by the team responsible, seeking the views of the organisations subject to examination by questionnaire, feedback from the Committee of Public Accounts, and an external assessment by contracted academics.

5.73 The external assessment work is undertaken currently by a broad group of specialist academics from the London School of Economics and Political Science, who assess each of the published reports against a set of agreed criteria and standards. They comment in detail on areas such as methodology, presentation, and the soundness of the recommendations and conclusions. Whilst there is inevitably a strong element of subjectivity in this, the NAO has recognised the benefits of independent expertise in helping to develop what remains a varied form of scrutiny. In its submission, the NAO has suggested that it will make the conclusions of the LSE's assessments available to departments to promote dialogue on the quality and usefulness of its work. These discussions will work best where full consideration is given to all the elements of assessment listed in paragraph 5.72.

The importance of communication and dialogue

5.74 Consideration of the accountability of the NAO raises the issue of the importance of good communication. Although the NAO produces considerable material about its work, the information available from the Public Accounts Commission - as the body overseeing the NAO - has been relatively limited. According to some departments, this has given rise to a perception that NAO is not subject to as rigorous a set of accountability arrangements as apply to departments. The lack of publicly available data on NAO's quality assurance procedures has led some departments to question whether they have sufficient assurance as to the quality of NAO's work in comparison to that of other auditors. There is no reason to doubt that NAO's work stands comparison with that of other auditors, but the recommendations below could help ensure that NAO's accountability procedures were more transparent, and so better understood.

5.75 Limited information can lead to misunderstandings about the role of the NAO and its work for Parliament amongst those with whom it has dealings. This can affect perceptions, for example, of how far the NAO is able to work with government bodies, and on the type of subjects that the C&AG chooses to examine. This underlines the importance for NAO as an organisation having sound strategies for communicating with all potential audiences.

Recommendations

The NAO's suggestion that its financial audit work be made subject to regular and routine scrutiny (perhaps annual) by the Joint Monitoring Unit is welcome as a significant step in providing an independent and more transparent overview of NAO's work. The idea should be taken forward and the conclusions could be made public.

Because of the nature of VFM work it is not subject to the same agreed explicit professional standards as can be applied to financial audit. Instead, the C&AG's reports are subject to several forms of assessment, including by seeking the views of the bodies subject to examination, and external assessment by academic specialists. The use of a panel of acknowledged experts, external to the NAO, is a sensible approach, even though there is an element of subjectivity in it, and the NAO's suggestion that the conclusions of these assessments be made available to audited bodies should be useful as part of a constructive dialogue between auditor and auditee.

It is a matter for the House of Commons Public Accounts Commission what information it decides to publish, but in the interests of transparency, and explaining the arrangements by which the NAO is held accountable, there may be scope for more information to be included in its reports. This might include information arising from the VFM reports on the NAO and from the Committee's annual examination of the NAO's own auditors.

¹⁵ The Joint Monitoring Unit (JMU) carries out regular and routine monitoring of the standards of audit work among member firms of the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland. Administratively the JMU is a part of the ICAEW's Professional Standards Office.

A

ANNEX

Review Methodology and Research

The Review of Audit and Accountability for Central Government was announced by the Chief Secretary to the Treasury on 28 February 2000. The Review was undertaken by a Project Team, and overseen by a Steering Group.

1. The Project Team

The Project Team was led by Lord Sharman of Redlynch, who was appointed in April 2000. He was assisted by John Breckenridge (on secondment from HM Treasury) and Jeremy Lonsdale (on secondment from the National Audit Office). The Project Team conducted research between September 2000 and January 2001. Legal advice was provided by Graham Johnston from Herbert Smith as necessary.

2. Composition of the Steering Group

The Steering Group, chaired by the Chief Secretary to the Treasury, met on four occasions, in July, October, and November 2000, and in January 2001. The Group discussed a series of issues related to the Review, and commented on draft papers and the final report. The membership of the Steering Group was:

Sir John Bourn KCB (Comptroller and Auditor General)
 Sir Bryan Carsberg (Secretary-General, International Accounting Standards Committee)
 Rt Hon David Davis MP (Chairman, Committee of Public Accounts)
 Professor Peter Hennessy (Professor of Contemporary History, Queen Mary and Westfield College, University of London)
 Professor Andrew Likierman (Head of the Government Accounting Service, HM Treasury)
 Mavis McDonald (Permanent Secretary, Cabinet Office)
 Ian Plaistowe (Chairman, Auditing Practices Board)
 David Rendel MP (Member - Committee of Public Accounts)
 Lord Sainsbury of Turville (Parliamentary Under Secretary of State, Department of Trade and Industry)
 Rt Hon Andrew Smith MP (Chief Secretary to the Treasury)
 Rosemary Thorne (Group Finance Director, Bradford & Bingley plc)
 Sir David Tweedie (Chairman, Accounting Standards Board)
 Rt Hon Alan Williams MP (Member - Committee of Public Accounts)

3. Review of existing work

The Project Team reviewed and drew on a range of published material. This included academic and other research into audit, accountability and regulation, publications of the Public Audit Forum, and documents published by HM Treasury, the National Audit Office, the Audit Commission, and other public and private sector bodies.

