Financial Auditing and Reporting

1999-2000 General Report of the Comptroller and Auditor General

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 25-XIX Session 2000-2001: 28 March 2001

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Ordered by the
House of Commons
to be printed on 26 March 2001

LONDON: The Stationery Office
£0.00

Foreword

Foreword by the Comptroller and Auditor General

My General Report summarises the results of financial audit work undertaken by the National Audit Office over the last twelve months and highlights key issues arising from it. The objective of this work is to provide Parliament with independent assurance that accounts are properly prepared, and that income and expenditure has been applied for the purposes intended by Parliament.

In my report, I have described the progress made by departments on a number of important developments, most notably on the introduction of resource accounting and on developments in corporate governance.

On resource accounting, 1999-2000 was the first "live year", i.e. the first year for audit and publication of departmental resource accounts. I will be examining this important subject separately to inform Parliament on how departments have progressed since the 1998-99 dry-run year, and how they have tackled key issues. A synopsis of the current position is, however, included in this report.

In brief, the overall results of my audit of the resource accounts indicate an improvement on the part of departments, in terms of the number of "qualified" audit opinions compared to the opinions which would have been given on the dry run resource account. This improvement is to be welcomed, and it has been realised following substantial work on the part of both departments and the National Audit Office. There is, however, still much progress to be made. In particular, I remain concerned at an over-reliance on too few key personnel and a lack of technically competent supporting staff in departments to prepare accounts. This has contributed to a continuation of the trends which I have highlighted previously of the late submission of accounts for audit and some of them being of poor quality.

With regard to corporate governance, the most significant development during the year has been the proposal to extend statements on the systems of control to cover operational as well as financial controls. I have reviewed the progress made by government bodies as they consider how they will respond to this challenge. This very important development was preceded by a lengthy consultation period between the Treasury and departments to ensure both that the timetable for implementation was realistic, and that the application to the central government sector of the recommendations of the Turnbull Committee, which examined these matters in the private sector, was reasonable. I support the Treasury initiative to implement revised corporate governance requirements, and consider that this will provide departments with a firm basis on which to further develop their own risk management systems. For our part, the National Audit Office will look to work closely with the bodies that we audit to advise on the development of corporate governance arrangements and risk management processes. This is a subject to which I expect to return in future years' general reports, as departments progress to meet the challenge.

Lord Sharman's report on audit and accountability arrangements in central government, *Holding to Account*, was published on 13 February 2001. The report recognises the importance of strong and comprehensive accountability regimes for public money whilst considering issues such as audit cost and the effect of audit on risk taking. It puts forward a range of recommendations to improve the ability of Parliament to hold the executive to account, in part through updating my powers to audit or have formal access to a range of public bodies outside of my current remit. The report also makes a number of recommendations addressed to me and to the National Audit Office, designed to ensure that the most is made of audit findings and to provide enhanced scrutiny of the cost and quality of the National Audit Office's work, - for example a commitment to accepting the inspection regime of the Joint Monitoring Unit, the body responsible for monitoring the quality of audit work undertaken by member firms of the Institutes of Chartered Accountants in England & Wales, of Scotland, and in Ireland.

The report's recommendations were endorsed by the Committee of Public Accounts in its report (Sixth Report, Session 2000-01, HC 260). The implementation of these recommendations would, in my view, considerably enhance Parliament's ability to scrutinise the executive's use of public money.

Lord Sharman's report also recognises that performance measurement, and the validation of performance information, will be a key factor in improving accountability and achieving better value for money. The National Audit Office is working with the Treasury, Cabinet Office, the Office for National Statistics and the Audit Commission, in developing a strategy to assist in improving the public sector's management and use of performance information, including the development of a performance information framework setting out the general principles underlying high quality performance information.

I have continued to carry out independent validations of performance against key targets for individual agencies. In March 2001, I will be publishing a report reviewing the ways by which government departments measure their performance. The report focuses on the challenges and good practice arising from the introduction of Public Service Agreements, and is designed to provide Parliament with a view of emerging issues in performance measurement, while assisting departments by setting out key questions that they may wish to

consider as they develop and implement their Public Service Agreement targets and measures.

The National Audit Office continues to play a leading role in the wider auditing and accounting profession. The Public Audit Forum published two consultation papers during the year, Propriety and Audit in the Public Sector and Data Matching and the Role of Public Sector Auditors. The Forum has also undertaken a project on the audit implications of electronic service delivery, and will be looking at relationships between auditors and inspectors, and developments in corporate governance in the public sector. Staff from the National Audit Office also play a full part in the work of the Auditing Practices Board, the ICAEW and CIPFA. In particular, the National Audit Office played a key role in the preparation of a revised Practice Note, *Audit of Financial Statements of Public Sector Entities in the United Kingdom,* which will be published shortly by the Auditing Practices Board.

Through these and the various other ways set out in this report we enhance the assurance provided to Parliament from our financial audit work. We will continue to work to enhance the standards of accountability, financial management and governance in the future.

John Bourn
Comptroller and Auditor General

7 March 2001

National Audit Office
157-197 Buckingham Palace Road
Victoria
London SW1W 9SP

Report contents

Responsibilities of the Com

ptroller and Auditor General

1.1 The Comptroller and Auditor General has dual responsibilities. As Comptroller, he authorises the issue of public funds to government departments and other public bodies. As Auditor General, he is required to audit the accounts of all government departments, executive agencies and a wide range of other public sector bodies and to report the results to Parliament. He is also required to ensure that monies provided by Parliament have been used only for the purposes intended. In carrying out his work, he has regard to the propriety with which public funds and assets have been handled, and how public business has been conducted.

1.2 The Comptroller and Auditor General examines and certifes a variety of accounts, including:

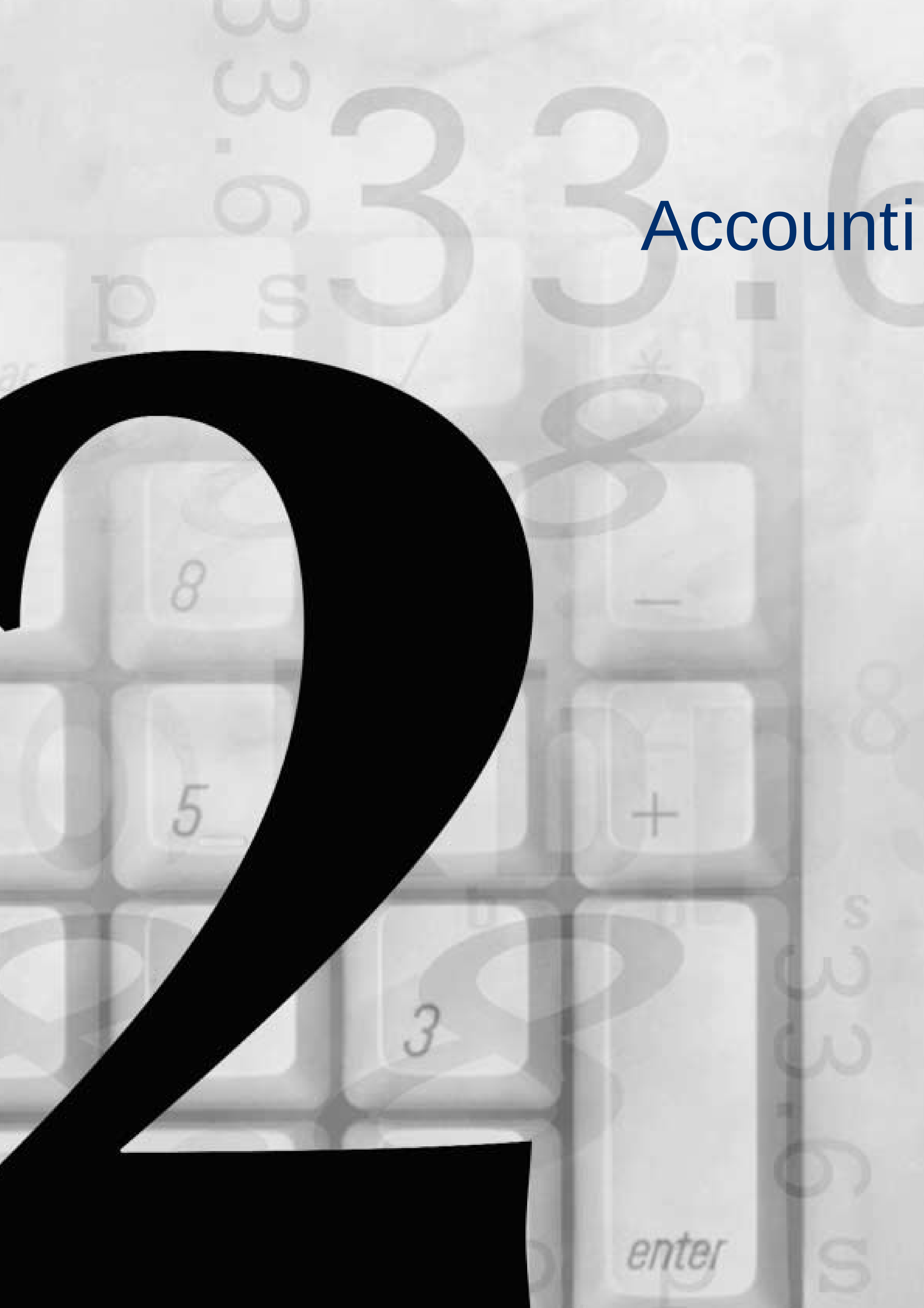
- appropriation accounts and resource accounts prepared by government departments;
- the accounts of executive agencies;
- accounts of the receipt of revenue by HM Customs and Excise and the Inland Revenue;
- National Loans Fund accounts;
- other accounts audited under statute; and
- accounts audited by agreement.

1.3 In addition to giving an audit opinion on the accounts, the Comptroller and Auditor General may bring other matters to Parliament's attention, for example those which relate to the proper use of public funds and the proper conduct of public business.

1.4 The National Audit Office undertakes the work necessary to support the responsibilities of the Comptroller and Auditor General. During the past year it audited the accounts of a large number of bodies varying in size and complexity, operating a variety of accounting systems, producing cash or accruals accounts and covering a range of central government spending programmes and other activities. In addition, it carried out examinations for the Comptroller and Auditor General on the accounts of the receipt of revenue, as required under section 2 of the Exchequer and Audit Departments Act 1921 and on stock and store accounts under section 4 of that Act. An analysis of the accounts audited by the Comptroller and Auditor General is set out at Appendix 1.

