NATIONAL AUDIT OFFICE

FINANCIAL AUDITING AND REPORTING

General Report of the Comptroller and Auditor General 2003-04

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 366 Session 2004-2005 | 24 March 2005

The National Audit Office scrutinises public spending on behalf of Parliament. The Comptroller and Auditor General, Sir John Bourn, is an Officer of the House of Commons. He is the head of the National Audit Office, which employs some 800 staff. He, and the National Audit Office, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources. Our work saves the taxpayer millions of pounds every year. At least £8 for every £1 spent running the Office.

NATIONAL AUDIT OFFICE

FINANCIAL AUDITING AND REPORTING

General Report of the Comptroller and Auditor General 2003-04

LONDON: The Stationery Office
£9.25

Ordered by the
House of Commons
to be printed on 21 March 2005

CONTENTS

This report has been prepared for presentation to the House of Commons under Section 6(4) and Section 7(3)(c) of the Government Resources and Accounts Act 2000.

John Bourn
Comptroller and Auditor General
National Audit Office

16 March 2005

This report can be found on the National Audit Office web site at www.nao.org.uk

For further information about the National Audit Office please contact:

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

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

Photographs courtesy of www.alamy.com

FOREWORD

It gives me great pleasure to present my General Report to Parliament, summarising the results of the financial audit work undertaken on my behalf by the National Audit Office over the twelve months from 1 February 2004 to 31 January 2005.

My financial audit work enables me to provide independent assurance that the annual financial statements of United Kingdom central government bodies are properly prepared and that the income and expenditure have been applied for the purposes intended by Parliament.

Overall, I consider that the standards of accountability and probity remain high. In this report I highlight my view of the good progress departments have continued to make in meeting the challenge of resource accounting and in improving the quality of accounts submitted for audit. As evidence of this, I issued qualified opinions on only four sets of departmental resource accounts compared with a total of eight in the prior year.

Good progress has also been made by departments in improving the timeliness of accounts submission. However, I consider that in order to meet the challenge of the Treasury's faster closing initiative, to accelerate the production and audit of resource accounts so as to lay audited accounts within four months of the year end, many departments still have much work to do. The aim of faster closing is to provide Parliament with more timely financial information and I am fully committed to a partnership with departments to help achieve this.

I am pleased to note that, following the Gershon Review, there is now general recognition of the key role that financial management has to play in the efficient use of resources and in the delivery of efficiency programmes. In this respect, I warmly welcome the steps being taken by the Treasury and departments to improve the professionalism of the finance function, not least the decision that, from December 2006, all departments will have qualified accountants as board level finance directors. I am also particularly pleased to be assisting the Treasury in the major department by department review of the effectiveness of financial management within central government.

I also comment upon developments in corporate governance and risk management across government and the work that the National Audit Office continues to undertake to assist government bodies to continually improve in this area. Robust risk management can help departments avoid failures in service delivery and also presents opportunities to deliver better public services, make more reliable decisions, improve efficiency and support innovation. I therefore fully support the steps taken to improve the risk management capacity of government bodies.

I am pleased to report that significant progress has been made by departments to improve their risk management capabilities. However, I consider that it is critical for departments to build on the momentum achieved to date as many have further to go to demonstrate that they have made effective risk management a central part of their day to day management processes in a way that can fully deliver improved performance and other benefits. In this respect I was pleased to recently host a joint conference with the Treasury for Accounting Officers of all government departments and their agencies to provide further stimulus for departments to maintain their efforts to fully develop and embed their risk management procedures.

I aim to continue to provide an efficient and effective audit service to central government bodies and other stakeholders and to provide independent assurance and comfort to Parliament and the people of the United Kingdom. In doing so I am conscious of the need to ensure that the methodologies employed by the National Audit Office continue to reflect best practice and the current thinking of the wider auditing profession. In this regard I am pleased to report that the National Audit Office will conduct their work in accordance with International Standards on Auditing in line with the timetable for the adoption of the Standards in the private sector.

In conducting my work I am mindful of the need to provide 'added value' advice to audited bodies as well as influencing developments in auditing, accounting and financial management within the wider national and international profession. Therefore, I also include in this report details of the additional services provided arising from my financial audit responsibilities.

John Bourn

Comptroller and Auditor General

11 March 2005

EXECUTIVE SUMMARY

1 This report to Parliament summarises the results of financial audit work undertaken by the National Audit Office over the twelve months from 1 February 2004 to 31 January 2005 and highlights key issues arising from that work.

2 The Comptroller and Auditor General is the appointed auditor of all United Kingdom central government departments, executive agencies, and a wide range of other public bodies.

3 The National Audit Office undertake, under the direction of the Comptroller and Auditor General, the detailed financial audit work necessary to support his duties and statutory responsibilities. In total, the Comptroller and Auditor General audits over 550 accounts per year, incorporating total expenditure and revenue of approximately £700 billion.

4 All financial audits are conducted in accordance with UK Auditing Standards issued by the Auditing Practices Board which require an opinion as to whether the accounts are free from material misstatement and show a true and fair view. The audit opinion also requires confirmation that the transactions in the accounts comply with appropriate Parliamentary authority – known as the "regularity" opinion. Audit procedures also have regard to the propriety with which public funds have been handled and the manner in which public business has been conducted.

5 In reporting the results of audit examinations, this report focuses upon the Comptroller and Auditor General's audits of the receipts of revenue and of public debt and reserves, as well as commenting upon progress made by audited bodies in developing systems to enable faster financial reporting and the future compilation of whole of government accounts. It also comments on the progress made by audited bodies in embedding risk management systems and other best practice within corporate governance.

6 An increasingly important aspect of the work of the Comptroller and Auditor General is his commitment to contribute towards improvements in financial management and control across central government. Consequently, this report also provides a summary of the various other services provided by the Comptroller and Auditor General arising from his financial audit work designed to add value to audited bodies.

7 This report does not deal with the value for money (VFM) audit work of the National Audit Office which supports the production of the Comptroller and Auditor General's published VFM reports. Details of the VFM reports published in the period covered by this report can be found on the National Audit Office web site at www.nao.org.uk.

Financial Audit

Quality and Timeliness of Accounts

8 During 2003-04, departments continued to make good progress in response to the challenges of resource accounting, and the quality of accounts submitted to the Comptroller and Auditor General for audit continued the pattern of improvement noted in recent years:

- Qualified opinions were issued on only four sets of departmental resource accounts, comparing favourably with a total of eight accounts from the prior year.
- The number of accounts qualified in relation to truth and fairness fell from three accounts to two.
- The nature of qualifications was less severe than in previous years as no opinions were 'disclaimed' because of a lack of audit evidence.
- The number of accounts qualified in respect of regularity was halved.

9 However, whilst the majority of departments and other public bodies falling within the Comptroller and Auditor General's remit are producing unqualified accounts, a small number still have more to do to prepare accounts for which there is sufficient audit evidence to conclude that the accounts provide a true and fair view and that the underlying transactions are regular in all areas.

10 In general, departments continue to make good progress in improving the timeliness of accounts submission. This was reflected in the fact that over 80 per cent of accounts had been submitted for audit by October 2004. There remain a small number of departments who struggle to meet the statutory timetable of 30 November and two departments failed to meet this deadline. This compares favourably with the prior year, in which eleven departments failed to adhere to the timetable.

11 The Treasury aim to accelerate the accounts process, with the ultimate intention being that all resource accounts from 2005-06 onwards should be laid before Parliament by the Summer Recess. Departments continue to make steady but slow progress towards meeting this agenda. Fundamental to the success of faster closing will be the recognition that the accounts production process is not merely a year end activity. Robust, accurate and timely financial information is pivotal to improved resource planning and should be something that departments produce and utilise throughout the financial year. The National Audit Office will continue to work with audited bodies to help achieve the aims of better financial management and timelier external financial reporting.

Implementation of a New Standard for Accounting for Retirement Benefit

12 Financial Reporting Standard 17 was implemented for the first time in the central government sector in 2003-04. This was in accordance with the original implementation timetable stipulated by the Accounting Standards Board. The standard was adapted for use in the central government sector and as a result the major unfunded central government pension schemes have recognised over £360 billion of pension liabilities in their balance sheet for the first time.

The Audit of Receipts of Revenue and Public Debt and Reserves

13 The Comptroller and Auditor General's audit of receipts of revenue was, with the exception of concerns over tax credit application errors, satisfactory, and gave assurance that regulations and procedures employed by HM Customs and Excise ('Customs'), the Inland Revenue ('Revenue') and the Driver and Vehicle Licensing Agency ('DVLA') provided an effective check over the assessment, collection and allocation of tax.

14 The Comptroller and Auditor General continued to note major reservations concerning tax credit application errors, and this led to a further qualification of his audit opinion on the Revenue's trust statement for 2003-04. In 2000-01, the Revenue had identified tax credit applicant error rates of 10-14 per cent by value, equivalent to overpayments of £510-£710 million per year. While improved controls in the new tax credit system are planned to reduce the incidence of such overpayments, the Revenue will not know the effect these controls have had on the error rates until an ongoing review is completed in July 2005.

15 The Trust Statements produced by Customs, Revenue, and the DVLA currently record taxation on a receipts and payments basis, although for 2004-05 statements will be produced on an accruals basis. Customs have already been producing a dry-run accruals statement since 2002-03. The National Audit Office will continue to work with each organisation to help implement and embed the changes required to produce true and fair accruals accounts for revenue, which are required for the production of Whole of Government Accounts.