4. Interviews

The Project Team interviewed a range of people with an interest in, and knowledge of, aspects of audit and accountability. They were:

Ted Awty, Mollie Bickerstaffe and Mark Stock, Partners, KPMG
 Lord Barnett, former Chief Secretary to the Treasury and former Chairman of the Committee of Public Accounts
 Sir Michael Bichard, Permanent Secretary, Department for Education and Employment
 Chris Butler, Head of Audit Policy and Advice, HM Treasury
 Joe Cavanagh, Director, National Audit Office
 Jeremy Colman, Assistant Auditor General, National Audit Office
 Rt Hon David Davis MP, Chairman, Committee of Public Accounts
 Professor Patrick Dunleavy, London School of Economics and Dr Helen Margetts, University College, London (responsible for the external review of the NAO's VFM reports)
 Naomi Eisenstadt, Head of Sure Start Unit, Department for Education and Employment
 Paul Elliott, Principal Finance Officer, Ministry of Agriculture, Fisheries and Food
 Tamara Finkelstein, HM Treasury
 Andrew George, Clerk, and Julie Bragg, Deputy Clerk, Welsh Assembly Audit Committee
 Peter Gershon, Chief Executive, Office of Government Commerce, Peter Ryan, Head of Private Finance and Policy, and Bryan Avery, Principal Finance Officer
 John Gieve, Managing Director for Finance, Regulation and Industry, HM Treasury
 Brian Glicksman, Treasury Officer of Accounts and Glenn Hull, Second Treasury Officer of Accounts

Clare Harding and John Grewe, Companies Law Division,
Department of Trade and Industry

Robin Hertzberg, Concessions Director, Carillion plc

Nick Johnston MSP, Convenor, Audit Committee, Scottish Parliament,
and Arwell Roberts, Audit Scotland

Gavin Kelly, Secretary, Commission on Public Private Partnerships, IPPR

Leigh Lewis, Chief Executive, and Mark Neale, Finance Director,
Employment Service

Professor Andrew Likierman, Head of the Government Accountancy
Service, HM Treasury

Rachel Lomax, Permanent Secretary, Department of Social Security

David Macdonald, Controller and Auditor-General of New Zealand

John Mason, formerly Trillium plc

Caroline Mawhood, Assistant Auditor General, National Audit Office

John Mayne, Principal, Office of the Auditor General of Canada

Adrian Montague, Deputy Chairman, Partnerships UK

Sir Richard Mottram, Permanent Secretary, Department of
Environment, Transport and the Regions

Robin Owen, Head of Innovation and Risk Team, Modernising Public
Services Group, Cabinet Office

Dr Norman Perry, Chief Executive, Housing Corporation

Gary Pusey, Managing Director, Siemens Business Systems

Jamie Rentoul, Deputy Director, and Stephen Aldridge, Chief
Economist, Performance and Innovation Unit, Cabinet Office

Dr James Robertson, Director of Health Studies, National Audit Office

Rt Hon Robert Sheldon MP, Chairman, Public Accounts Commission

Martin Sinclair, Assistant Auditor General, National Audit Office

Nick Sloan, Director, National Audit Office

John Smith, Director of Finance, BBC

James Stewart, Chief Executive, Partnerships UK

Kevin Tebbit, Permanent Secretary, Ministry of Defence

Chris Turner, Head of Internal Audit, Department of Social Security

Nigel Turnbull, Lasmco plc

Michael Whitehouse, Director, National Audit Office (responsible for
the development of VFM work)

Robin Woodland, Head of Criminal Justice Joint Planning, Home Office

Sir David Wright KCMG, LVO, Group Chief Executive,
British Trade International

Dr Tony Wright MP, Chairman of the Public Administration Committee,
House of Commons

Phil Wynn-Owen, Head, Regulatory Impact Unit, Cabinet Office

Robin Young, Permanent Secretary, Department of Culture,
Media and Sport

5. Other evidence

In addition, the Project Team attended hearings of the audit committees at the Scottish Parliament in Edinburgh and at the Welsh Assembly in Cardiff. A visit was also undertaken to the Algemene Rekenkamer (the national audit office of the Netherlands) to discuss audit and accountability arrangements. We are grateful to Cor van Montfort, Annette Kruihof, Peter Millecam, Martin Dees and Herman Oosterhof for giving up their time. We are also grateful to Angela Hands, currently on secondment from the NAO to the Office of the Controller and Auditor-General in New Zealand as Assistant Auditor General, for providing information about developments in that country.