1.5 Appropriation accounts are the primary accounts in terms of departmental accountability for funds granted by Parliament, and record the expenditure and receipts of government departments. They are produced on a cash basis. The actual expenditure and receipts in 1999-2000 compared with those voted by Parliament are shown in Appendix 2. Appropriation accounts will be replaced by departmental resource accounts, as detailed in Part 6 of this report.

1.6 This report summarises some of the issues arising from financial audit work undertaken by the National Audit Office on the appropriation and resource accounts of government departments for 1999-2000, and on the accounts of executive agencies and other United Kingdom bodies certified by the Comptroller and Auditor General during the year to 31 January 2001.



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Accounti

ng & financial management

Introduction

2.1 The maintenance of proper financial systems is the responsibility of an organisation's management. This involves keeping appropriate financial records and, where applicable, following generally accepted accounting practices. In the central government sector it also involves designing, implementing and maintaining effective financial controls, which meet the fundamental requirement that public funds are used properly and only to the extent and for the purposes intended by Parliament.

2.2 The Comptroller and Auditor General's examination of annual financial statements includes an assessment of the adequacy of audited bodies' accounting systems, procedures and records to the extent he considers necessary for the effective performance of his audit. This assessment and the other audit work carried out on the accounting records may reveal limitations in the ability of audited bodies to prepare proper financial statements and identify weaknesses in the controls and procedures exercised within the accounting, management, and administrative functions. Weaknesses may also become apparent during the course of additional work undertaken to assess specific risks to regularity or propriety.

2.3 Where the Comptroller and Auditor General considers that a significant breakdown in financial control has occurred, he will report this matter to Parliament by means of a qualified audit opinion or a report on the accounts concerned. Other weaknesses identified during the Comptroller and Auditor General's examination are brought to the attention of management and the action necessary to achieve improvements is agreed with them.

2.4 Only a small proportion of accounts are qualified - some 1.9 per cent of those falling within the scope of this report compared with some 2.5 per cent in the previous year. But the qualification of accounts covering a large part of Social Security benefit spend means that qualifications cover a much greater proportion of government expenditure. A full list of the accounts qualified by the Comptroller and Auditor General is at Appendix 3. The Comptroller and Auditor General may also produce reports without qualifying his opinion, in order to bring to Parliament's attention matters that he considers appropriate. Appendix 4 lists the reports issued by the Comptroller and Auditor General during the year.

2.5 The audit work carried out by the National Audit Office indicates that the overall standard of central government accounting and financial control is satisfactory. However, there is a need for substantial improvements in a significant minority of bodies. The Comptroller and Auditor General will continue to work with these bodies in order to ensure their performance is improved to acceptable levels.

2.6 The remainder of this part of the report draws out the key findings of the National Audit Office from their financial audit work in the period covered by this report. This includes issues reported to Parliament and matters raised with the management of the bodies concerned. They are summarised under the following headings:

- financial management and the preparation of financial statements;
- regularity and propriety;
- developments in issues raised in previous years;
- positive reponses to management letters; and
- significant losses.

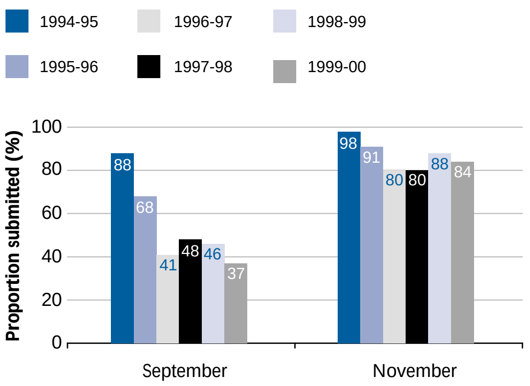
Financial management and the preparation of financial statements

2.7 To fulfil their responsibilities to Parliament, management need to ensure that financial statements are prepared properly and in good time; are supported by sound financial controls and accounting systems; and that the accounting process is managed and regularly monitored.

2.8 Management should also prepare financial statements and supporting accounting information on a timely basis in order to allow for the audit of the financial statements. As the Comptroller and Auditor General reported last year, it is an increasing concern that a significant number of government and executive agencies are not managing to meet this important element of accountability.

2.9 Government departments are required by statute to submit final signed appropriation accounts for audit by 30 November following the financial year ending 31 March. In practice, however, and to meet a commitment given to the Committee of Public Accounts to publish most accounts by the end of October, the Treasury expect departments to submit final accounts signed by the Accounting Officer by 30 September. By the end of September 2000 however, only 34 (37 per cent) of the 92 signed accounts expected had been received, and 15 (16 per cent) were submitted after the statutory deadline. Notwithstanding the slight improvement seen last year in the submission of accounts meeting the statutory deadline, the overall trend since the mid-1990s remains one of deteriorating performance (**Figure 1**). In the event all 1999-2000 appropriation accounts were audited and laid before Parliament by the end of January 2001, the statutory deadline.

1 Data of submission of signed appropriation accounts 1994-1995 to 1999-2000



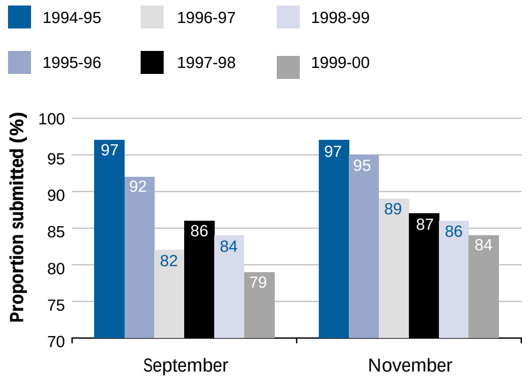
Source: *National Audit Office*

2.10 Executive agencies are subject to the same statutory deadlines as government departments, notwithstanding the expectation that they will normally be audited and laid before Parliament by the Summer Recess. But of the 96 accounts expected, 15 (16 per cent) missed the statutory deadline for submission of 1999-2000 accounts compared with 14 per cent in 1998-99 and just 3 per cent in 1994-95 (**Figure 2**).

2.11 The late submission of financial statements inevitably impacts upon the timing of the audit. This continues to represent a significant problem. Chief among the reasons for late accounts is an over-reliance on too few key personnel and a lack of technically competent supporting staff. This has caused particular problems with the implementation of resource accounts (see Part 6). Some of the other most common reasons for late accounts are:

- the need to devote time and resources to the production of resource accounts;
- problems resulting from the implementation of new accounting systems;

2 Data of submission of signed Executive Agency accounts 1994-1995 to 1999-2000



Source: *National Audit Office*

- resolving technical issues not previously encountered;
- slow responses from sponsoring departments or other government bodies; and
- extended deliberations regarding the application of new accounting or disclosure requirements.

2.12 A continuing factor that leads to difficulties for the audit process and delays in the certification of accounts is the poor quality of some financial statements rendered for audit. Whilst the Comptroller and Auditor General has recognised the effect that a move to more complex accruals-based accounts has had on the production of some financial statements, he is concerned that a number of fundamental weaknesses remain. Most notable is the failure by management to prepare and review accounts with sufficient scrutiny or attention to detail. This inevitably leads to the audit process being unduly taken up with the identification and correction of error that management should have prevented or detected in the first instance. Other common weaknesses that stem either directly or indirectly from insufficient management review are:

- a lack of reconciliations between information held on accounting systems and other records including bank accounts, payroll, debtors and creditors;
- unidentifiable balances held within suspense accounts or other areas;
- a lack of supporting evidence for certain transactions and deficiencies in the audit trail; and
- inappropriate accounting treatment in areas such as provisions, revaluations and fixed assets generally.

2.13 As highlighted above, a greater degree of ownership and review by management of their financial statements would enable many problems to be avoided. Specific examples include:

- six versions of the same supporting documentation were produced by one body before audit evidence on creditors was considered acceptable. Total audit adjustments amounted to over £17 million;
- income of £654,000 had to be written out of the accounts of one Agency when it was proved that invoices had been raised in error;
- one Department had excluded payments of almost £16 million in the last month of the financial year from their draft accounts;
- one body had an underspend of £10 million against its Estimate, despite seeking approval for additional spending of £1 million in the Winter Supplementary; and
- a lack of review prior to processing journal adjustments led to a prepayment being overstated by over £5 million.

Regularity and propriety

2.14 Weaknesses in financial management may reduce government bodies' ability to account properly for the use of public funds and increase the risk of error, fraud and impropriety. Such weaknesses can undermine the integrity of financial transactions that result in income or expenditure not being applied for the purposes authorised by Parliament or which do not conform to the authorities that govern them - that is, they are irregular. Propriety goes wider and is concerned more with Parliament's expectations as to the way in which public business should be conducted, and can involve standards of conduct, behaviour and corporate governance.

2.15 Cases where financial statements were qualified or reported on during the year because of concerns about the regularity or propriety of transactions are summarised below, together with issues raised with management. It is of particular concern that, in a number of cases, the Comptroller and Auditor General had qualified financial statements on a similar basis in previous years.

Child Support Agency: errors in child maintenance

2.16 The Comptroller and Auditor General again qualified his opinion on the Child Support Agency Client Funds Account because the results of examinations of representative samples of receipts from non-resident parents and outstanding maintenance balances allowed him to confirm the existence of material error. These results indicated that 49 per cent of receipts from non-resident parents were for the wrong amount and 77 per cent of full maintenance balances, and 57 per cent of interim maintenance balances, examined were incorrectly stated. The National Audit Office estimated that the £473.6 million received from non-resident parents in 1999-2000 contained overpayments of £8 million and underpayments of £51 million. Of the £521.4 million shown as collectable full maintenance assessment balances outstanding at 31 March 2000 the National Audit Office estimated that there were overstatements of £45 million and understatements of £102 million. Of the corresponding balance of £132.2 million for interim maintenance assessments, overstatements were estimated at £39 million and understatements at £7 million.

2.17 The Comptroller and Auditor General recognises there is a legacy of error due to the Agency's poor past performance which continues to affect amounts being paid in respect of child maintenance and the maintenance balances due.

Social Security: losses arising from errors in benefit awards and from fraudulent benefit claims

2.18 The Comptroller and Auditor General qualified his opinion on the Central Government Administered Social Security Benefits and Other Payments Appropriation Account (Class XII, Vote 1) for 1999-2000 because of a material level of irregular expenditure arising from errors in benefit awards and from fraudulent benefit claims. The Department had estimated that there had been significant losses in Income Support and Jobseeker's Allowance as a result of errors by officials, errors by customers and fraud amounting to £1.32 billion, which was 8.4 per cent of expenditure on these two benefits.