16 The Comptroller and Auditor General's audit of public debt and reserves was conducted satisfactorily, and benefited greatly from a general acceleration in the reporting timetable.

17 The National Audit Office's work on the audit of public debt and reserves has seen significant developments during 2003-04. The accounts of the National Loans Fund, investment accounts prepared by the Commissioners for the Reduction of the National Debt, and the financial statements of the Public Works Loan Board have been prepared on an accruals basis for the first time. In addition, the format of the Consolidated Fund financial statements has been revised in response to developments in central government accounts. While these developments have been challenging, they reflect an ongoing desire to bring greater transparency and accountability to a complex area.

18 Advances in the audit timetable of debt and reserves continue to be made, for example - the Exchange Equalisation Account was certified by the Comptroller and Auditor General some four months earlier than last year.

Whole of Government Accounts

19 Good progress continues to be made towards the publication of Whole of Government Accounts (WGA). The Treasury prepared dry run Central Government Accounts (CGA) for 2002-03, which were reviewed by the National Audit Office, and these built upon the experience of the first dry run with significant advances being made since 2001-02.

20 These advances have been important as the Treasury move towards preparing the first published CGA for 2003-04 which will be audited by the Comptroller and Auditor General. While a precise publication timetable has yet to be determined, good progress has been made, and the National Audit Office continue to work closely with the Treasury to address the resolution of issues identified from the dry run process.

21 CGA is an interim, albeit important, step towards the publication of WGA, and running in parallel with the CGA process the Treasury and the National Audit Office have commenced work on planning the first dry run WGA for 2004-05. The move to WGA presents new logistic and technical challenges, and the National Audit Office are committed to helping address those issues while consulting on a suitable approach to dealing with the WGA consolidation.

Looking Forward

22 The scope of financial audit work carried out by the Comptroller and Auditor General and National Audit Office continues to evolve. Further progress has been made in implementing the recommendations of Lord Sharman's report into audit and accountability in central government. The European Commission and the Department of Trade and Industry have accepted that there is no barrier in principle to the Comptroller and Auditor General auditing government owned companies, as proposed in Lord Sharman's report. The National Audit Office are consulting with the relevant parties to determine what legislative changes would be required to facilitate this development.

23 International Accounting Standards (IAS) are mandatory for EU listed companies in their group financial statements from 1 January 2005. The Treasury have decided that the implementation of accounting standards will follow UK Accounting Standards as they converge with international standards. There will thus be major changes in accounting standards over the next few years. The National Audit Office will work with the Financial Reporting Advisory Board to ensure the appropriate application of IAS to central government bodies.
More generally, the National Audit Office will continue to play a prominent role in the development of the accounting framework at both a national and international level thereby reflecting the arena in which central government bodies operate.

Corporate Governance

24 Properly planned and managed risk taking by government departments can promote innovation and lead to improved value for money for tax payers. The National Audit Office continue to work closely with audited bodies and their Audit and Risk Committees in assisting the development of corporate governance arrangements and, more broadly, risk management procedures.

25 The Comptroller and Auditor General followed up his previous report on risk management by looking at the progress made by departments in embedding risk management. This concluded that whilst significant progress has been made by departments, many must undertake further work to demonstrate that they have made effective risk management a central part of their day to day general management processes.

26 The National Audit Office is well placed to identify good practice in specific areas within its client base and to share that good practice across a wider audience. A well functioning audit committee is key to achieving good corporate governance and consequently, the National Audit Office have been developing a range of guidance and tools to assist public sector audit committees. This guidance has included an award winning self assessment toolkit for audit committees. This will allow audit committees to assess their performance against best practice.

27 On a more strategic level, the Comptroller and Auditor General and his staff continue to influence the development of risk management, through participation in such bodies as the Public Audit Forum, the Auditing Practices Board and the International Organisation of Supreme Audit Institutions. In addition, National Audit Staff have attended various events to aid clients and audit committees in developing corporate governance.

28 The development of corporate governance in the central government sector is on-going and considerable work remains to be completed. The Treasury have recently undertaken a review of the corporate governance framework in central government. It is intended that this will facilitate a Governance Code for the sector. The National Audit Office have actively contributed to this review and will continue to work with the Treasury to provide further stimulus for departments to maintain their efforts to fully embed risk management in their day to day activities.

Adding Value: Other Financial Audit Work

29 The overall results of the Comptroller and Auditor General's financial audit work indicated that, in general, standards remained high. However, the Comptroller and Auditor General was able to contribute to improvements in the effective financial management and financial control within the bodies which the National Audit Office audits. This contribution was made in a number of ways; most directly, by the provision of a management letter at the end of the audit process or as a result of the recommendations arising from good governance projects.

30 The Comptroller and Auditor General has always been highly supportive of the need to improve efficiency within central government. The efficiency agenda has gained new impetus following the publication of the Gershon Review in July 2004 and there is now greater awareness of the key role that financial management has to play in the effective use of resources and in delivering efficiency programmes. The Comptroller and Auditor General and his staff fully support the steps being taken to professionalise the finance function in departments and are assisting the Treasury in a department by department review of the effectiveness of financial management within central government.

31 The Comptroller and Auditor General and staff from the National Audit Office continue to contribute towards the shaping of accounting and auditing best practice through active participation on a number of professional bodies. The Comptroller and Auditor General continues as Chairman of the Review Board and is Chairman of the Professional Oversight Board for Accountancy. National Audit Office staff are represented on committees and working groups of bodies such as the Accounting Standards Board, the Institute of Chartered Accountants in England and Wales, the Treasury, the Public Audit Forum, the Chartered Institute of Public Finance and Accountancy, and the International Auditing and Assurance Standards Board. In addition to this, staff continue to contribute to the debate on issues which are key to the central government sector, most notably the accounting treatment of Private Finance Initiative projects.

PART ONE
Financial Audit

Introduction

1.1 The Comptroller and Auditor General is the appointed auditor of all government departments, executive agencies, and a wide range of other public bodies. This section of his report summarises the results and conclusions of financial audits undertaken over the twelve months from 1 February 2004 to 31 January 2005. A summary of all accounts audited by the Comptroller and Auditor General is included at **Appendix 2** to this report.

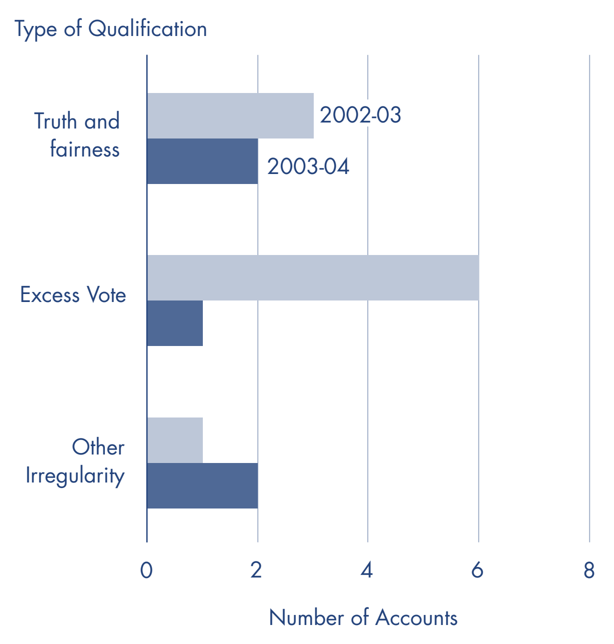
1.2 The Comptroller and Auditor General will express an opinion on the financial statements of the bodies for which he is the appointed auditor, reporting whether in his opinion the financial statements give a true and fair view of the financial position of the entity and have been properly prepared in accordance with the relevant statute and Treasury directions made thereunder. This includes examining how well the management of audited bodies meet their responsibilities for keeping appropriate and accurate financial records.

1.3 The Comptroller and Auditor General will also report his opinion as to whether the transactions contained within the financial statements are regular in that they have been undertaken in accordance with relevant legislation, other regulations issued by Ministers, and with Parliamentary and Treasury authority.

1.4 The Comptroller and Auditor General will draw to the attention of Parliament, by way of a qualified audit opinion and an accompanying published report on the accounts, significant matters relating to poor financial control or matters having an impact on public expenditure. Reports on other matters believed to be of significant interest to Parliament may also be published without qualifying the opinion on the financial statements.

1.5 In the period covered by this report the Comptroller and Auditor General qualified his opinion on four sets of departmental resource accounts. This was a decrease over the previous year, indicating that; in general, standards of financial control in departments are improving. An analysis of qualified departmental resource accounts is provided in **Figure 1,** while a full list of qualified opinions is included in Appendix 3 of this report.

1 Number of Qualifications by type



1.6 While the accuracy of financial statements is essential to the Parliamentary control of government expenditure, timely reporting is equally important. Therefore, this part of the report also comments upon progress made by departments in submitting high quality accounts, on a more timely basis to the Comptroller and Auditor General for audit, as well as commenting on key developments in the area of faster financial closing.

1.7 The remainder of this part of the report provides a commentary on some significant aspects of the Comptroller and Auditor General's current financial audit responsibilities and some key developments impacting on those responsibilities going forward.