6. Written evidence submitted

The Project Team invited written evidence from a range of interested parties and individuals. The following submitted written evidence.

Accounting Standards Board

Audit Commission

Auditing Practices Board

Auditor General for Scotland

Auditor General for Wales

Mary Bowerman, University of Sheffield
(author of various papers on audit and accountability)

Chartered Institute of Public Finance and Accountancy

Rt Hon David Davis, Chairman, Committee of Public Accounts

John Garrett (former member of PAC and writer on audit
and accountability)

David Hencke, The Guardian

Higher Education Funding Council for England

HM Government

Kathryn Hollingsworth, Cardiff University and Fidelma White,
University College, Cork (authors of 'Audit, Accountability and
Government' published by Clarendon)

Institute of Chartered Accountants in England and Wales

KPMG

National Audit Office

National Housing Federation

PricewaterhouseCoopers

Public and Commercial Service Union

Rt Hon Robert Sheldon MP,
Chairman of the Public Accounts Commission

B

ANNEX

Key developments in central government audit in the United Kingdom

19th century

In 1861 the House of Commons Committee of Public Accounts (PAC) was created to examine on behalf of the House, 'the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit...':

In 1866 the Exchequer and Audit Departments Act was passed, requiring government departments to prepare appropriation accounts. The Act also created the post of the Comptroller and Auditor General, and established the Exchequer and Audit Department to assist him. The C&AG audited the departmental appropriation accounts required under the 1866 Act, and reported to Parliament.

Towards the end of the nineteenth century, the examination of the economy and efficiency of government expenditure, rather than just regularity, became a feature of the C&AG's work. This was undertaken with PAC support, rather than under any specific statutory authority.

Pre-World War II

The 1866 Act required the C&AG and his staff to examine every transaction, a task which became increasingly unrealistic as government activity expanded in the twentieth century. Consequently, the Exchequer and Audit Departments Act 1921 addressed this by allowing the C&AG to rely in part on departmental systems of control and thus only examine a sample of transactions in undertaking his work.

Post-war

The cost of World War II and the subsequent growth in public expenditure (with the creation of the welfare state) underlined the importance of ensuring that public funds were well spent. As a result, auditors developed their examinations into many aspects of government financial management, especially from the early 1950s. Between 1946 and 1983 the Exchequer and

Audit Department prepared more than 1,000 reports on a wide range of VFM issues including defence projects, contract control and pricing, civil works, roads and hospitals and assistance to industry.

1970s

In the late 1970s the role and function of the C&AG were considered by Parliament on several occasions. In 1977 the House of Commons Expenditure Committee commented on the need for modernisation of the system of public audit, as did the Procedure Committee around the same time. In 1979 the Committee of Public Accounts reported on the status and functions of the C&AG. The role of the C&AG was considered in a Government Green Paper in 1980, and in a subsequent PAC report in 1981.

1980s

The end result of the examination of the work of the C&AG was the National Audit Act 1983 - a private member's bill - which took effect in January 1984. The Act established the National Audit Office, provided for the staff to become employees of the C&AG, rather than civil servants, and gave statutory provision for the first time to value for money examinations. It also allowed the C&AG to present reports on individual subjects to Parliament at any time the House was sitting, and created the Public Accounts Commission to oversee the work of the National Audit Office.

1990s

During the 1990s the number of accounts audited by the C&AG grew as the number of public bodies expanded. The number of VFM reports published also increased to around 50 per annum and remained at that level throughout the decade. The subject matter of the work of the NAO expanded to encompass a range of new areas of government. The C&AG reported to Parliament, for example, on the work of executive agencies, the conduct of privatisations, contracts under the Private Finance Initiative, and aspects of the quality of public services.

Also during the 1990s, there were significant changes to the way in which audit was organised within the NAO and the skills employed for the work. Audit staff were required to specialise in either financial audit or VFM work. The NAO increasingly recruited specialists in areas such as statistics, economics, operational research and private finance, as well as those with sector specific knowledge and experience.