2.19 This is the twelfth consecutive year that the Class XII, Vote 1 Appropriation Account has been qualified because such losses are material. The Department of Social Security's target is to reduce the percentage of benefit losses from fraud and error in Income Support and Jobseeker's Allowance by 50 per cent by March 2006, with an initial reduction of at least 10 per cent by March 2002. Both targets are measured against a baseline of a loss of 9 per cent of expenditure on these two benefits in the twelve months to September 1998. The Department's estimate indicated that a reduction of 6.6 per cent had been achieved by 31 March 2000.

National Health Service: Fraud

2.20 The Directorate of Counter-Fraud Services has overall responsibility for all work to counter fraud and corruption within the NHS with particular priority for countering fraud in the Family Health Services. In respect of prescription fraud, in particular point of dispensing checks for non-age related exemptions, measurement exercises undertaken by the Directorate suggested an estimated annual loss to the taxpayer of £137 million (within a range of ± £15 million) had been reduced to £92 million (within a range of ± £12 million). The preventative and deterrent measures adopted by the NHS Executive to combat fraud will be factors in this reduction although it is not possible to separate these from other causes. These results were welcomed by the Comptroller and Auditor General and he will continue to monitor further progress.

Further examples of the scope of qualifications and reports

2.21 Regularity and propriety are not the only reasons why the Comptroller and Auditor General qualifies his opinion or reports on accounts. A selection of other examples that demonstrate the scope of such qualifications and reports, a number of which bring positive developments to the attention of Parliament are set out below.

Public Health Laboratory Service Board

2.22 The Comptroller and Auditor General reported on the 1998-99 accounts of the Public Health Laboratory Service Board following a breakdown of internal financial controls that occurred after the Board contracted out its central finance functions to CSL Ltd. The failure to perform timely and complete bank reconciliations, inaccurate accounting records for debtors and cash, and poor controls over payments for goods and the creation of creditors on the accounting system placed public funds at risk from error or fraud. In response to these problems, CSL Ltd initiated a recovery programme to improve financial controls and the Board employed extra staff to improve credit control. The Board also commissioned an external accounting firm to review all the major financial systems in place at CSL Ltd. The results of this review enabled the Board to report that they were confident that key controls had been put in place and were operating over all key financial systems.

2.23 As a result of additional work undertaken by the Board, CSL Ltd and the National Audit Office, the Comptroller and Auditor General was able to conclude that the breakdown in internal financial controls did not result in material misstatement within the Board's 1998-99 accounts. Accordingly, he did not qualify his opinion on the accounts.

National Health Service: clinical negligence costs

2.24 The 1998-99 Summarised Accounts for the NHS in England disclosed total potential clinical negligence liabilities of £2.4 billion, an increase of £0.6 billion on the previous year. This excludes the estimated cost of clinical incidents that have occurred but had not been reported by the balance sheet date. At the time of the Comptroller and Auditor General's report on the summarised accounts, the latest information from the Clinical Negligence Scheme for Trusts suggested that incidents since April 1995 were being reported earlier than previously predicted. The Comptroller and Auditor General expressed his support for the continuing work on improving the system for handling claims and minimising the risk of negligence and welcomed the developments that resulted from the consultation document "A First Class Service: Quality in the NHS".

HM Prison Service: lack of evidence to support the valuation of fixed assets

2.25 The Comptroller and Auditor General qualified his opinion on the 1999-2000 accounts of HM Prison Service due to the limitations placed on the scope of his examination of the valuation of fixed assets. There was insufficient evidence to ascertain whether the overall method of valuation used complied in all material respects with the requirements of Financial Reporting Standard (FRS) 15, nor was an audit trail showing adjustments to the valuation within individual prison establishments. Evidence of the external validation exercise required by FRS15 was also unavailable. Any adjustments to the valuation of land and buildings would have had a consequential effect on net operating costs for the year.

Fire Service College: activity based costing system

2.26 The Fire Service College is required by a Treasury Minute of March 1992 to ensure that the prices it charges to UK fire authorities and other Exchequer customers for courses do not exceed the full cost of providing those courses. The Comptroller and Auditor General was forced to qualify his opinion on the 1996-97 and 1997-98 accounts because he was unable to satisfy himself that the College had complied with the terms of the Minute because it did not have a reliable costing system at that time. The Comptroller and Auditor General was pleased to be able to remove the qualification for the 1998-99 accounts and report that this was due to the College's implementation of an improved activity based costing (ABC) system that enabled them to demonstrate their compliance with the terms of the Treasury Minute.

Developments in issues raised in previous years

2.27 Where bodies have agreed to address matters that have been reported to Parliament, the Comptroller and Auditor General looks again at the areas in question to review the action taken. In general, management respond positively to recommendations made by the Comptroller and Auditor General, and improvements in financial management are achieved.

Losses on Ministry of Defence IT projects

2.28 The Comptroller and Auditor General criticised the Ministry of Defence for their management of two abortive information technology projects in his report on the 1998-99 Class I Appropriation Accounts. The Common User Data System was to be a bespoke signal message handling system and was intended to replace teleprinters used for sending and receiving signal messages for the Royal Air Force. Continual problems prevented the system from becoming operational and it was terminated with costs of £21 million written off. The Pay Replacement System was intended to deliver the Royal Navy's pay and pensions system, unit based applications and associated infrastructure. Cost increases and projected delays coupled with a change in policy led to the suspension, running down and closure of the project. Of the £10.2 million spent, £1.5 million related to hardware and software that was used elsewhere in the Ministry of Defence. The remaining costs of £8.7 million were written off.

2.29 The Ministry of Defence has learnt significant lessons from these losses and has sought to address the weaknesses through adopting a policy of 'smart' procurement that involves purchasing off the shelf packages where this is possible. Projects are also staffed with experienced personnel and user requirements are being specified in a testable way. Developmental risks are transferred outside the Ministry of Defence, where such risk transfer is possible.

Misappropriation of funds

2.30 The Comptroller and Auditor General also drew attention to a fraud against the Army Pensions System. In a little over a year, a civil servant employed at the Army Personnel Centre, Glasgow paid into his personal bank accounts one-off payments amounting to over £470,000. An internal investigation by the Ministry of Defence identified a number of weaknesses in the operating procedures within the Pensions Division that contributed to the alleged fraud, including inadequate documented regulations, failure to monitor information reports detailing payments made, staff inexperience and inadequate staff rotation procedures.

2.31 The Ministry of Defence has now introduced new controls that include greater separation of duties, increased levels of financial report monitoring and tighter controls over the processing of ad hoc payments. The person concerned, who had been suspended from duty when the alleged actions came to light, received a four-year prison sentence in February 2000. Some £48,000 was recovered from the individual, and further action is in hand.

Positive responses to management letters

2.32 The National Audit Office reviews progress where limitations in controls and other issues have been raised with management. The following are examples of positive responses to National Audit Office recommendations:

- concerns were raised with one body over the adequacy of controls in place over its investment holdings and the completeness of its underlying records. These concerns included the need to ensure that share dividends held on the body's behalf by Registrars were adequately recorded. The body has now addressed these issues by introducing quarterly checks of its holdings and related records and obtaining Registrar confirmations;
- concerns were raised over the ability of one body to reconcile properly their record of funds distributed to other organisations with the returns received from those organisations. Minor errors generated in prior years had accumulated to unacceptable levels especially given the strict guidance laid down in Government Accounting on the control and management of suspense accounts. The body recognised the importance of ensuring all transactions are properly brought to account and further acknowledged the obligation of the Comptroller and Auditor General to report on such issues where they are not resolved. In response, the body undertook a separate exercise to circularise those organisations that it funded that enabled the (net) reconciliation difference of £6 million to be eliminated; and
- the National Audit Office raised concerns with one body regarding the failure in controls that had enabled a payment to be processed which had already been refused approval by the body's own finance department after consultation with both the National Audit Office and Treasury regarding its regularity. Further intervention was necessary before the payment was stopped. The body reviewed their safeguards and issued further guidance to staff reminding them of the procedures for dealing with abnormal payments.

Significant losses

2.33 Chapter 36 of Government Accounting refers to losses and special payments and explains how these are transactions of a type which Parliament cannot be supposed to have contemplated. Accordingly, they are subject to special control procedures and to special notation arrangements in the appropriation account or (for non-Vote financed operations) other relevant accounts, to ensure that they are drawn to the attention of Parliament.

2.34 It remains the duty of the Accounting Officer to ensure that funds are applied only to the extent and for the purposes authorised by Parliament and to safeguard public funds and property. Losses are written off or special payments authorised only where departments have satisfied themselves that there is no feasible alternative.

2.35 In the past twelve months, over £1 billion of losses and special payments have been reported. A significant proportion of this relates to the losses in respect of excise diversion fraud (see Part 4 of this report). It should be noted that these figures do not in all cases represent cash losses. Of the remainder, the majority comprises a small number of cases in which losses and special payments are individually in excess of £5 million. Examples include:

- a loss of £127 million caused by the abandonment of a project which left elements of a new system redundant;
- the write-off of £22 million of previously unreported losses when an error in the recording system was identified;
- a special payment of £19.5 million in respect of compensation for delayed payments of age-related rebates made to pension providers on behalf of their clients;
- two cases totalling £19.1 million where unreconciled suspense account balances have had to be written off ;
- a special payment of £15 million of interest following a Court of Appeal judgement; and
- the write-off of £7.3 million of additional expenditure incurred on a contract secured to construct a road for a dependent territory of the UK.

Corporate governance

Introduction

3.1 The Comptroller and Auditor General noted last year that the most significant development in corporate governance had been the introduction by central government bodies of statements by the Accounting Officer on the system of internal financial control which included, where appropriate, details of significant weaknesses and the action being taken to address them. The Comptroller and Auditor General also recognised that a future key challenge would be the likely extension of these statements to cover operational as well as financial controls, thereby mirroring in substantial part the recommendations of the Turnbull Committee that had examined these matters in the private sector.

3.2 This year, in considering the further progress made by government bodies to embrace corporate governance, the Comptroller and Auditor General has focussed his attention on:

- review of statements on the system of internal financial control;
- the implementation of the recommendations of the Turnbull Committee in central government;
- the role of the National Audit Office in promoting corporate governance;
- the challenges in raising the standard of corporate governance; and
- audit committees.

Review of Statements on the System of Internal Financial Control

3.3 Although some bodies did experience difficulties with the requirements to produce a statement by the Accounting Officer on the system of internal financial control, the vast majority of government bodies complied fully. The Comptroller and Auditor General referred in his last General Report to the benefits in terms of improved accountability and standards of corporate governance that had been brought about by the requirement to prepare these statements and the work of the National Audit Office in reviewing them. These included:

- an increased awareness of internal controls and control weaknesses and risk management among Accounting Officers and senior management;
- a better appreciation of the benefits of a strong internal audit function; and
- an increased profile for audit committees.