Departmental Resource Accounts – Qualified Opinions

1.8 The quality of accounts submitted to the Comptroller and Auditor General for audit during the period covered by this report continued the pattern of improvement shown in recent years. Qualified opinions were issued on only four sets of departmental resource accounts, comparing favourably with a total of eight from the prior year.

Truth and Fairness

1.9 As shown in Figure 1 the number of departmental resource accounts whose audit opinion was qualified in relation to truth and fairness was two; this was a reduction of one on last year's figure. In each case this was because sufficient audit evidence could not be obtained regarding one or more specified elements of the accounts (for example, the valuation of the long term liabilities of a pension scheme or the completeness, existence and accuracy of benefit overpayment debt). The scope of the audit opinion was accordingly limited in this regard. The nature of the qualifications was less severe than in previous years as no opinions were 'disclaimed' (in effect, a 'non-opinion') because the lack of audit evidence was so pervasive or material. One account was subject to a disclaimer opinion in the comparative period last year.

1.10 While the majority of departmental resource accounts continued to receive an unqualified audit opinion, the fact that true and fair qualifications still occur is indicative of weaknesses in departmental financial control, weaknesses that compromise the ability of the departments concerned to provide sound accountability to Parliament. Those departments need to continue to improve their financial controls so as to remove the causes of the qualifications as soon as possible, and the Comptroller and Auditor General will continue to work with them in recommending control improvements.

Regularity

1.11 Significant improvements were also noted in the number of departmental resource accounts where the audit opinion on the 'regularity' of expenditure was qualified. As shown in Figure 1 the number of regularity qualifications fell, reducing from seven to three over the same period as last year.

1.12 Resource based supply estimates were introduced for 2001-02 accounts onwards. Resource accounts report against these estimates and can be qualified if the accounts reveal an Excess Vote, i.e. outturn exceeds the authorised estimates for resources or cash. Only one department incurred an Excess Vote in 2003-04. This was a reduction from six departments in the previous year. In this instance the department breached both their resource and cash based limits. Such excesses, however small, are irregular and result in a qualified opinion. They require retrospective parliamentary authority in a subsequent Appropriation Act.

1.13 Taken in isolation this improvement indicates that departments are becoming more familiar with the requirements of resource accounting and budgeting. However, the Comptroller and Auditor General's audit work indicates that a number of departments must further develop their procedures and financial systems to fully embed accruals based financial management and facilitate resource planning. This is reflected in the recommendations that the National Audit Office have raised with departments.

1.14 The National Audit Office will continue to work with Departments to help improve their ability to effectively manage and budget for their resource consumption and where necessary, to implement improvements and enhancements to their financial systems. This will assist departments to adopt a more sophisticated approach to Estimate setting and monitoring and serve to fully embed accruals based financial management. In this regard the National Audit Office are also pleased to be participating in the Treasury's department by department review of the effectiveness of financial management. This includes an assessment of the planning and budgeting processes in place at each department. Part 3 of this report provides further details of this work.

1.15 The remaining two regularity qualifications in 2003-04 arose as a result of expenditure which was not in accordance with the relevant regulations or legislation and which therefore had not been applied to the purposes intended by Parliament. In one case HM Customs and Excise incurred expenditure of £167,140 providing services which were not covered by the ambit of their Estimate. This expenditure is referred to as 'ultra vires' and the amount will be included in the statement of excesses presented to Parliament by HM Treasury for retrospective Parliamentary approval. In the other case, the Department for Work and Pensions incurred expenditure arising from erroneous benefit awards and fraudulent benefits claims.

Other Entities - Qualified Accounts

1.16 In the period covered by this report the Comptroller and Auditor General qualified his opinion on a further thirteen sets of accounts. A full list of these qualified opinions is included in **Appendix 3** of this report.

1.17 The thirteen qualifications included eight in respect of the 2002-03 summarised accounts of Special Health Authorities and the Dental Practice Board. Under Section 97 of the National Health Service Act 1977, these bodies have a statutory financial duty to ensure that the use of their resources in a financial year does not exceed the amount specified for them in relation to that year by the Secretary of State. Separate limits are set for revenue and capital resources. Failure to keep expenditure within agreed revenue and capital resource limits will therefore result in an automatic qualification to the regularity opinion. Three Special Health Authorities breached their revenue resource limit and four Special Health Authorities and the Dental Practice Board breached their capital resource limit in 2002-03. The C&AG therefore qualified the regularity opinion on the 2002-03 summarised accounts of each of these eight bodies. The Department of Health have investigated the reasons for these breaches, and management arrangements have been revised and appropriate measures put in place to prevent a recurrence in future years.

1.18 The accounts of the Criminal Records Bureau were qualified for 2002-03 and 2003-04 on the basis of certain payments which were made to police authorities. These payments were not calculated in accordance with the appropriate legislation (Police Act 1997) and as such constituted irregular expenditure. The 2002-03 accounts were additionally qualified in relation to truth and fairness because there was insufficient audit evidence to support the value ascribed to turnover and year end debtors. This issue was resolved in the 2003-04 accounts.

1.19 The Child Support Agency's Client Funds Accounts for 2003-04 were qualified as a result of material errors identified in the value of receipts from non resident parents and in subsequent payments over to the parent with care or the Secretary of State. This was largely due to errors in the underlying maintenance assessments.

1.20 The scope of the Comptroller and Auditor General's audit opinion (including regularity) on the National Insurance Fund (GB) was limited as a direct consequence of his qualification of the Department for Work and Pensions resource account arising from the limitation in the evidence made available to the National Audit Office during the audit of expenditure on Incapacity Benefit.

1.21 Further details on the audit and subsequent qualification of the Inland Revenue Trust Statement 2003-04 are included at paragraph 1.55 below.

Conclusion

1.22 Whilst nearly all departments and the other public bodies falling within the Comptroller and Auditor General's remit are producing unqualified accounts, a small number still have more to do to prepare accounts for which there is sufficient audit evidence to conclude that the accounts provide a true and fair view and that the underlying transactions are regular in all areas. Such instances are indicative of weaknesses in internal control which may impinge upon a body's ability to provide sound accountability to Parliament.

Departmental Resource Accounts – Timeliness of Rendering Accounts for Audit

1.23 Accurate reporting of departmental performance is only a part of ensuring Parliamentary accountability: equally important is the need for timely reporting of government expenditure to Parliament. To facilitate this, departments must ensure that the financial statements for which they are responsible are prepared and submitted for audit on a timely basis.

Performance in Period

1.24 Previous reports have commented upon the timeliness of accounts: namely whether departments had met the statutory requirement to submit accounts for audit by 30 November following the financial year ended the previous 31 March.

1.25 **Figure 2** shows departments' performance in delivering signed accounts for audit over the previous four years.

1.26 In general, departments continue to make good progress in improving the timeliness of accounts submission. For example, by October 2004 84 per cent of resource accounts had been submitted for audit, which compares favourably with the prior year position of 53 per cent. A small number of departments, however, continue to struggle to meet the statutory timetable of 30 November, and two departments actually missed this statutory deadline. Nevertheless, this represents a clear improvement on the prior year when eleven departments failed to meet the timetable. As a consequence of the delays in submission, these two accounts were not certified in accordance with the deadline of 15 January 2005 and one account was not laid before the House of Commons by the deadline of 31 January 2005.

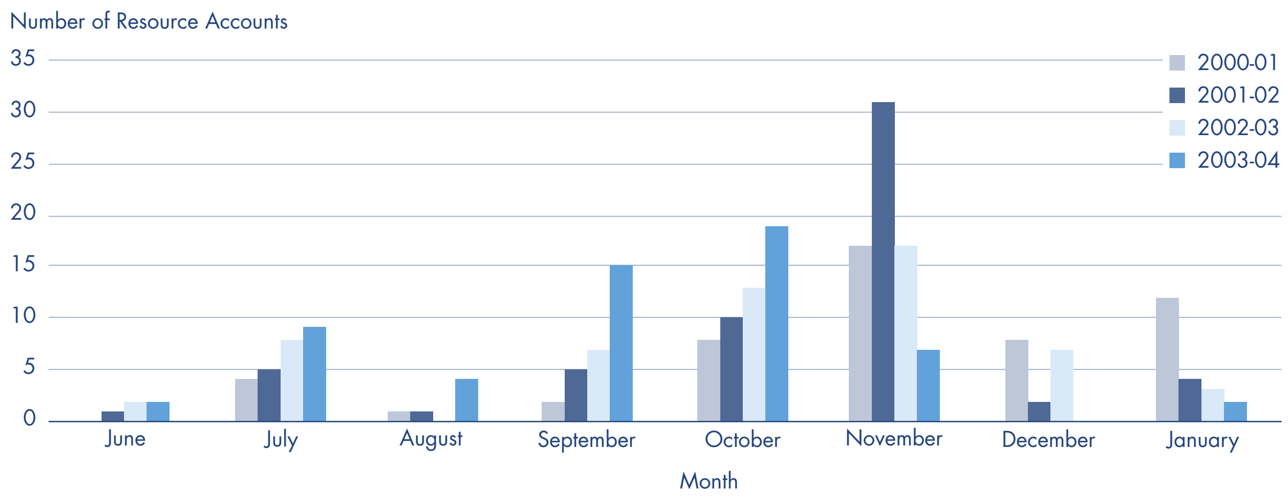
Faster Financial Closing

1.27 The Treasury have launched an initiative to accelerate the production and audit of resource accounts, its ultimate intention being that for the reporting year 2005-06 and subsequent years all departmental resource accounts will be laid before Parliament before the Summer Recess. This replicates the timetable that already applies to the accounts of departments' Executive Agencies. The impetus for this initiative stems from calls by the Committee of Public Accounts for faster accounts closure and from a desire to mirror what is accepted as general commercial best practice. Moreover, the accelerated timetable will be necessary to allow Whole of Government Accounts to be produced in a timely fashion. Further detail on Whole of Government Accounts is given later in this section of the Report.