Following a recommendation in the 1997 White Paper 'The Governance of Public Bodies: A Progress Report', the Public Audit Forum was established. It was made up of the then four national audit agencies - the National Audit Office, the Northern Ireland Audit Office, the Audit Commission, and the Accounts Commission for Scotland - to provide a focus for developmental thinking in relation to public audit. The Forum has published a series of papers on aspects of audit and accountability.

Towards the end of the decade, there were a number of changes to audit arrangements as a result of devolution. The Scotland Act 1998, which established the Scottish Parliament, created the post of Auditor General for Scotland to audit the accounts of bodies funded by the Scottish Parliament. The Auditor General for Wales was created by the Government of Wales Act 1998 to audit the accounts of the Welsh Assembly and its sponsored bodies.

2000

In July 2000 the Government Resources and Accounts Act received Royal Assent. This provided for the introduction of resource accounts for government departments, and the Whole of Government Account, all of which are to be audited by the C&AG.

C ANNEX

Key developments in private sector corporate governance

A series of spectacular corporate failures and financial scandals in the late 1980s heightened concerns about the standard of financial reporting and accountability. In response to these concerns, the Committee on the Financial Aspects of Corporate Governance (the **Cadbury Committee**) was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession, under the chairmanship of Sir Adrian Cadbury. The terms of reference of the Committee were to consider the following issues in relation to financial reporting and accountability, and to make recommendations on good practice:

- (a) the responsibilities of executive and non-executive directors for reviewing and reporting on performance to shareholders and other financially interested parties; and the frequency, clarity and form in which information should be provided;
- (b) the case for audit committees of the board, including their composition and role;
- (c) the principal responsibilities of auditors and the extent and value of the audit;
- (d) the links between shareholders, boards and auditors; and
- (e) any other relevant matters.

The Committee's approach was to provide a framework for establishing good corporate governance and accountability. This was done through its Code of Best Practice (the Cadbury Code), which it put forward as a benchmark against which companies could be assessed. The Code embodied underlying principles of openness, integrity and accountability, which, according to the Committee, went together.

In response to the Committee's recommendations, the London Stock Exchange adopted as part of its Listing Rules the requirement for UK incorporated listed companies to include in their annual report and accounts, a statement as to whether or not they had complied throughout the period with the Code.

The Code was followed in 1994 by the **Ruttemann** guidance on internal financial control. Under this guidance, most listed companies had to review the effectiveness of internal financial control, and make a statement in their annual report to this effect. In 1995, following media interest about the amount of remuneration directors of large companies were earning, the **Greenbury** Committee published a report requiring various additional disclosures to be made in listed company accounts. These remuneration requirements were incorporated into the Listing Rules.

The **Hampel** Committee hoped to reduce the 'box-ticking' approach to governance which had surfaced, and so produced a report in 1998 which, following discussions with the London Stock Exchange, was tailored to form the Combined Code. From December 1998, the Combined Code has formed part of the appendix to the Listing Rules.

When the Combined Code was issued, the only guidance the directors had on internal control was the Rutteman guidance, which focused only on internal financial control, rather than the wider aspects of control as intended by Principle D.2.1 of the Combined Code. Guidance on this area was produced by the ICAEW's working party (commonly known as the **Turnbull** working party), which issued guidance on internal control in September 1999.

Where possible and practical, the principles of the Combined Code have been adapted for the public sector. For example, there is guidance on the establishment and remit of audit committees, disclosures relating to salaries and pension entitlements, and a requirement for a statement on the system of internal financial control (which is to be widened to statement on the system on internal control with effect from 2001/02). This is all in addition to existing Accounting Officer responsibilities, which overlap with some of the Code provisions for Directors.

D

ANNEX

Audit and accountability arrangements for central government bodies

Central government departments (including executive agencies and trading funds)

Accounts

- All Government departments are required to prepare accounts which are audited by the Comptroller and Auditor General and laid before Parliament.
- Up to and including the current financial year (2000/2001) these accounts have been cash based appropriation accounts, prepared under section 22 of the Exchequer and Audit Departments Act 1866 (the 1866 Act). From 2001/2002 these will be replaced by resource accounts prepared under section 5 of the Government Resources and Accounts Act 2000 (GRAA 2000).
- Financial information on executive agencies is included in the accounts of their parent departments (executive agencies remain an integral part of their department). In addition, executive agencies currently prepare accruals based accounts under section 5 of the Exchequer and Audit Departments Act 1921 (the 1921 Act). From 2001/2002 agency accounts will be prepared under section 7 of the GRAA 2000.
- Trading Funds prepare accounts under section 4 of the Government Trading Funds Act 1973 (the 1973 Act). This will continue after the move to resource accounting, although the form of the accounts will be changed to reflect the requirements of resource accounts.
- In addition to these main accounts, departments prepare a large number of other accounts for specific purposes. For example, these include the revenue accounts prepared by Inland Revenue and HM Customs and Excise, the accounts of the central funds (such as the Consolidated Fund and the National Loans Fund) and accounts for specialised activities