3.4 The Comptroller and Auditor General's review of the 1999-2000 statements on the system of internal financial control confirms that, in general, these benefits are ongoing and that the importance of sound corporate governance and robust internal control is increasingly acknowledged by the senior management of audited bodies.

Implemention of the recommendations of the Turnbull Committee in central government

3.5 The "Turnbull Committee" published its report in September 1999, setting out guidance on internal control requirements of the Combined Code for listed companies. Its recommendations, particularly that which required corporate governance statements for listed companies to encompass internal controls generally rather than just internal financial controls, prompted the Treasury to consider how the principles behind the recommendations could be usefully applied to central government bodies. For 1999-2000 accounts, the Treasury amended the standard form of wording for statements on the system of internal financial control to include a reference that Accounting Officers were aware of the recommendations of the Turnbull Committee and were taking reasonable steps to enable them to comply with the Treasury's requirement for a statement of internal control to be prepared.

3.6 In December 2000 the Treasury issued further guidance for central government bodies in the form of a *'Dear Accounting Officer' letter, Corporate Governance: Statement on Internal Control* (DAO (GEN) 13/00) together with detailed guidance *Management of Risk - A Strategic Overview* (known more generally as 'the Orange Book'). This requires Turnbull style statements to be published with 2001-02 accounts onwards, although it recognises that some bodies may need to do further work before all relevant risk management and review processes are fully in place. By 2003-04, however, all central government bodies will be required to publish full internal control statements.

3.7 Examples of the positive steps that government bodies have already taken to meet the requirements of the Treasury in respect of the wider statement of internal control are:

- setting up seminars, courses and workshops to increase awareness and understanding of key issues and promote discussion on the identification and management of business risks;
- the establishment of risk audit committees, risk management sections and working groups specifically tasked to address business risks and develop risk management strategies;
- the introduction of risk registers in which to record identified problem areas, consider mitigating controls and allocate responsibilities for risk management;
- the development of frameworks designed to clarify the roles and responsibilities of staff with mandatory training for those with financial responsibilities; and
- operating control risk self-assessment workshops to establish a sound foundation for the management of lower level and operational risks.

3.8 In some cases, these steps have generated further benefits, such as management providing clear leadership and proactive strategic management and facilitating a change in focus of internal audit work from traditional cyclical audits to a more risk-based approach.

The role of the National Audit Office in promoting corporate governance

3.9 The National Audit Office has participated in the development of the Treasury and Cabinet Office initiatives and worked with the Treasury on how best to adapt the Turnbull recommendations for application in the public sector. The Treasury guidance includes a statement from the National Audit Office setting out its basic approach to the examination of the internal control statement.

3.10 For 2000-01, the Comptroller and Auditor General will continue to perform a review of the statements on the system of internal financial control and his audit certificate will report whether the statement reflects the body's compliance with Treasury's guidance and the required disclosures specified by Treasury, or if the statement is misleading or inconsistent with the information he is aware of from his audit of the financial statements.

3.11 A similar approach will apply to statements of internal control from 2001-02 accounts onwards. The methodology for this review will be similar to that adopted for the statements on the system of internal financial control and will relate to the processes that audited bodies have put in place to support the statement made by Accounting Officers, together with an overall knowledge of the organisation based on the audit. In particular, this will include:

- consideration of whether disclosures are consistent with the National Audit Office's review of board and committee minutes and its knowledge of the audited body obtained during the audit;
- National Audit Office attendance at audit committee meetings at which corporate governance, internal control and risk management are considered; and
- consideration of the process adopted by the Accounting Officer for their effectiveness review, and of the documentation prepared to support their statement.

3.12 In addition the National Audit Office's audit methodology is a risk-based approach, involving the development of a comprehensive understanding of the audited body's business, the risks that it faces and how those risks are managed. This should provide a sound base for consideration of the internal control statement and opportunities to make recommendations for improvements to internal controls.

3.13 Drawing on the wider work of the National Audit Office, with regard to the Cabinet Office initiatives on risk management, the Comptroller and Auditor General's published a report - *Supporting Innovation - Managing Risk in Government* - in August 2000 (HC 864, Session 1999-2000). This was intended to help departments with their risk management frameworks by highlighting common failings in the risk management process and by providing examples of good practice.

The challenges in raising corporate governance standards

3.14 In seeking to raise standards of corporate governance, central government bodies face a number of challenges. These include:

- how to overcome problems where they do not have direct control over expenditure (for example cross-departmental programmes);
- determining the extent of information needed to support the statement's requirements;
- introducing a more structured approach for providing evidence to the Accounting Officer to support the statement; and
- developing procedures to address the implications of third-party contractors discharging significant portions of a body's functions.

3.15 In reviewing and reporting on statements on the system of internal financial control in 1999-2000 accounts the National Audit Office also noted that it is important that bodies are proactive in meeting the challenges posed by the need to raise standards of corporate governance. There can also be a tendency to be overly reliant on the role and work of internal audit to provide Accounting Officers with assurances that enable the statement on the system of internal financial control to be prepared. Whilst the assurances provided by internal auditors are a key contribution in this area, they form only part of those required.

3.16 In recognition that some bodies may need to do further work, Treasury provides for the statement to contain descriptions of such planned further work for statements of internal control made in 2001-02 and 2002-03.

Audit committees

3.17 Audit committees advise the Accounting Officer of an organisation on the adequacy of audit arrangements (internal and external) and on the implications for the organisation of assurances provided in respect of risk and control.

3.18 In relation to the development and production of statements on the system of internal financial control and preparation for Turnbull, the indications are that the influence of audit committees varies considerably. In part, this reflects the disparity noted in the Comptroller and Auditor General's 1998-99 General Report in the role of audit committees in many of the larger departments and organisations compared with that observed in smaller bodies. In many cases audit committees are playing a leading role and acting as a driving force for progress. But there are others where the committee's influence remains small, often relying too heavily on the work of internal audit alone. In a number of cases, audit committees are either newly formed and have yet to make an impact, or have not been established at all.

3.19 From the National Audit Office's contact with audit committees it is clear that a number of factors can contribute to their effective operation. These include:

- comprehensive, documented terms of reference, including a remit to consider the adequacy of risk management and internal control, and corporate governance issues;
- considering the work of internal and external audit; and
- regular meetings at least three times a year, with internal and external audit attending.

Audit of receipts of revenue

4.1 The accounts of the receipts of revenue by government departments are examined under section 2 of the Exchequer and Audit Departments Act 1921. The Comptroller and Auditor General is required to examine these accounts on behalf of the House of Commons in order to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue. He also examines whether such regulations and procedures are being duly carried out. In addition, he is required to carry out any such examinations as he thinks fit with respect to the correctness of sums brought to account and, together with a report on the appropriation accounts of the department concerned, report to the House of Commons.

4.2 The results of the examination for this reporting year were satisfactory for the Inland Revenue (Class XVI, Vote 4). However, because of his continuing investigation into diversion frauds (see paragraphs 4.7 to 4.9 below) the Comptroller and Auditor General has not been able to conclude his examination for HM Customs and Excise (Class XVI, Vote 3).

4.3 In accordance with directions given by the Treasury, summarised financial statements of receipts and payments are published in the respective annual reports of HM Customs and Excise and the Board of Inland Revenue. The Comptroller and Auditor General audits these financial statements and issued an unqualified opinion on each Department's accounts for 1999-2000. However the Certificate and Report in respect of the HM Customs and Excise accounts made reference to the details of diversion fraud.

HM Customs and Excise

Receipts

4.4 Net revenue receipts rose by 4 per cent over the previous year to £97,700 million. This total includes customs duties (£1,700 million) and agricultural levies (£300 million) which form part of the United Kingdom's contribution to the European Communities' budget. The main increases in revenue were for the two largest taxes, VAT and Hydrocarbon Oils. Net VAT receipts rose by 8.5 per cent to £56,800 million, and Hydrocarbon Oils receipts increased by 4.5 per cent to £22,500 million.

4.5 There was a significant decrease in Tobacco Duty receipts of 31 per cent, a reduction of £2,500 million to £5,700 million. This was as a result of higher duty rates leading to price increases, but also the effect of some companies having (legitimately) paid the equivalent of six months tax in advance of budget increases towards the end of the prior accounting period (1998-99) called "forestalling". Receipts were also affected by tobacco smuggling. Landfill Tax receipts also rose by 29 per cent over the previous year to £430 million due to a tax rate increase from £7 to £10 per tonne from April 1999.

4.6 The Department's net expenditure in 1999-00 was £881 million, £22 million higher than in the previous year. Costs of collection (compared to net revenue receipts) were therefore 0.90 per cent (1998-99 0.91 per cent).

Excise diversion fraud

4.7 On 1 June 2000, the Chairman of HM Customs and Excise informed Treasury Ministers that a series of excise diversion frauds between 1994 and 1998 appeared to have been mishandled. He had commissioned an internal review to investigate the matter. The weaknesses in controls over the collection of duty and the failings of Customs' management had contributed to the loss of substantial amounts of revenue estimated at around £668 million from diversion on to UK markets. A further £216 million was lost resulting from diversion on to overseas markets where duty would have been due in the country of import had the goods not been fraudulently diverted.

4.8 Although Customs became aware of the threat of outward excise diversion frauds as early as 1994 they did not take effective action to curtail these frauds until 1998. About half of the revenue could have been protected if fraudulent consignments had been intercepted rather than letting the investigations continue in order to obtain sufficient evidence to prosecute those involved or if effective action had been taken earlier.

4.9 Customs have undertaken a number of internal reviews on the revenue losses from excise diversion which have been examined by the National Audit Office. They have now produced an action plan to improve their controls over the collection of excise duty and the Comptroller and Auditor General will be reporting further to Parliament on the causes and lessons to be learnt in this case. The Comptroller and Auditor General's Report (HC 25-XVI, Session 2000-01: Departments of the Chancellor of the Exchequer), published on 9 February 2001, gives full details.

Review of key accounting functions and selected local offices

4.10 The Comptroller and Auditor General found that controls were operating satisfactorily in these areas but there were significant issues which he brought to the attention of management. These included:

- weaknesses in the way that departmental standards have been applied to some traders and which ensure that they have systems and procedures in place to record and pay taxes at the right time;
- problems on repayments to traders of default interest on under-declarations of VAT;
- the need to improve checks by Customs on consignments imported from outside the European Union which ensure that the correct amount of duties have been paid by importers; and
- the need for improved procedures to ensure that potential liabilities and provisions have been properly considered, recorded and reported in the accounts produced by the Department.