1.28 To facilitate faster closing, the Treasury have sought proposals from each department for a timetable illustrating how they intend to achieve the faster closing deadline. These timetables are kept under review by the Treasury and the NAO to identify areas of concern and practical steps which can be taken by departments in order to meet the accelerated timetable.

1.29 Current proposals, along with the actual results for 2002-03 and 2003-04, are illustrated in **Figure 3**.

2 Delivery of Signed Resource Accounts



1.30 Figure 3 shows that departments continue to make steady but slow progress towards meeting the faster closing agenda. In 2004, eleven departments were able to lay their 2003-04 accounts to a pre-recess timetable. This is a small improvement on the prior year when ten resource accounts met the recess deadline. Other improvements have been secured with a number of larger departments continuing to make good progress in accelerating their accounts production process and, for the first time, nine departments laid their accounts in September. However, the graph indicates that the majority of departments still consider the move towards faster closing of accounts to be a heavily end-loaded process with the most significant movements being anticipated in the final two years. Achievement of the proposed accelerated timetable will require significant effort by these departments in particular.

1.31 Fundamental to the success of faster closing will be the recognition that the accounts production process is not merely a year end activity. Robust, accurate and timely financial information is key to improved resource planning and should be something that departments produce and utilise throughout the financial year. Indeed, departments should not view the faster closing initiative in isolation, but should consider it as an outcome within the context of wider improvements in financial management across central government in general.

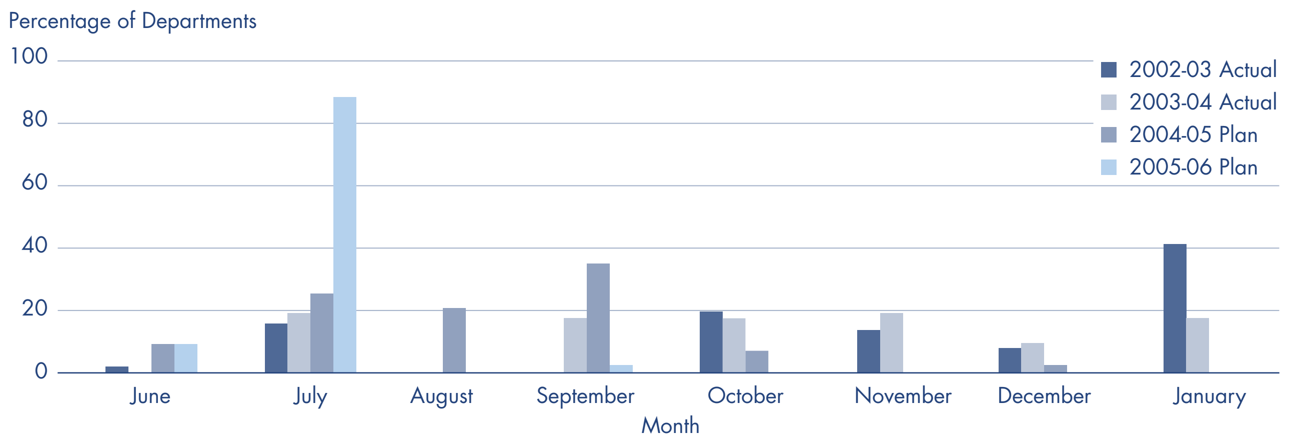
1.32 The Comptroller and Auditor General fully welcomes the steps which the Treasury is taking to speed up the delivery of accounts and is wholly committed to a partnership with departments to help achieve this. Part 3 of this report provides further detail of his work in this area

Implementation of a New Standard for Accounting for Retirement Benefits

1.33 Financial Reporting Standard 17 was implemented in 2003-04 for the first time in the central government sector. Initially, the Accounting Standards Board required full compliance with the standard from accounting periods ending on or after 22 June 2003. However, the Accounting Standards Board later amended the standard to require compliance for accounting periods beginning on or after 1 January 2005 although early adoption was encouraged. The National Audit Office supported the Financial Reporting and Advisory Board's decision to retain the original implementation timetable in the central government sector in order to enhance the reporting of future liabilities for public sector pensions.

1.34 This accounting standard requires employers to show the defined benefit pension asset or liability on their balance sheet. In the central government sector, where many defined pension schemes are multi-employer, the Treasury has specified that the pension liability must be shown on the balance sheet of the pension scheme itself rather than the balance sheet of the employer. This has resulted in the major unfunded central government pension schemes recognising over £360 billion of pension liabilities in their balance sheets for the first time in 2003-04. The majority of pension scheme accounts implemented the new standard satisfactorily and received unqualified audit opinions. However, in the following two cases there were problems that resulted in the Comptroller and Auditor General qualifying his audit opinion.

3 Timetable of Laying of Accounts



1.35 The Comptroller and Auditor General qualified his opinion in respect of the NHS Pension Scheme as it was not possible to obtain sufficient audit evidence to support the liability for paying future pensions in these accounts. The liability as at 31st March 2004 is based on membership data for the NHS Pension Scheme as at 31st March 1999 with an approximate updating for subsequent financial years to reflect known changes that have occurred in the intervening period. This is not compliant with the requirement, as set out in the Treasury's Resource Accounting Manual, that the scheme obtains full actuarial valuations by a professionally qualified actuary at intervals not exceeding four years.

1.36 The Comptroller and Auditor General qualified his opinion in respect of the Teachers' Pension Scheme as the Scheme did not, when calculating its resource needs, allow for the full implications of pension liabilities or for the change in the Treasury's discount rate. As a result of this, the Scheme incurred an excess vote on both its resource outturn and net cash requirement.

Audit of Receipts of Revenue

Introduction

1.37 In 2003-04, HM Customs and Excise collected net revenue of £115.9 billion, and the Inland Revenue net revenue of £234.5 billion, including National Insurance Contributions. The Inland Revenue paid out £13.5 billion in Tax Credits. The Driver Vehicle Licensing Agency (DVLA) collected net revenue of £4.7 billion from Vehicle Excise Duty (VED). Overall this represents approximately 90 per cent of central government revenue for the year.

1.38 Under Section 2 of the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General is required to examine the accounts of the receipts of revenue on behalf of the House of Commons, to ascertain whether adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and 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 examination as he thinks fit and, together with a report on the resource accounts of the Department concerned, report to the House of Commons.

1.39 In accordance with the directions given by the Treasury, HM Customs and Excise and the Inland Revenue prepare financial statements of revenue receipts and payments which are laid before Parliament. The Comptroller and Auditor General audits these financial statements, and qualified his opinion in respect of the Customs and Excise Resource Account, and the Trust Statement prepared by the Inland Revenue (for further details see paragraphs 1.41 and 1.55 below). The Customs and Excise Trust Statement, the Inland Revenue Resource Account, the DVLA Trust Statement and the DVLA Business Accounts received unqualified opinions.

HM Customs and Excise

1.40 During 2003-04, the National Audit Office examined both new and existing systems for the assessment and collection of revenue, and certain of Customs' associated information technology systems. The Comptroller and Auditor General's published Standard Report, presented to Parliament in the HM Customs and Excise Annual Report (HC 119 2004-05) details the outcome of the work carried out by the National Audit Office.

1.41 Subject to the issues outlined in his Standard Report the Comptroller and Auditor General was satisfied that his work in 2003-04 gave him assurance that Customs' regulations and procedures provided an effective check over the assessment, collection and allocation of tax. He was also able to provide an unqualified opinion on the Department's Trust Statement. As mentioned in paragraph 1.15 above, the Comptroller and Auditor General was, however, required to qualify his regularity opinion on the resource account because the Department incurred expenditure of £167,140 for which it did not have Parliamentary authority.

1.42 The Comptroller and Auditor General reported to Parliament on two major areas in his Standard Report: the Department's effectiveness in tackling oils fraud and compliance in small and medium-sized enterprises. The results of other examinations carried out during the year were reported to Customs' management. The National Audit Office's coverage included:

- examinations of Customs' internal controls, including the development of governance arrangements;
- reviews of quality assurance work and other checks carried out by the Department on the tax systems;

- periodic in-depth reviews of existing systems and significant changes to them, and evaluation of new systems;
- reviews of Customs' computer installations, networks and specific information technology applications; and
- test examinations of individual transactions and balances.

1.43 The Comptroller and Auditor General made the following observations as a result of his examinations of the Department's effectiveness in tackling UK oils fraud and compliance in small and medium-sized enterprises.

UK Oils Fraud

1.44 Customs have devised and implemented a Strategy to tackle the illegal use of diesel, aimed at reducing the scale of the illicit market to a level of two per cent by March 2006. Customs estimated that the scale of the illicit market in 2002 was six per cent, costing the Exchequer some £750 million. Latest available data for 2003 revealed that the scale of the illicit market remained constant at six per cent, but at an increased cost to the Exchequer of £850 million.