(such as the National Savings product accounts, Funds in Court account, National non-domestic rates accounts and many others). Such accounts are either prepared under specific legislation, or under section 5 of the 1921 Act or, in some cases, on a non-statutory basis. Under resource accounting, these accounts will continue, although in some cases they will now be published alongside the resource accounts as 'trust statements'. Section 7 of the GRAA 2000 gives the Treasury a general power to require departments to prepare accounts for specified purposes when this is deemed necessary.

Audit

- The Comptroller and Auditor General (C&AG) currently audits all appropriation accounts under section 22 of the 1866 Act and section 1 of the 1921 Act. He will audit resource accounts under section 6 of the GRAA 2000.
- Executive agency accounts are currently audited under section 5 of the 1921 Act, and from 2001/2002 will be audited under section 7 of the GRAA 2000. Trading Funds are audited under section 4(6) of the 1973 Act. The C&AG audits other departmental accounts either under the provisions of the legislation requiring the account to be produced or, where the account is prepared on a non-statutory basis, by agreement with the Treasury and the relevant department.
- The C&AG is also able, under the provisions of the National Audit Act 1983, to carry out value for money studies in all Government departments, executive agencies and trading funds.

Executive Non-departmental public bodies (NDPBs)

Accounts and audit

- Executive NDPBs are required to prepare accounts (although some smaller executive bodies are accounted for within their sponsor department and do not publish separate accounts). In most cases, the requirement to prepare accounts will be set down in the legislation governing the NDPB (which in the case of those NDPBs which are set up as companies will be the Companies Act)¹. In a few cases the requirement to produce accounts is non-statutory, but is required by Treasury guidance.
- Almost all NDPBs now produce accruals based accounts (in the case of those which are companies these must, of course, meet the requirements of the Companies Act), and it is intended that all remaining bodies should move to accruals accounts as soon as possible. NDPB accounts now fall within the remit of the Financial Reporting Advisory Board (which advises the Treasury on financial accounting matters), so that, although the requirements of resource accounting do not officially extend to NDPBs, they will in practice have to produce resource accounts.
- The accounts of all NDPBs are subject to audit and are laid before Parliament. Audit requirements are usually set out in the statute governing the body. These normally specify one of the following:
 - that the C&AG should be the auditor;
 - that the auditor should be appointed by the relevant Secretary of State (sometimes with the proviso that the auditor be a Companies Act auditor)²; or
 - that the auditor should be appointed by the body itself (most commonly found in the 'levy funded' bodies).
- NDPBs that are companies will appoint their auditors in accordance with Companies Act requirements. As the main shareholders in most NDPBs are the sponsoring ministers, this means that, in practice, most such bodies have their auditors appointed by the relevant Secretary of State.
- There are no statutory audit requirements for some bodies. In most of these cases, the C&AG audits by agreement with the Treasury and the sponsoring department.

- Where the C&AG is not the auditor of a body, he should nevertheless have inspection rights. These will enable him to gain access to a body to follow up issues of concern. Such rights also enable him to carry out value for money studies in these bodies.
- Some NDPBs have set up subsidiary companies (usually as trading arms). The results of such bodies are consolidated into the accounts of the parent NDPB. Because these bodies are companies, the C&AG cannot audit them. However, Government Accounting requires NDPBs to ensure that the C&AG has access.

NHS bodies and public corporations

Accounts and audit

- Individual NHS bodies prepare annual accounts, which are subject to audit by auditors appointed by the Audit Commission. Summarised accounts covering the whole NHS are compiled by the Department of Health and are audited by the C&AG.
- Other public corporations (including nationalised industries) will generally prepare annual accounts in accordance with normal commercial accounting practice. Private sector audit firms audit these bodies.

¹ A number of NDPBs (notably some of the museums and galleries) are charities and so are also bound by the accounting requirements of the Charities Act 1993.

² Even where there is no statutory requirement for the auditor to be a Companies Act auditor it is now normal practice to appoint such an auditor.