The Landfill Tax Credit Scheme

4.11 The operation of the Landfill Tax Credit Scheme and the Landfill Tax from which credits can be deducted has been the subject of considerable Parliamentary and media interest, especially about the effectiveness of the scheme and the projects paid for by contributions from Landfill site operators i.e. the tax foregone. The operation of the Scheme involves complex and novel arrangements between the private and public sector. A key part of Customs' role is to ensure that Entrust, a private sector company limited by guarantee, is fulfilling its role of regulating the Credit Scheme.

4.12 Payments for projects that fall within the Scheme's rules do not count as public expenditure which makes external examination of the value for money achieved by the scheme difficult for anyone to assess. The Comptroller and Auditor's examination covered how Entrust regulate the scheme and Customs' monitoring of Entrust's activities as regulator of the Scheme. Although the he was satisfied that Entrust fulfils its duties satisfactorily, he concluded that there were some fundamental weaknesses in the design of the scheme and made recommendations on the way Entrust can improve its review of projects and enrolled environmental bodies and in the way Customs monitor Entrust.

Developments in corporate governance

4.13 In line with other central government departments, Customs produce a Statement on Systems of Internal Financial Control for the two accounts which record their administrative expenditure (the Appropriation Account records voted cash administrative expenditure and the Resource Account shows resources utilised on an accruals basis). This statement confirms that the Accounting Officer has satisfied his responsibility to ensure that effective management systems, including financial monitoring and control systems, have been put in place.

4.14 In June 2000, Treasury issued guidance extending this requirement to all accounts that have to be laid before Parliament for the 1999-2000 financial year. However, departments were allowed to defer the application of this guidance until the year ending 31 March 2001 if the required systems were not in place for the year ending 31 March 2000. The Department have chosen to extend the scope of their Statement on Systems of Internal Financial Control to cover their Resource Account. However, they do not plan to widen the statement to cover the systems in place for the assessment, collection and allocation of revenues until the 2000-01 financial year, because the timing of the Treasury's guidance meant that they were not in a position to retrospectively seek evidence about the internal financial controls relating to revenue systems in operation throughout 1999-2000.

Other Reports on the work of Customs and Excise

4.15 The Comptroller and Auditor General also examines the economy, efficiency and effectiveness with which Customs and Excise have used their resources under section 6 of the National Audit Act 1983. The results of these value for money examinations are published in separate reports to the House of Commons under section 9 of that Act. Since the Comptroller and Auditor General's last report on the Department's systems and procedures (HC11-XVI, Session 1999-2000), he has reported on Improving VAT Assurance (HC15, Session 1999-00), on Revenue from Gambling Duties (HC352, Session 1999-00) and on Regulating Freight Imports from Outside the European Community (HC 131, Session 2000-01). Other reports where there has been coverage of Customs and Excise include: Good Practice in Performance Reporting in Executive Agencies and Non-Departmental Public Bodies (HC272, Session 1999-00) and Supporting Innovation: Risk Management in Government Departments (HC864, Session 1999-00).

Inland Revenue

Collection of tax in 1999-00

4.16 Net receipts of revenue in 1999-00 amounted to £139.3 billion, some nine per cent higher than in the previous year. Net receipts of income tax, corporation tax and stamp duty increased by £6.4 billion, £4.4 billion and £2.3 billion respectively.

4.17 In 1999-00, the Department spent £1.84 billion on assessing and collecting tax. The cost of collection, as a percentage of net tax receipts, was 1.32 per cent, slightly lower than in the previous year.

Processing of PAYE tax records

4.18 Under PAYE arrangements, employers are required to deduct tax and National Insurance contributions from their staff's earnings and pay over these sums to the Inland Revenue. At the end of each tax year, employers are obliged to complete a return for each employee showing the gross amount earned and the total amount of tax and National Insurance deducted.

4.19 The Inland Revenue cleared the PAYE tax records of one million people without knowing whether they had paid the correct amount of tax in respect of 1997-98 because of difficulties in processing employers' end of year returns. The Department believes that the processing difficulties have now been resolved, but will not know for sure until it has completed work on processing 1998-99 end off year returns.

4.20 The Inland Revenue is conducting a fundamental review of their systems. This needs to be completed quickly to provide assurance on the completeness and reliability of the entire process, particularly as the systems will have to cope with additional information on tax credits and collection of student loan repayments from 2000-01.

Tax credits

4.21 In the 1998 Budget, the Chancellor of the Exchequer announced the introduction of working families' tax credit and disabled person's tax credit as part of the government's programme of tax and benefit reforms to make work pay. The tax credits are designed to enable working families and disabled people to receive financial assistance through the tax system rather than through social security benefits.

4.22 In the first six months of the new tax credits scheme, the Inland Revenue paid out more than £1 billion to around one million applicants. The Department is continuing to strengthen the controls necessary for the effective operation of the scheme. The Department should continue to refine its approach to managing the risk of erroneous or fraudulent applications and improve the assurance it obtains about the reliability and accuracy of the substantial amounts paid out of tax revenue.

Construction industry scheme

4.23 The Department estimated that abuse of the previous system for collecting tax and National Insurance contributions from individuals working in the construction industry was costing the Exchequer in excess of £100 million each year through non-declaration of taxable income and from false claims for repayment of tax deducted at source. Some sub-contractors also claimed benefits while working. Ministers therefore decided to strengthen the arrangements.

4.24 The main changes introduced under the construction industry scheme, which became operational in August 1999, included:

- tighter rules governing the entitlement of individuals to a tax certificate allowing them to be paid without deduction of tax at source;
- the introduction of a registration card for subcontractors who are not entitled to be paid without deduction of tax at source;
- a requirement for contractors to send vouchers detailing payments made under the scheme to the Inland Revenue each month; and
- new powers for the Inland Revenue to penalise contractors who use unregistered subcontractors.

4.25 Introduction of the new construction industry scheme in August 1999 has led to the identification of around 100,000 people not previously registered with the Department, and produced an estimated £280 million extra tax receipts in 1999-00. But there were some teething troubles, particularly with the issue of registration cards and tax certificates to over one million contractors and subcontractors in the industry and in managing the issue and receipt of returns from taxpayers. As a result, the Department has temporarily scaled back planned work to reconcile tax paid with contractors' returns. These difficulties have increased the risk of fraud and error remaining undetected in the early stages of the scheme, when procedures are settling down and systems are at their most vulnerable. The Department is working to resolve these difficulties.

Employer compliance

4.26 As part of its strategy to encourage employers to comply with their legal obligations relating to the operation of the PAYE and National Insurance schemes, the Inland Revenue carries out compliance reviews on employers' premises. The main objectives of these reviews are to:

- encourage and improve compliance with the law;
- identify and put right non-compliance; and
- recover any unpaid tax and National Insurance contributions.

4.27 Following a Committee of Public Accounts report in 1998, the Inland Revenue has made a number of improvements to the way it checks employers' compliance with PAYE regulations. The transfer of the Contributions Agency in April 1999 streamlined the way that checks on tax and National Insurance contributions are carried out. But this, and other organisational changes, have affected the level and quality of work, and there is further scope to target resources on higher-risk employers. Having completed a major reorganisation in April 2000, the Department is now in a position to address these issues.

Audit of assets

5.1 The examination of assets held by public bodies takes a number of forms. Where public bodies produce accounts on an accruals basis, assets included in the balance sheet are covered by the National Audit Office's normal audit procedures and the associated opinion on the financial statements. In addition, section 4 of the Exchequer and Audit Department Act 1921 requires the Comptroller and Auditor General to examine stock and store accounts on behalf of the House of Commons. This examination enables him to confirm whether adequate regulations have been made and enforced for control and stocktaking, and whether the Treasury requirements have been met. The National Audit Office also undertakes reviews of the custody and control of assets with particular reference to risks to propriety and regularity. Where weaknesses or risks are identified, these are notified to management.

5.2 The Comptroller and Auditor General gave an unqualified stores report under section 4 of the Act for 1999-2000 (Appendix 5) although the National Audit Office's work identified a number of specific matters which were reported to the management of the relevant organisation.

5.3 The implementation of resource accounting, and the growth in the number of executive agencies and other bodies required to produce accruals accounts, continues to increase the importance of accounting for fixed assets within central government bodies.

Asset registers and inventories

5.4 The existence and maintenance of asset registers and inventories are a critical prerequisite to enable bodies to exercise effective control over their assets. They are also an important source of evidence for the amounts shown in the financial statements. Last year, the Comptroller and Auditor General reported that how the National Audit Office had identified a number of cases where effective asset registers and inventories were not being maintained and went on to provide examples of the positive recommendations for improvement that had been made to audited bodies.

5.5 As in previous years the National Audit Office have found a number of cases where asset registers and inventories require development in order to enable the relevant bodies to exercise effective control of their assets. The continued existence of such cases remains a cause for concern. Common themes are:

- problems associated with reconciling locally maintained records to centrally held registers;
- an inability to reconcile asset registers to information held on accounting systems;
- a failure to update asset registers on a timely basis; and
- weaknesses in the labelling of assets

5.6 Specific examples of these themes include:

- Difficulties experienced in one department in agreeing the details of almost £145 million of fixed assets recorded on its central register to physical assets held. Whilst directorates maintained inventories sufficiently detailed to allow reconciliation to assets held, these local inventories could not readily be reconciled to the central register; and
- an Agency failed to record additions of information technology assets totalling some £1.8 million on their asset register, and thus omitted them from their draft accounts. Clearer guidance for staff involved in the purchase and management of fixed assets was recommended.

Custody and verification of assets

5.7 A comprehensive and regular verification of assets and stores against records found in asset registers and inventories is an important part of a sound internal control framework. This helps properly manage this important area and ensures the accuracy of the values of assets recorded in the accounts. An additional benefit is that weaknesses in the custody of assets can be highlighted, either in general or in relation to particular locations or asset types.