1.45 The Comptroller and Auditor General reported that Customs have developed an innovative approach in their fight against fraud. A scheme has been established that requires dealers in rebated oils to be registered. During the implementation phase of the Strategy, Customs have invested significant resources towards educating traders so that they understand their obligations, and to build a trader database. The registration scheme has in turn provided Customs with access to much greater information to strengthen their intelligence and drive assurance and detection work. From April 2004 onwards, Customs have adopted a tougher approach to the use of sanctions, to ensure compliance of dealers for whom a solely educative approach has not delivered the required results.

1.46 The Comptroller and Auditor General noted that the development of the Strategy represents effective cross-departmental working, and has also seen the development of information sharing with other organisations to improve the quantity and quality of intelligence material. Customs have focused on improving the intelligence processes and networks to deliver more and better quality intelligence to front line officers. However, he noted that the picture across the UK was far from uniform and some regions could learn much from the good practice in other regions as highlighted in his Standard Report.

1.47 The Strategy provides Customs with significant operational challenges in ensuring that proper support, particularly in the IT area, is provided to officers. Customs and industry also need to work together to incentivise greater take up of e-lodgement for monthly returns amongst the trader population using the Registered Dealers Scheme. This will allow significant savings in administrative and support resources deployed.

1.48 The Comptroller and Auditor General concluded that it is difficult to devise a robust performance measurement system to allow the effectiveness of resources deployed to be assessed on a timely basis. Nevertheless the developments made by Customs appear promising and have created an integrated approach within the department to tackle oils fraud effectively.

Improving compliance in small and medium-sized enterprises

1.49 Customs have implemented a new VAT Compliance Strategy aimed to reduce the VAT gap from 15.8 per cent of what should be collected in 2002-03 to a target of 12 per cent by 2006. The Comptroller and Auditor General's Standard Report focused on areas where the implementation of the VAT Compliance Strategy can be improved within the Regional Business Services.

1.50 Results for 2003-04 show that Customs have made significant progress, with the VAT gap reducing by almost three per cent to 12.9 per cent. However, the Comptroller and Auditor General noted that it was too early to report formally on the effectiveness of the VAT Compliance Strategy because of the difficulties in separating out the increase in revenues as a result of assurance and compliance activities, and those caused by other fiscal and economic factors. Nevertheless, the reduction in the VAT gap, to which the Strategy contributes, appears impressive and there have been a number of innovative developments which have enhanced the approach to risk taken within the Regional Business Services. As part of the implementation of the strategy the risk analysis system has been restructured by introducing risk centres to all regions. Initial signs are encouraging, with the move towards a more flexible and varied risk assessment co-ordinated by a national risk management structure.

1.51 The Comptroller and Auditor General reported that performance measurement systems to evaluate the impact of these changes were still evolving. Customs were able to assess the effect of different elements of the Strategy to varying degrees, and their end of year performance report to the Treasury was a step in the right direction that would need to be further enhanced in the future. New measures of performance will continue to evolve as their interventions become more targeted. Customs will continue to evaluate the effect of redeploying and reprioritising resources to address the areas of perceived greatest risk and concern.

Inland Revenue

1.52 The National Audit Office review periodically existing and new systems and significant changes to them, and undertake test examinations of individual transactions and balances as necessary. The audit emphasises aspects of management control over business and tax streams, including accountability; corporate governance; management's quality assurance procedures; risk analysis of the tax or business stream; and the Department's identification of obstacles to the assessment and collection of tax.

1.53 The Comptroller and Auditor General's published Standard Report, presented to Parliament in the Inland Revenue Annual Report (HC 1062 2003-04) details the outcome of the work carried out by the National Audit Office.

1.54 The Comptroller and Auditor General's 2003-04 Standard Report covered Working Tax Credits, Child Tax Credits and Stamp Duty Land Tax. In his Report he also outlined certain developments and the circumstances in which the Department had detected the incorrect deletion of several hundred thousand taxpayer records (for further details see paragraph 1.64 below). These matters were considered by the Committee of Public Accounts in January 2005.

1.55 The Comptroller and Auditor General qualified his audit opinion on the Department's Trust Statement account for 2002-03, in respect of Working Families' and Disabled Person's Tax Credit payments, as a Departmental exercise had estimated that overpayments resulting from claimant error and fraud amounted to 10 to 14 percent by value. The Department told the Committee of Public Accounts in January 2004 that error rates under the new Tax Credits might be half of those under the previous Tax Credit schemes. The Department had not yet estimated the level of financial error on the new Tax Credits and so the Comptroller and Auditor General had no evidence that error had been reduced sufficiently to enable him to give an unqualified audit opinion. He therefore qualified his audit opinion on the 2003-04 Trust Statement account in respect of the new Tax Credit payments.

1.56 Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, the National Audit Office's work in 2003-04 provided overall assurance that the Inland Revenue's regulations and procedures continued to provide an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out, subject to reservations about Tax Credits and certain other matters, discussed in the following paragraphs.

Child and Working Tax Credits

1.57 The Department undertook the major annual exercise to finalise and renew Tax Credit awards mainly from April to September 2004. In planning the renewals exercise, the Department aimed to address the lessons learned from the system problems of the previous year. The Comptroller and Auditor General noted that the extent of the Department's success in the renewal process, and in avoiding significant problems, would be seen fully only later in 2004-05 when the renewals process is finished and reviewed.

1.58 The new Tax Credits has proved relatively easy for people to access but many have found it difficult to understand exactly how much they are due - a problem made worse for those who have been paid the wrong amounts. The administration of the new Tax Credits has proved complex in parts, reflecting the underlying design of the new Tax Credits and the desire to provide support that is responsive and tailored to a wide range of circumstances.

1.59 Some essential controls over the new Tax Credits did not work in 2003-04, including the daily reconciliation of payments authorised with payments made, which was planned as a fundamental daily check on processing. The Department retrospectively completed reconciliations for 2003-04 in September 2004 and this work has resulted in the correction of a significant number of claimants' records. The Department plan to introduce fully automated daily reconciliations in the second half of 2005.

1.60 The Department had to move staff from other tax work to help when the new Tax Credits system problems arose in the first half of 2003-04. They planned to recover fully from the impact of the initial Tax Credits problems by the end of 2004-05. The Comptroller and Auditor General observed that the Department will need to ensure that the recovery plans are not frustrated by further extensions of the new Tax Credit IT systems. Business as usual collecting taxes must not be allowed to suffer and the Department must ensure that their responses to system problems do not undermine their reputation for integrity of processing taxpayers' affairs.

Stamp Duty Land Tax

1.61 The Department modernised stamp duty on land and buildings with the introduction of Stamp Duty Land Tax on 1 December 2003. New legislation, together with regulations and consequent administrative procedures and checks, sought to minimise recognised stamp duty tax avoidance. These measures, however, did not fully close all the known tax avoidance opportunities.

1.62 The Comptroller and Auditor General reported that the new tax was implemented without the introduction of an automated system and the success of the interim, manual arrangements was a credit to those involved. There were, however, lessons to be learnt from tight project timetables which need to be allowed for when planning future projects.

1.63 The Comptroller and Auditor General noted that the Department were developing IT systems to remedy the limitations in procedures and controls during manual running. During that period some compliance work was undertaken to a lower level than planned and the Department plan to introduce a more comprehensive approach. This will only be fully effective once the IT systems are in place. The Department need to remedy the current limitations and ensure that this work is undertaken comprehensively for the future.

Deleted taxpayer records

1.64 The Department became aware in the autumn of 2003 that a well established housekeeping routine on the PAYE computer databases had, for a number of years, deleted several hundred thousand records before the usual final review to check whether any tax remains overpaid or underpaid for the relevant year. The Comptroller and Auditor General noted that some customers have not received the repayment to which they were entitled and others owed tax which has not been collected. As the records had been deleted there was no way of identifying those whose records were open when the routine was run. This routine has been corrected.

1.65 The Department decided in late 2004 that on balance they could not justify any further action to try to identify and contact likely affected taxpayers.

Merger of Customs and the Inland Revenue

1.66 In the 2004 Budget, the Chancellor announced the merger of the revenue departments to form a new department HM Revenue and Customs, subject to the passing of required legislation.

1.67 The Treasury will have lead responsibility and accountability for tax policy and the new department – HM Revenue and Customs – will implement the policy.

1.68 The National Audit Office and both departments are already working closely to help bring about the transition to the new arrangements, whilst recognising the risks to revenue during the necessary organisational changes. Work is already underway to agree a common set of accounting policies which will be needed to produce a single set of accounts, and the Departments intend to produce a consolidated account for 2004-05 which the NAO will audit on a dry run basis.

Accruals Based Accounts for Revenue Receipts

1.69 Accounts of revenue receipts have to date been prepared on a cash basis. To fully implement the principles of resource accounting and to prepare for Whole of Government Accounts the revenue departments and the DVLA have been making progress towards accounting for taxation income on an accruals basis.

1.70 The National Audit Office have worked with Customs to ensure that a robust framework has been developed to allow the production of revenue accounts on a full accruals basis. Although the 2003-04 accounts were reported to Parliament on a cash basis, a dry run audit of an accruals based account was also carried out and the results reported to Customs' management. The work carried out to date will now allow Customs to move to account for revenue receipts from 2004-05 on an accruals basis. No further cash based accounts will be required.