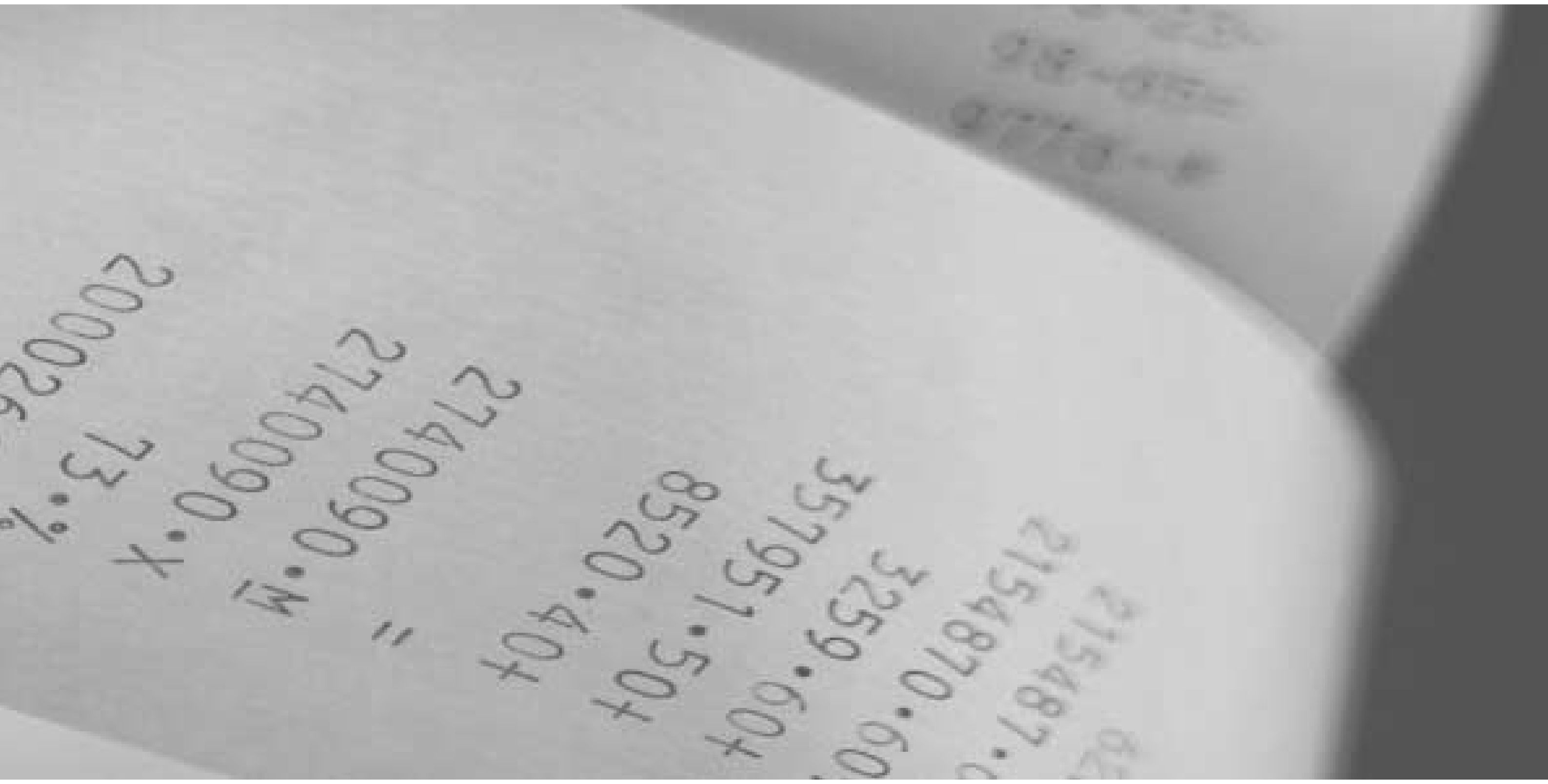
5.8 The National Audit Office found a small number of instances where development of stock control and physical security is considered necessary in order to ensure the effectiveness of these controls. Although issues relating to the need for regular stocktaking and improvements in investigating discrepancies have emerged again this year, it is encouraging that the number of instances appears to be diminishing. The National Audit Office did, however, identify other weaknesses in the verification of assets and made further recommendations for improvement. Common issues were problems associated with new accounting systems and a lack of matching physical assets to original purchase orders.

5.9 Examples of weaknesses in the custody and verification of assets include:

- almost 11 per cent of one Agency's cost centres failed to complete a stocktaking return. Furthermore, following a stocktaking exercise, one cost centre, listed as having 36 assets, found that 35 of these were either lost or stolen;
- a £90 million discrepancy between the actual holdings of assets on the ground and the records maintained on the fixed asset register within a large department; and
- in another body, it was found that some £4 million worth of spares had been double-counted as they were already included within the balance of a related but separate organisation.

Valuation of fixed assets

5.10 In accordance with Treasury guidance, for those bodies that prepare accruals accounts assets must be valued with reference to current costs. This necessitates an annual exercise to restate the value of assets based on a number of alternatives, for example professional valuations by an appropriately qualified person such as a surveyor, the use of appropriate cost indices or reference to replacement cost from suppliers' price lists. The requirement to value assets on a current cost basis can create problems, particularly the treatment of depreciation. Other problems arise from inappropriate accounting policies for assets and a failure to apply accounting policies on a consistent basis. In addition, the introduction of the Financial Reporting Standard (FRS) 15 has required government bodies to revisit the manner in which they account for, value and control their tangible fixed assets. For some bodies, this represents a significant challenge.



5.11 The National Audit Office made a number of recommendations for strengthening controls and procedures over the accounting for, and valuation of, assets. Examples of the issues raised include:

- working with a department to develop a methodology for valuing a substantial asset based on future income streams. Following an initial examination of the detailed calculations by the department's internal audit, management reassessed the treatment of inflation in the valuation and agreed with the National Audit Office a reduction of some £200 million;
- providing guidance to a department on determining an appropriate policy and methodology for valuing furniture and fittings in offices that are currently valued at £105 million using a standard cost per square metre;
- ensuring one department undertakes regular valuations of over £100 million of land and buildings in accordance with the provisions of Financial Reporting Standard 15;
- advising an Agency of the correct accounting treatment for downward revaluations below historic cost after some £23 million had been netted off the revaluation reserve rather than being correctly charged to the operating cost statement;
- continuing to monitor the progress a major accounting unit within a large department is making to confirm the accuracy of the valuation of land and buildings where potential understatements of £14 million have been identified; and
- cautioning an Agency against the capitalisation of £8 million of revenue expenditure.

6 Resource accounting

and resource-based Parliamentary Supply

6.1 Resource accounting is an accruals-based means of financial reporting being introduced in all government departments. It is intended to reinforce the planning and control of Government spending and help improve departmental management. It is also intended to improve departments' accountability to Parliament through the more comprehensive financial information it will provide.

6.2 In parallel with the introduction of resource accounting the Government asked Parliament to agree to change its wholly cash-based approach to departmental funding to one in which it approved accruals-based current expenditure limits as well as overall cash funding. Such 'resource-based' Supply would then reflect the changes that the Government itself was introducing, to manage departmental expenditure on a dual 'resource' and 'cash' basis, instead of only cash. Under the Government's proposals, resource accounts would replace cash-based appropriation accounts as the means of providing accountability to Parliament.

6.3 The Government sought to make the change to resource-based Supply from 2001-02, and for the two preceding years to have resource accounts prepared in parallel with appropriation accounts before replacing them.

6.4 The Government consulted the Committee of Public Accounts and the Treasury Select Committee on the proposed changes. It also introduced amendments to the legislation that underpins Parliamentary Supply. The Government Resources and Accounts Act 2000, which was given the Royal Assent in July 2000 now provides the enabling legislation to implement resource accounting and resource-based Supply. The relevant provisions take effect from 1 April 2001.

Progress on resource accounts

6.5 In previous General Reports the Comptroller and Auditor General has commented on departments' progress in implementing resource accounting. This has been monitored through a series of 'Trigger Points' set by the Treasury. The third, and key, Trigger Point required departments to prepare 'dry run', unpublished, resource accounts for 1998-99 as a precursor to preparing their first sets of published resource accounts for the financial year 1999-2000.

1998-99 dry run accounts

6.6 Accordingly, dry run accounts for 1998-99 were prepared by all departments on a non-statutory basis. Although the accounts did not receive a formal audit opinion and were unpublished, the National Audit Office carried out a full audit of them as part of the Trigger Point process and reported its findings to departments and to the Treasury. Those findings, which came too late for the Comptroller and Auditor General's 1998-99 General Report, were also reported in detail in a memorandum that the Comptroller and Auditor General provided to the Committee of Public Accounts in May 2000. They were included in the Committee's 29th Report of 1999-2000.

6.7 The 'informal' audit opinions reached on those 52 accounts were as follows:

- 22 unqualified opinions;
- 9 opinions qualified on grounds of limitation of audit scope;
- 9 opinions qualified on grounds of disagreement;
- 5 adverse opinions;
- 4 opinions disclaimed; and
- 3 'nil' opinions[1]

[1] *'Nil' opinions were given where the accounts were insufficiently developed to offer an audit opinion*

1999-2000 accounts

6.8 Resource accounts for 1999-2000 have been produced on a full statutory basis. In advance of the necessary changes to legislation referred to above, the accounts have been prepared under statutory directions given by the Treasury, using powers contained in the Exchequer and Audit Departments Act 1921. The Act requires such accounts to be rendered for audit by 30 November following the year-end and, after audit and certification by the Comptroller and Auditor General, laid before the House of Commons by 31 January the following year.

6.9 Because of devolution and other changes in the composition of accounts, the total numbers have changed. Of the 49 departmental resource accounts for 1999-2000 due to be laid before the House of Commons (42 main accounts and 7 pension scheme accounts), 39 were certified and laid by 31 January 2001.

6.10 The audit opinions reached on these 39 accounts were:

- 35 unqualified opinions;
- 3 opinions qualified on grounds of audit scope limitation; and
- 1 opinion disclaimed.

6.11 The balance of 10 accounts comprise those where, after consultation with the National Audit Office, the Treasury have issued departments with a dispensation from the statutory accounts direction. This has been done where departments were unable to render a satisfactorily finalised account for audit by 30 November, or where the information supporting the account was not sufficient to enable the Comptroller and Auditor General to certify the account in time for it to be laid by 31 January.

6.12 Such accounts are nonetheless being completed and audited on a non-statutory basis. They will receive an audit opinion by the Comptroller and Auditor General and will be laid before the House of Commons as Command Papers. Dispensations have been granted, in effect, to remove the deadlines imposed by the Act. The Treasury's intention has been to allow additional time to improve the quality of such accounts, but with the agreement of the National Audit Office it has imposed an administrative timetable with the intention of laying these accounts before the House by 31 March 2001.

6.13 In due course the Comptroller and Auditor General will be providing the Committee of Public Accounts with a fuller analysis of these findings, including those relating to accounts prepared under a dispensation. It is probable that some of these latter accounts will attract qualified opinions. Nonetheless, the overall results are an improvement over those of the 1998-99 dry run. Although there is still more to be done by some departments, encouraging progress has been made.

6.14 The National Audit Office have played a significant part in this progress by providing support and guidance to departments, as it has throughout the transition process. They will continue to do so. It has also continued to liaise with the Treasury, to help identify where remaining problems lie and so assist the Treasury in following up those problems with departments.

Introduction of resource-based Supply

6.15 In order to implement the change to resource-based Supply from 2001-02, the Government sought to have the agreement of the Committee of Public Accounts and the Treasury Committee by July 2000. As indicated above, the Comptroller and Auditor General provided a memorandum to the Committee in May 2000 setting out the results of the audit of the 1998-99 dry run accounts. The Treasury also provided a memorandum and subsequently gave oral evidence to the Committee. As a result, the Committee in its 29th Report of 1999-2000 gave approval for the transition to take place from 2001-02 (as did the Treasury Committee and the Liaison Committee). It did so whilst recognising that a number of departments still had problems to resolve but on the basis that each had action plans for doing so, which it called on the Treasury to monitor and report on to the Committee. The Comptroller and Auditor General will also be advising the Committee on progress.

Whole of Government Accounts

6.16 The Government Resources and Accounts Act 2000 places a requirement on the Government to prepare consolidated accounts for the public sector. This is a wider development of the principles of resource accounting. The National Audit Office contributed to preliminary research carried out by the Treasury into the feasibility of such an account and presented a joint memorandum on their findings to the Committee of Public Accounts in July 1998. The National Audit Office concluded on the basis of work done so far that it should be possible to consolidate the accounts of central government.

6.17 The Treasury's current plan, presented in a memorandum to the Committee of Public Accounts in December 2000, is to produce an account for Central Government (CGA) to be published and audited for 2003-04, with dry runs for the two preceding years. Subject to further research on the costs, benefits and practicalities of additionally consolidating local authorities and other public sector bodies into a wider Whole of Government Account, the Treasury plan is to produce such an account to be audited and published for 2005-06 with dry runs for the two preceding years.

6.18 The 2000 Act provides the statutory basis for the Treasury to prepare Whole of Government accounts and for the Comptroller and Auditor General to audit them. The Act also provides the Treasury with the authority to designate bodies for the purposes of obtaining information for Whole of Government accounts. The Treasury has laid a Statutory Instrument before Parliament of all the bodies for designation in a CGA and the National Audit Office has reviewed and agreed the proposals for bodies included in the Statutory Instrument.

Accounting an

7

d auditing developments

Review of audit and accountability arrangements in central government

7.1 The Committee of Public Accounts, during the passage of the Government Resources and Accounts Act 2000, made recommendations that the powers of the Comptroller and Auditor General should be brought up to date to reflect changes in the delivery of central government services (4th and 9th Reports, Session 1999-2000). In February 2000, the Chief Secretary to the Treasury announced a review of audit and accountability arrangements in central government in response to the Committee's concerns.

7.2 The Review was led by Lord Sharman of Redlynch and overseen by a Steering Group chaired by the Chief Secretary and including the Comptroller and Auditor General, the Chairman of the Committee of Public Accounts, the Head of the Government Accounting Service, the Chairman of the Auditing Practices Board and the Chairman of the Accounting Standards Board. The report of the review, *Holding to Account*, was published on 13 February 2001.

7.3 The report recognised the importance of strong and comprehensive audit and accountability regimes for public money whilst considering issues such as audit cost and the effect of audit on risk taking. The importance of Parliament's ability to hold the executive to account for its use of public money was reflected in many of the report's recommendations. For example:

- as a matter of principle, the Comptroller and Auditor General should be the auditor, on behalf of Parliament, of all non-departmental public bodies;
- the Comptroller and Auditor General's access rights should be formalised where they are currently based on negotiated agreement or conventions;
- the Comptroller and Auditor General should be able to audit companies owned by a department, or which are subsidiaries of a non-departmental public body; when asked to do so, the Comptroller and Auditor General should be eligible to audit companies where a department has a substantial stake and where companies have a 'public interest' role; and
- there should be external validation of departmental information systems as a first step in a process towards validation of published data (see paragraphs 7.6 to 7.7 below).

7.4 The report also made a number of recommendations designed to ensure that the most is made of audit findings and to provide enhanced scrutiny of the cost and quality of the National Audit Office's work. These included a commitment to accepting the inspection regime of the Joint Monitoring Unit, which is responsible for monitoring the quality of audit work undertaken by member firms of the Institutes of Chartered Accountants in England & Wales, of Scotland, and in Ireland.

7.5 The report's recommendations were endorsed by the Committee of Public Accounts (6th Report, Session 2000-01, HC 260). If implemented, the recommendations will considerably enhance Parliament's ability to scrutinise the executive's use of public money.

Validation of Reported Performance Information

7.6 Lord Sharman's report considered the issue of the validation of performance data reported by government. He noted that performance measurement was well established as an important means of improving performance and reinforcing accountability, including helping Parliament and the public to assess how well public money was spent and what was achieved with it. It also recognised that the involvement of external parties is crucial in providing credibility to performance information published by public bodies. And he observed that there was much experience of validation within the National Audit Office, the Audit Commission and the private sector.

7.7 Lord Sharman concluded that there was a strong case for pursuing performance validation vigorously now. He recommended that there should be external validation of departmental information systems as first step in a process towards validation of published data; and that the Comptroller and Auditor General and the Audit

Commission, as the auditors of the bodies responsible for much of the data, should be responsible for external validation in their respective areas. They should work closely with the Office for 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.

7.8 Lord Sharman's conclusions on performance validation are the same as those reached by other reviews of the topic. The Committee of Public Accounts has pressed for the validation of Departmental performance measures on several occasions, most recently in its Ninth Report of 1999-2000. The Treasury Select Committee has produced two reports in the last year - on the Spending Review 2000 (Ninth Report 1999-2000), and on the Treasury itself (Third Report, 2000-2001) - which reaffirmed its previous reports in recommending that a body accountable to Parliament, such as the National Audit Office, should review Departments' assessment of their performance against Public Service Agreement targets.

7.9 Meanwhile, the National Audit Office have continued to promote good practice in performance measurement and reporting by carrying out independent validation of a number of Executive Agencies' performance against their key targets. For 1999-00 performance information, the National Audit Office continued its work in validating performance in Agencies such as the Employment Service, which have been subject to previous validation, as well as starting new work on other Agencies. While Agencies subject to validation for several years tended to have better developed performance measurement systems than those new to validation, some aspects of performance measurement practice such as the scope of performance measurement, the comparability and consistency of performance measures, and the quality of underlying data systems, commonly show room for improvement.

Developing Performance Measurement Practice

7.10 In January 2000, the Performance and Innovation Unit in the Cabinet Office published its report *Wiring It Up: Whitehall's Management of Cross-Cutting Policies and Services*. The report recommended that a Government performance information strategy was needed to bring together work on the design, usability and accessibility of performance measures and targets. In response, the National Audit Office is playing a full part, with the Treasury, Cabinet Office, the Office for National Statistics and the Audit Commission, in developing a strategy to assist in improving the public sector's management and use of performance information, including the development of a performance information framework setting out the general principles underlying high quality performance information.

7.11 The National Audit Office has also played an active role in providing advice on the technical aspects of performance measures and targets set out in the Public Service Agreements for 2001-04 and their supporting Service Delivery Agreements, through their work on the Technical Review Panel, which brings together performance measurement expertise from Departmental, audit and statistical bodies. The Panel will continue to provide a source of advice to departments as part of the development of the performance information strategy.

Auditing standards

7.12 The National Audit Office continues to play an active role in the development of auditing standards, beyond providing responses to exposure drafts as they are issued for public consultation. A former senior officer from the National Audit Office is a member of the Auditing Practices Board, and also chairs a public sector sub-committee of the Board. The role of the sub-committee is to assess the need for specific standards and guidance on audit issues in the public sector, and to advise the Board generally on matters relating to the public sector.

7.13 In last year's General Report it was noted that the sub-committee was developing a new Public Sector Practice Note. This would consolidate the guidance provided in the Auditing Practices Board's Practice Note 10 on the audit of central government financial statements and the guidance in Practice Note 17 on the audit of regularity, and extend the guidance to cover the public sector as a whole, including local authorities and the Health sector. A Consultation Draft of the new Practice Note was published in July 2000, and responses were received by September 2000. The Auditing Practices Board approved a revised draft of the Practice Note in January 2001, and publication is planned shortly.

7.14 The Practice Note consists of three main elements:

- A **Foreword** (Introduction) to set out the nature of the public sector and public sector audit and the roles and responsibilities of the key players in the sector. The Foreword also sets out the accountability and audit arrangements in the different sectors - central and local government, the health sector and the devolved arrangements in Scotland, Wales and Northern Ireland;
- **Individual sections for each Statement of Auditing Standards (SAS)** setting out a summary of the SAS, followed by guidance on its application to the public sector. The SAS sections are generic, but draw out any sector-specific issues where appropriate; and
- A separate **Regularity section** to incorporate the material in the current Practice Note 17 and to emphasise the importance of regularity in the public sector and to public sector auditors.

Public Audit Forum

7.15 In his previous General Reports, the Comptroller and Auditor General has referred to the work of the Public Audit Forum, which was launched in October 1998 to provide a focus for developmental work on public audit. The Forum comprises the heads of the four national audit agencies (the National Audit Office, the Audit Commission, Audit Scotland, and the Northern Ireland Audit Office). It is supported by a Consultative Forum that has a wide representation drawn from key stakeholders in the public audit process. The Consultative Forum is responsible for delivering the agreed programme of work and for proposing future subjects for consideration by the Forum.

7.16 Public Audit Forum publications to date include:

- *The Principles of Public Audit;*
- *Implications for Audit of the Modernising Government Agenda;*
- *What Public Sector Bodies can expect from their Auditors;*
- *Propriety and Audit in the Public Sector* (consultation paper); and
- *Data Matching and the Role of Public Sector Auditors* (consultation paper).

7.17 The consultation paper *Propriety and Audit in the Public Sector* was published in May 2000. It set out to promote a common understanding of what constitutes propriety in the public sector and was aimed those involved in the governance, management and audit of organisations in the public sector. It was intended to help public sector managers understand what is expected of them and to clarify the type of work that auditors of public sector bodies may undertake on propriety. The Forum received responses to the consultation paper from across the public sector throughout the United Kingdom. These were predominantly supportive and constructive, and the Forum is using them to prepare a final version of the paper.