1.71 The progress made by the department reflects the results of close working with the National Audit Office to agree appropriate accounting policies, and to ensure that the underlying information technology and accounting systems can generate sufficient, appropriate audit evidence to support the Comptroller and Auditor General's audit opinion.

1.72 Accruals based accounting for the Inland Revenue presents a number of additional challenges, since there are several tax streams for which accruals will need to be based on statistical forecasts due to the nature of the tax regimes currently in place. For example, on Self Assessment Income Tax, taxpayers' returns are not due until ten months after the financial year end. Nevertheless, Inland Revenue are pushing forward with presenting an accruals based trust statement for 2004-05, and the National Audit Office will continue to work closely with the department to assist in the production of robust and accurate financial statements.

1.73 Changes to the rules governing the liability of vehicle owners in respect of Vehicle Excise Duty (VED), introduced in 2004, are enabling the DVLA to make more accurate assessments of the VED payable during any one year. As a result the DVLA are intending to produce an interim Trust Account on an accruals basis for the first half of 2004-05 to test the procedures and proposed accounting policies for preparing such an account. If successful this test should enable a full year account to be prepared for audit as a dry-run with a view to transferring to an accruals based Trust Statement for 2005-06.

Audit of Public Debt and Reserves

Introduction

1.74 The Comptroller and Auditor General's audit of debt and reserves involves the examination of a number of areas including central government receipts, payments and borrowing via the Consolidated Fund and National Loans Fund, debt and cash management through the Debt Management Account, the operations of the Commissioners for the Reduction of the National Debt and the Public Works Loans Board, and the management of foreign exchange reserves through the Exchange Equalisation Account.

The Consolidated Fund and the National Loans Fund

1.75 The Consolidated Fund is the government's account at the Bank of England through which the vast majority of central government receipts – for example, tax receipts – and payments flow. Payments from the Consolidated Fund fall into two broad categories:

- Supply services – these are issues required to meet government expenditure. Parliament provide amounts of money to government departments each financial year through the annual Consolidated Fund Act and Appropriation Act;
- Standing services – these are payments for services that Parliament have decided should be made directly from the Consolidated Fund and are not subject to annual authorisation by Parliament, for example, Civil List payments and payments to the European Union.

1.76 While the Consolidated Fund continues to be accounted for on a cash basis, the Treasury incorporated additional disclosures in the 2003-04 accounts to provide more information on the Fund's obligations under standing services - for example, on Royal Household and Members of the European Parliament pensions and payments to the European Union. The 2003-04 accounts show that total receipts and payments into and out of the Consolidated Fund were almost £339 billion, including gross receipts of £146 billion and £116 billion from the Inland Revenue and Customs and Excise respectively. Payments for supply services came to £313 billion while the total for standing services was £22 billion.

1.77 The National Loans Fund is the government's principal borrowing account. It is also an important source of finance for government lending. Money borrowed by the government, for example through the issue of gilts, flows into the National Loans Fund, together with interest and principal repayments on loan finance made available from the Fund to public corporations and local authorities. In addition to making loans, money flows out of the National Loans Fund to meet government debt obligations, for example, gilt coupon and redemption payments.

1.78 The Consolidated Fund and the National Loans Fund are closely linked. The Consolidated Fund is balanced on a daily basis via a payment from, or transfer to, the National Loans Fund.

1.79 In 2003-04, following amendments to the National Loans Act 1968 through the Finance Act 2003, the first set of accruals accounts was produced for the National Loans Fund. These show that at 31 March 2004 the government's net liabilities through National Loans Fund borrowing were £413 billion, compared to £368 billion at the end of the previous financial year. In total, the Fund's liabilities were £503 billion, and included £342 billion in long term borrowing through gilt-edged stock, £65 billion borrowed in the retail savings market by National Savings and Investments, and a further £60 billion gross (£25 billion net) financed from the Debt Management Account and its money market borrowing operations. The Fund's assets were £90 billion, and included £41 billion advanced to the Public Works Loans Board to finance loans to local authorities and a further £35 billion advanced to the Debt Management Office to finance its debt and cash management activities. The 2003-04 accounts also show that the total cost of financing the Government's borrowing through the Fund of £25 billion, was offset partly by income of £5.5 billion, from lending operations.

1.80 Both the Consolidated Fund and the National Loans Fund are operated by the Treasury. However, except for transfers between the two funds, the Treasury can only make issues from them with the authority of the Comptroller and Auditor General. On each business day, the Treasury sends a "credit requisition" to the Comptroller and Auditor General showing why the issues are needed and the relevant statutory authority. Once the Comptroller and Auditor General has checked the credit requisition and is content with the proposed issue, a "credit" for the amount requested is sent to the Bank of England, who can then make the payments required on direction from the Treasury.

1.81 During 2003-04, the Treasury took forward a project to introduce a new computerised system for the authorisation and payment of transactions relating to the Consolidated Fund and National Loans Fund. The Treasury have consulted the National Audit Office throughout this process to ensure that the requirements of the Comptroller function are reflected properly within the new system while taking advantage of the benefits expected from the introduction of new technology.

Debt and Cash Management

1.82 The Debt Management Office is an executive agency of the Treasury that exists to support the government's debt management objective – to minimise over the long term the cost of meeting the government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the objectives of monetary policy. The Debt Management Office is also responsible for managing the government's daily cash requirement – to offset, through its market operations, the expected cash flow into or out of the National Loans Fund, in a cost effective manner and taking account of risk.

1.83 The Debt Management Account facilitates the management and reporting of the activities of the Debt Management Office in pursuit of its debt and cash management activities. At 31 March 2004, the Account held £41 billion in assets, for example – debt securities and loans, for the purpose of debt and cash management.

1.84 In 2002-03 a new target was set to complete the audit of the Debt Management Account prior to Parliament's summer recess. This was achieved successfully, and this progress was consolidated in 2003-04 as the Comptroller and Auditor General certified the Account in July 2004.

1.85 The Debt Management Office also administers functions relating to the Commissioners for the Reduction of the National Debt and the Public Works Loans Board. The main function of the Commissioners for the Reduction of the National Debt is to invest funds on behalf of certain government entities. Financial statements are prepared for each investment fund and these are audited by the Comptroller and Auditor General. In 2003-04, these accounts were prepared on an accruals basis for the first time. The additional work involved meant that completion of these audits was delayed until after Parliament's summer recess, although the quality of the financial statements produced was enhanced considerably.

1.86 At 31 March 2004, the Commissioners controlled funds with a market value of some £39 billion. This included £27 billion, £4 billion and £3 billion on behalf of the National Insurance Fund, Court Funds (England and Wales) and the National Lottery Distribution Fund respectively. The financial statements for 2003-04 were certified with unqualified audit opinions.

1.87 The Public Works Loans Board considers loan applications from local authorities and other prescribed bodies and, where loans are made, collects the repayments. In 2003-04 the financial statements of the Public Works Loans Board were also prepared on an accruals basis for the first time. The 2003-04 accounts were certified with an unqualified audit opinion and show that the Public Works Loans Board had loans outstanding of £42 billion at 31 March 2004, compared with £45 billion at the end of the previous financial year. The accounts also show that the Board's income from interest receipts and premiums amounted to £4 billion in 2003-04.

Foreign Exchange Reserves

1.88 The management of the United Kingdom's foreign exchange reserves is reported through the Exchange Equalisation Account. The reserves comprise holdings of gold, foreign currencies and International Monetary Fund Special Drawing Rights. The Exchange Equalisation Account is controlled by the Treasury, although day to day management and operation of the Account is performed on behalf of the Treasury by the Bank of England.

1.89 In 2003-04 the National Audit Office, HM Treasury and the Bank of England revisited the audit timetable and set a target to complete before Parliament's summer recess – an advance of some four months on the prior year. The three parties worked closely to ensure that this target was met successfully and the 2003-04 financial statements were given an unqualified audit opinion by the Comptroller and Auditor General in July 2004. As at 31 March 2004, the Account held total assets of £24 billion including £16 billion of debt securities, £4 billion of loans and advances to banks and £2 billion of gold.

Whole of Government Accounts

Introduction

1.90 The Chancellor's 2003 Pre-Budget Report announced the Government's decision to proceed with the publication of Whole of Government Accounts (WGA) for the year ending 31 March 2007 onwards, fulfilling commitments in the 1998 Code for Fiscal Stability and the Government Resources and Accounts Act 2000.

1.91 WGA will be commercial-style group accounts for the whole of the public sector, prepared by the Treasury and audited by the Comptroller and Auditor General. The main aim of the Treasury's WGA programme is the provision of better quality financial information on the Government as a whole, underpinning the decisions of government fiscal planners, and improving the accountability of government.

1.92 The WGA programme continues to advance significantly, a key element being the production of published Central Government Accounts (CGA) for the year ended 31 March 2004, which will be subject to a full audit by the Comptroller and Auditor General. The first of the dry runs of WGA produced in parallel with the CGA will be undertaken for the 2004-05 year of account, culminating in the first published WGA in 2006-07.

Results of the second dry run Central Government Accounts for 2002-03

1.93 The WGA programme, with CGA as an interim step towards full WGA, was designed with clearly defined "milestones". These are intended to identify and make the changes that are necessary regarding the accounting polices, systems and procedures, and to do this in a progressive, manageable way. CGA encompasses the devolved administrations, central government departments, funds and non-departmental bodies (NDPBs). With the expansion of CGA to WGA the boundary will extend to include local authorities, NHS Trusts, trading funds and public corporations.