7.18 The consultation paper, *Data Matching and the Role of Public Sector Auditors*, was published in August 2000. It addressed the use of data matching - the comparison of different sets of personal data to reveal duplications and anomalies that might indicate potential fraud or missed entitlements. The main issues covered were:

- identifying the proper role of the auditor;
- ensuring that there are powers to transfer data, when data is matched between different organisations; and
- complying with privacy legislation (the Data Protection Act 1998 and the Human Rights Act 1998) to ensure a balance between protecting the public purse and individuals' rights to privacy.

7.19 The paper generated considerable interest, particularly from local authorities. The Forum is now taking the comments into account along with proposals for new legislation in this area.

7.20 Public Audit Forum working groups are also working on issues of electronic service delivery, the relationships between auditors and inspectors, and developments in corporate governance.

"Whistleblowing" - The Public Interest Disclosure Act 1998

7.21 The Public Interest Disclosure Act 1998 came into force on 2 July 1999 and provides protection from the dismissal or other sanction for individuals ("Whistleblowers") who make disclosures relating to malpractice in the workplace. The Act aims to encourage responsible disclosures and encourages internal disclosures in the first instance. However, where an individual reasonably believes they would be victimised or there would be a cover up, the Act provides for them to make protected disclosures externally to prescribed persons. The Comptroller and Auditor General is one of several prescribed persons under the Act. His responsibility as a prescribed person is to consider allegations made to him by individuals relating to the proper conduct of public business, value for money, fraud and corruption in relation to the provision of centrally funded public services.

7.22 The National Audit Office has established procedures to ensure that appropriate and reasonable steps are taken to investigate allegations that fall within the criteria for disclosures laid down in the Act. These procedures include liaising with the individual making disclosures, respecting confidentiality where this is requested, and ensuring that they receive a detailed reply on the outcome of their investigation. To date, the Comptroller and Auditor General has received some 40 disclosures. Examples of issues that the Office is currently pursuing where the individual would be entitled to protection under the Act include allegations that grants are being applied in breach of rules; and possible irregular tendering procedures.

7.23 The National Audit Office has a dedicated telephone line[2] to receive disclosures.

Audit of New Bodies

7.24 The Comptroller and Auditor General is frequently appointed as the statutory auditor to new bodies as they are created by the government. One of the new types of bodies which he now audits are the Education Action Zones sponsored by the Department for Education and Employment. In January 2001, the Comptroller and Auditor General published a separate report (*Meeting the Challenge - the lessons identified from auditing the first 25 zones,* HC 130 Session 2000-01) setting out the main findings arising from the National Audit Office's examination of the financial statements produced by the first 25 Zones to cover their initial period of operation.

7.25 An Education Action Zone is based on a cluster of schools, usually in a local area. Its aim is to develop, in conjunction with local partners, imaginative approaches to raising educational standards in seriously disadvantaged areas. Each Zone is run by an Education Action Forum that is a corporate body and exempt[3] charity. The first 25 Zones each receive £750,000 of annual grant funding and are expected to raise £250,000 each year in business contributions.

7.26 From the outset, delivery of the innovative Education Action Zones programme presented the Department for Education and Employment with risks of impropriety, poor value for money and inadequate accounting. They were preparing to pay sums of the taxpayer's money to very small, newly formed charitable bodies with little corporate experience of handling public money or the proper conduct of public business.

7.27 The Department took appropriate steps to mitigate the financial risks. They phased the introduction of the Zones with the result that valuable lessons could be learned by later Zones from the experiences of the first 25. To secure effective financial control and corporate governance arrangements the Department prepared an Education Action Zone handbook, with assistance from PricewaterhouseCoopers and in consultation with the National Audit Office. The handbook established ground rules for the Zones, including the conditions under which they would receive their Government grants.

7.28 However, with only one or two full-time staff in post, many Zones experienced difficulty in meeting some of the Department's initial requirements and expectations. The result was that in the early days of their existence, some Zones were spending large sums of public money before they had sound financial controls in place. In addition, some Zones experienced difficulty in raising the expected level of business contributions. Further, there were instances where Forum members did not know or did not understand their role and responsibilities.

7.29 The Department responded positively to these issues, expanding the guidance and extending the help available to the zones. A successful feature of the first two years of the programme was the joint working between the Department, their consultants PricewaterhouseCoopers and the National Audit Office. This was aimed at helping Zones to deal effectively with financial control and governance. All parties have shared information and views in order to resolve or prevent emerging problems both locally and nationally.

7.30 The Department and the Zones will need to remain vigilant to ensure that risks to financial control and corporate governance are well managed to avoid irregularities or improprieties that could detract from the Zones' educational achievements. The Comptroller and Auditor General's report identifies the key issues for the Department and the Zones to focus on.

7.31 The report also sets out wider lessons that can be learned from the establishment of the Zones that can be applied to other Government programmes involving the setting up of innovative new bodies.

[2] *020 7798 7999*
[3] *Exempt charities are not required to register with the Charity Commission and are not subject to its supervision*

Appendix 1

Accounts audited by the Comptroller and Auditor General

Type of account (1998-99 figures in brackets)	Number audited	Opinion qualified [1]	Opinion not qualified but report attached [2]
Appropriation Account [3]	92	4	4
	(104)	(6)	(8)
Resource Accounts [4]	39	4	0
	(n/a)	(n/a)	(n/a)
Executive Agency [5]	91	1	1
	(96)	(2)	(-)
National Loans Fund	14	(-)	(-)
	(28)	(-)	(-)
Other UK accounts audited under statute or by agreement [6]	333	2	6
	(302)	(5)	(5)
Total 1999-2000	569	11	11
Total 1998-99	(530)	(13)	(13)

Notes

1 Appendix 3 provides details of the accounts qualified

2 Appendix 4 lists reports issued by the Comptroller and Auditor General on financial audit matters

3 Appropriation accounts are the accounts of the expenditure and receipts of government departments and are produced on a cash basis. Under section 22 of the Exchequer and Audit Departments Act 1866, the Comptroller and Auditor General is required to report on the appropriation accounts. The actual payments and receipts in 1999-2000 compared with those voted by Parliament is shown in Appendix 2.

4 Resource accounting is an accruals-based form of financial reporting that has been introduced in all government departments. Resource accounts comprise financial statements similar to those found in commercial accounts but additionally include a statement designed for Parliamentary reporting purposes and a further statement analysing income and expenditure by objectives. Dry-run versions were run 1998-99 but not published. The first sets of fully audited, published resource accounts have been produced in 1999-2000 and have initially run in parallel with department's present cash-based appropriation accounts.

5 Executive Agencies have been established to undertake operational functions of departments. They are required to produced financial statements on an accruals basis and in compliance with the requirements of the Companies Acts, the Resource Accounting Manual issued by the Treasury and generally accepted accounting practices, insofar as these are appropriate.

6 The Comptroller and Auditor General also undertakes the audit of a large number of other accounts whether under statute or by agreement. These include investment accounts, stewardship accounts, charity and pension fund accounts as well as receipts and payments and accruals accounts covering a variety of other activities and purposes.

Appendix 2 Outturn of the Votes in all Classes

This summary records the outtrun of the Votes in all Classes as follows:

Gross expenditure	**£000**	**£000**
Estimates:		
Original Estimates	254,559,091	
Supplementary etc. Estimates	7,004,657	
		261,563,748
Actual		252,299,839
Saving		9,263,909
Appropriations in Aid		
Authorised:		
Original Estimates	27,957,723	
Supplementary etc. Estimates	442,668	
	28,400,391	
Applied	26,629,540	
Deficiency		1,770,851
Net saving before adjustment for excesses		7,493,058
Amount for which Parliamentary authority is required to make good excesses on certain votes		756
Total of amounts to be surrendered being 3.2 per cent of Supply		7,493,814

Grants

The exact amount for surrender is £7,493,816,664.35. The figure stated above differs by £2,664.35 because of rounding within the Classes.

Extra receipts

Extra receipts payable to Consolidated Fund recorded in the Appropriation Accounts of all Classes amount to £5,735,695,231.74.

Adjustment of balance on 1998-99 Votes

The surplus to be surrendered for 1998-99 amounted to £6,849,925,919.49. This balance has been duly surrendered to the Consolidated Fund. The excesses which occurred on five Votes in 1998-99 have been made good by Vote of Parliament.

Appendix 3

Accounts qualified by the Comptroller and Auditor General

Appropriation Accounts 1999-2000

Class X	Vote 2	Ministry of Agriculture, Food and Fisheries: Excess Vote and irregular receipts
Class X	Vote 3	Forestry Commission: Excess Vote
Class XII	Vote 1	Central Government Administered Social Security Benefits and Other Payments: Fraud and error
Class XV	Vote 2	Northern Ireland Office - transfers to the Northern Ireland Consolidated Fund (Northern Ireland Office did not have any basis for presenting the expenditure in the same subhead detail as included in the Supply Estimates)

Resource Accounts 1999-2000

Ministry of Defence

Department of Health

Department of Social Security

Forestry Commission England/GB

Other Accounts qualified

Child Support Agency Client Funds Account 1999-2000

Ordnance Survey Trading Fund Accounts 1999-2000

HM Prison Service 1999-2000

Appendix 4 Reports of the Comptroller and Auditor General

Appropriation Accounts 1999-2000

Class III	Vote 9	Driver and Vehicle Licensing Agency: Motor Tax collection
Class VI	Votes A	Ministry of Defence Votes A
Class XVI	Vote 3	HM Customs and Excise; administration (report on the revenue accounts)
Class XVI	Vote 4	Inland Revenue: administration (report on the revenue accounts)

Other Reports

Millennium Commission 1999-2000

Fire Service College 1999-2000

UKAEA 1999-2000

Education Action Zones 1999-2000

NHS (England) Summarised Accounts 1998-99

NHS (Wales) Summarised Accounts 1998-99

Public Health Laboratory Service Board 1998-99

Appendix 5 Examination of Stock and Store Accounts

Report of the Comptroller and Auditor General to the House of Commons

I am required under section 4 of the Exchequer and Audit Departments Act 1921 to examine, on behalf of the House of Commons, stock and store accounts to ascertain whether adequate regulations have been made and enforced for control and stocktaking, and whether the requirements of the Treasury have been complied with.

The frequency of the audit cycle of department stock and store systems depends upon the sensitivity and risk of the systems involved. Work undertaken by my staff during 1999-2000 concluded that in most instances, systems operated satisfactorily. A number of matters have been raised directly with the organisations concerned.

John Bourn
Comptroller and Auditor General

7 March 2001

National Audit Office
157-197 Buckingham Palace Road
Victoria
London SW1W 9SP