1.94 The second dry run for CGA in 2002-03 built on the experience of 2001-02 and lessons continued to be learned that will be of key importance in producing published CGA for 2003-04. Any dry run process is intended to identify issues, but it is encouraging that significant advances have been made since 2001-02, and that the technical aspects of the consolidation were working well. Items of note included:

- a marked improvement in the delivery of the CGA returns by departments and consolidating bodies within the timeframes set by the Treasury;
- an improvement in the ability of the CGA bodies to identify transactions and balances with other CGA bodies, although there were still some areas of difficulty that arose partly because cash-based systems were still being used, but also because some departments had been less successful than others in establishing systems (whether automated or manual) that identify such transactions and balances throughout the year. This issue is of importance to ensure that the overall picture of government finances is not unduly distorted through the inclusion of internal balances and transactions that should have been eliminated;
- as noted in paragraphs 1.69 to 1.73 above, progress has been made in accounting for taxation income on an accruals basis, particularly in respect of Customs revenue, although significant challenges still remain before robust accruals figures can be produced for the largest taxation streams; and
- considerable progress has been made in recognising the assets and liabilities of the Central Funds on a full accruals basis.

1.95 The NAO and the Treasury continue to work together to address these and other issues to ensure that the timeframe for the 2003-04 CGA can be met successfully, and at all times have been conscious to ensure that the burden placed on Departments and other consolidating bodies is kept to a minimum.

Progress on the first published Central Government Accounts 2003-04

1.96 Good progress has been made in producing the first published CGA for 2003-04, and while a publication timetable has not yet been determined, this is expected to be decided soon. In this first year of publication the emphasis has correctly been on ensuring accuracy of disclosure and the satisfactory resolution of issues, such that the accounts meet the user expectations of Parliament and the wider public. In future years it is intended that publication will be accelerated in line with the Treasury's wider commitment to the faster closing of all accounts.

1.97 The 2003-04 CGA will be published with an audit certificate from the Comptroller and Auditor General, and will be laid before Parliament. The Comptroller and Auditor General will also publish a report on the 2003-04 CGA. This report is likely to address, amongst other matters, significant accounting and auditing issues, as well as commenting on the governance statement and the operational and financial review.

1.98 Areas of relevance to CGA 2003-04 include those identified from the dry run process. In particular, the identification of transactions and balances between CGA bodies and the accounting for taxation on an accruals basis will continue to be important, but in addition a number of other issues may be of significance:

- because 2003-04 is the first year that pension schemes' liabilities have to be reflected in the primary statements, following public sector implementation of FRS 17, there is significant work to be done in compiling and validating this information;
- the completeness and disclosure of contingent liabilities; and
- financial instrument disclosures required by FRS 13, and the wider disclosure of Central Funds to reflect Government's management of its financial resources.

The Move to Whole of Government Accounts

1.99 The move to WGA will add significant extra work and complexity to the consolidation process. There will be the addition of approximately 900 bodies (in the region of 600 local authorities, 300 NHS Trusts, and 60 Public Corporations) that will result in a large number of sub-consolidations. In addition to the logistical challenges of data collection and compilation, there are a number of other significant issues that will need to be addressed, including:

- inconsistency of accounting policies, such as different methods of accounting for fixed assets;
- agreement of the WGA accounting boundary; and
- co-ordinating audit effort, which will include the Audit Commission appointed auditors (local government and NHS Trusts) and private firms (public corporations and foundation trusts).

1.100 The move to WGA is a significant one that will have many advantages. Comprehensive, audited public sector financial information based on UK Generally Accepted Accounting Principles (UK GAAP) will be available for the first time, and will contribute significantly to policy formulation and resource allocation, and will raise the quality of debate on the public finances. The Comptroller and Auditor General remains committed to working with the Treasury and other bodies across the public sector in making a success of the WGA project and, in so doing, increasing the accountability and transparency of the whole public sector, to the benefit of Parliament and the wider public.

Looking Forward

Lord Sharman's Review

1.101 In February 2001 Lord Sharman published his review of Audit and Accountability for Central Government, to recommend suitable audit and accountability arrangements for central government in the 21st century. The Government response to the review was published in March 2002.

1.102 Among the recommendations of the review was that the Comptroller and Auditor General should be appointed statutory auditor of all non-departmental public bodies (NDPBs), and that he should be given statutory access to a variety of private sector bodies in receipt of public funds where previously this depended on negotiated agreement or conventions. Ultimately, the Comptroller and Auditor General should be able to audit non-departmental public bodies that are companies and companies which are subsidiaries of non-departmental public bodies.

1.103 The Treasury have now made four orders under the Government Resources and Accounts Act 2000 (GRAA) extending the Comptroller and Auditor General's statutory rights of access to the bodies listed in Lord Sharman's report, as well as transferring the audits of a number of NDPBs. These orders came into force in May 2003 and July 2004.

1.104 Further to Lord Sharman's recommendation that the Comptroller and Auditor General should be able to audit government owned companies, the European Commission and the Department of Trade and Industry have accepted that there is no barrier in principle to the Comptroller and Auditor General taking on the audit of these companies. The National Audit Office is in discussion with the Institute of Chartered Accountants of England and Wales, the Department of Trade and Industry and the Treasury on the changes to UK legislation that might be required and on the practical arrangements that would be necessary to put this into effect.

1.105 International Accounting Standards are mandatory for EU listed companies in their group financial statements from 1 January 2005. The Treasury have decided that the implementation of international accounting standards in central government will follow UK Accounting Standards as they converge with international standards. There will thus be major changes in accounting standards over the next few years. The Financial Reporting Advisory Board, on which the National Audit Office are represented, and Treasury will have to consider how these should be applied or adapted for use in the government sector. The impact of this is addressed in Part 3 of this report.

1.106 These developments present exciting challenges, and are further evidence of the evolving nature of financial audit. They are challenges which are readily embraced and which will better place the Comptroller and Auditor General to discharge his responsibilities to Parliament in scrutinising the expenditure and income of all government bodies.

PART TWO

Corporate Governance Section

Introduction

2.1 In recent years, both the public and private sectors have seen the development of systematic 'risk management' arrangements as a basis for ensuring the effective delivery of organisations' objectives. In the central government sector, the Treasury require Accounting Officers in all central government public bodies to maintain, and review, a sound system of risk management and internal control and to attest to their compliance with Treasury's requirements through the publication of a Statement on Internal Control in their financial statements.

2.2 The Comptroller and Auditor General fully supports the steps taken to improve the risk management capacity of central government bodies. Today's public service delivery environment constantly presents new risks to the provision of public services, and robust risk management can help departments respond effectively and avoid failures in service delivery. Well managed risk taking also presents opportunities to deliver better public services, make more reliable decisions, improve efficiency and support innovation. The announcement in the Government's July 2004 Spending Review of its intention to achieve savings of £21.5 billion a year, staff reductions of 84,000 in support functions by 2008 and sales of £30 billion of assets by 2010 makes effective risk management even more critical. If these targets are to be successfully met whilst also meeting Public Service Agreements risks will need to be successfully managed.

The Implementation of Risk Management across Central Government

2.3 In August 2000, the Comptroller and Auditor General commented that properly planned and managed risk taking by government departments can promote innovation and lead to improved value for money for taxpayers.[1] Partly in response to this report Departments were considering how best to devise and implement effective risk management strategies.

2.4 In 2004, the Comptroller and Auditor General looked again at the progress departments have made and published a follow-up report.[2] This report was based on a survey of the main Whitehall departments, focus groups of departmental risk managers, comparisons with private sector organisations, academic research, case studies of five departments and the work of National Audit Office financial auditors in relation to their review of departmental Statements on Internal Control. The Comptroller and Auditor General reported that departments had made good progress in embedding risk management, providing staff with greater access to training and guidance on risk management, and building a common understanding of risks they face. He noted that progress had been made particularly in defining risk objectives, having processes to report changes in risks and in regarding risk as an opportunity as well as a threat.

2.5 The Comptroller and Auditor General highlighted a number of areas where more needs to be done. Only one quarter of the departments surveyed by the National Audit Office were confident that they had established an overall view about their exposure to risk. The management of working relationships with partner organisations needs to be strengthened, particularly where there are complex delivery networks or where clarity is lacking about which delivery organisation is responsible for different risks. More progress is needed to embed risk management in the day to day activities of departments, particularly by making sure that there is a sufficient critical mass of staff with well developed skills and expertise to manage risk effectively.

2.6 The report identified five key aspects of risk management which, if more widely applied, could contribute to better public services and increased efficiency:

- Sufficient time, resource, and top level commitment needs to be devoted to handling risks.
- Responsibility and accountability for risks need to be clear and subject to scrutiny and robust challenge.
- Judgements about risks need to be based on reliable, timely and up to date information.
- Risk management needs to be applied throughout departments' delivery networks.
- Departments need to continue to develop their understanding of the common risks they share and work together to manage them.

1 'Supporting Innovation: Managing Risk in Government Departments' – HC864 1999-2000.
2 'Managing Risks to Improve Public Services' – HC1078-I 2003-2004.

2.7 Overall, while significant progress has been made by departments to improve their risk management, the Comptroller and Auditor General concluded that they have further to go to demonstrate that they have made effective risk management a central part of their day to day general management processes in a way that can fully deliver improved performance and other benefits. They need to continue to develop their ability to take risks and innovate, to keep projects and programmes on track, to handle complex service delivery networks, and to be ready to respond to unexpected events.

Corporate Governance and Risk Management – the Role of the National Audit Office

2.8 The National Audit Office continue to work closely with audited bodies and their Audit and Risk Committees in assisting in the development of corporate governance arrangements and, more broadly, risk management procedures. As well as contributing to enhanced disclosures in Statements on Internal Control, auditors have given active support, encouragement and advice to help audited bodies to develop underlying internal control procedures.

2.9 The National Audit Office's financial audit methodology is a risk-based approach, involving explicit analysis of the audited body's business, the risks that they face and how those risks are managed. This provides a sound basis for consideration of the Statement on Internal Control. And it also leaves the auditors well placed to make recommendations for improvements to the client's internal control framework, including their approach to risk management.

2.10 On a more strategic level, the National Audit Office have continued to participate in various events to aid clients and their audit committees in developing their corporate governance arrangements. For example, the National Audit Office in association with the Northern Ireland Office, held a joint seminar in Belfast for senior public sector managers and non-executives to highlight best practice in Corporate Governance. The National Audit Office were also pleased to provide speakers for the Treasury's best practice Audit Committee Conference in November 2004 aimed primarily at central government audit committee members.

2.11 The National Audit Office regard well functioning audit committees as a key to achieving good corporate governance and consequently have been developing a range of guidance and tools to assist public sector audit committees. A key output in this regard has been the development of a self-assessment toolkit for audit committees. This uses externally facilitated, syndicate based workshops so that audit committees can assess their performance against best practice. The toolkit was initially developed for the Forensic Science Service and has been subsequently used by a number of other audit committees and has been well received culminating in the National Audit Office project team winning the 2004 Chartered Institute of Public Finance and Accountancy award for innovation and excellence in auditing.

2.12 In addition, in recognition of the significant contribution non-executive and independent members of audit committees can make, the National Audit Office have been actively encouraging the exchange of best practice by facilitating a programme of networking discussion groups for non-executives involved with central government bodies. These discussion groups are designed for six non-executives and two or three National Audit Office Directors, including one with a broad facilitator role. Groups discuss and share experiences and interests drawn from a range of topics including

- induction of new non-executives
- managing the audit committee agenda
- briefings from business directors
- financial matters and performance measurement
- judging the effectiveness of the audit committee.

2.13 The National Audit Office also contribute to the continuing development of advice in the audit of corporate governance through participation in such bodies as the Public Audit Forum, the Auditing Practices Board and the International Organisation of Supreme Audit Institutions (INTOSAI). Representatives of the National Audit Office served on the working group that developed the new INTOSAI Standard on Internal Control which was published in November 2004.

2.14 The National Audit Office are also well placed to identify good practice in specific areas within their client base and to share that good practice across wider audiences. In this regard, the National Audit Office recently undertook a review of corporate governance of Sponsored Bodies, paying particular attention to the risks to corporate governance of progressing departmental objectives and deliveries through Executive Agencies and Non-Departmental Public Bodies.

2.15 This review considered how effective corporate governance of sponsorship arrangements in the public sector can be achieved, the specific issues that arise from sponsorship arrangements and how these can best be integrated within the overall corporate governance arrangements of sponsors and sponsored bodies. The National Audit Office looked at the variety of sponsorship structures in place and developed a model of the essential dynamics of an effective sponsorship relationship. The review[3] included a framework of key questions and suggested action points for sponsor departments and their sponsored bodies to consider when reviewing the effectiveness of sponsorship arrangements.

Corporate Governance – Future Developments

2.16 The Treasury have recently undertaken a project to review the governance framework in central government. The expected outcome of this review will be the development of a Governance Code for Central Government along the lines of the Combined Code applicable to listed companies in the private sector. This aims to help central government departments to establish robust corporate governance arrangements to help provide a sound underpinning for the direction and control of departments. The National Audit Office have actively contributed to this review and are able to bring to bear a wide knowledge of the central government sector and its unique accountability arrangements.

2.17 The two year Risk Programme, launched by the Prime Minister in 2002 and led by the Treasury, was established to give focus and drive to departments in the development of plans and frameworks designed to make effective risk management a reality. The Programme came to an end in December 2004 and, following the Comptroller and Auditor General's report on Managing Risks to Improve Public Services which highlighted that it is critical for departments and their agencies to build on the momentum achieved to date, the National Audit Office jointly hosted with the Treasury a conference in February 2005 to provide further stimulus for departments and their agencies to maintain their efforts to fully embed risk management in their day to day activities.

2.18 The Conference was aimed at members of the Public Accounts Committee (PAC) and Accounting Officers of all Government Departments and agencies. It provided an opportunity to take stock of progress in improving risk management across government, and discuss what specific further improvements are needed in light of the Treasury's Cross Departmental Risk Programme, the Comptroller and Auditor General's own Report on risk management, and the PAC's subsequent conclusions to further improve risk management and encourage well managed risk taking.

3 'Corporate Governance of Sponsored Bodies: a review by the National Audit Office, November 2004.

PART THREE
Adding Value

Introduction

3.1 The range of financial audit work undertaken by the National Audit Office continues to evolve and this part of the report describes the additional audit services provided by the National Audit Office. The recent developments in this area reflect the commitment on behalf of the Comptroller and Auditor General to further contribute to the improvement of financial management and effective financial control across the United Kingdom central government sector.

3.2 This contribution can be made in many ways, most directly by reporting to the audited body on issues identified through the audit process and added value work. This role is supplemented through the direct secondment of National Audit Office staff to government bodies, and advice given on accounting treatments and developments. In addition, active participation by staff in relevant external bodies and organisations helps shape the auditing and accounting framework for the central government sector, at the same time as influencing the wider UK and international environment that central government operates within.

Reporting to the Audited Body

3.3 The primary objective of the National Audit Office's financial audit is to provide independent assurance, information and advice to Parliament on the proper accounting and use of public resources. A subsidiary, but nevertheless important, objective is to assist audited bodies to improve their financial and risk management.

3.4 As part of the audit process, National Audit Office staff assess the adequacy of a body's accounting systems and financial controls to the extent necessary to form an opinion on the accounts. In undertaking this work, they are able to offer constructive advice to the audited body where they identify weaknesses in the design, operation or application of these systems and controls, and to recommend potential improvements that could be made to the effectiveness or efficiency of the body's operations.

Management Letters

3.5 Advice provided during the course of an audit is often given orally. However, the more significant issues are raised formally at the end of the audit in the management letter. The Comptroller and Auditor General uses the management letter to inform clients of internal control and financial management weaknesses that he has identified as a result of his audit work, and will make recommendations as to how those controls and management procedures may be improved. He will also use the management letters to comment, where necessary, on an organisation's accounts production process and make recommendations to improve the quality and timeliness of the draft accounts produced for audit.

3.6 The overall results of the Comptroller and Auditor General's financial audit work in the period covered by this report indicated that, in general, the standards of financial control in audited bodies remained high. However, the Comptroller and Auditor General was able to make a number of recommendations for improvements to the majority of bodies' control environments and accounting processes.

3.7 Whilst the precise nature of the recommendations raised was tailored to the particular circumstances of each audited body, there were a number of key areas where common themes emerged during the audit of the 2003-04 accounts. These included recommendations designed to:

- improve the speed and accuracy with which accounts are produced in order to facilitate the faster closing initiative;
- enhance the disclosure of accounts presented for audit to ensure that these meet with best practice;
- further improve Governance and Risk Management procedures so that they reflect current best practice;
- improve the robustness of monitoring against Parliamentary and Treasury control totals as stipulated in each Department's supply estimate;
- further develop financial systems and controls to fully embed accruals based financial management; and
- improve the control and accounting of balance sheet items, in particular fixed asset accounting and provisions.

3.8 Whilst audited bodies are generally proactive in implementing recommendations raised by the Comptroller and Auditor General, there were still instances where recommendations arising from the previous year's financial audit had not been actioned appropriately. The Comptroller and Auditor General will continue to work with the audited bodies concerned, and where relevant their audit committees, to follow up and review the process of implementation.

Financial Impacts

3.9 While typically, recommendations arising from the financial audit have tended to focus upon improvements to audited bodies processes and procedures, the Comptroller and Auditor General is fully aware of the need to contribute towards the identification of financial savings within audited bodies. These savings will have a beneficial and direct impact upon the United Kingdom taxpayer.

3.10 Such savings are categorised as 'financial impacts', and whilst many of the impacts are realised through the Comptroller and Auditor General's value for money work, a number of significant impacts have been realised as a result of his financial audit work on 2003-04 accounts.

3.11 The Comptroller and Auditor General measures his impacts by calendar year and all reported financial savings are validated and agreed by the department(s) concerned. The process of agreeing the savings achieved as a result of the Comptroller and Auditor General's work during 2004 is ongoing, but the current estimate is that these will exceed £500 million. This is in excess of the Comptroller and Auditor General's target to generate savings to the public sector of £8 for every £1 spent in running the National Audit Office. It is estimated that £47 million of these impacts will be as a direct result of our financial audit work.

3.12 An example of a financial impact generated is detailed in the table below:

An example of a financial impact generated as a result of financial audit work
An impact of £10 million arising from recommendations made regarding improvements to record keeping and the monitoring of private sector led contracts with training providers. It is estimated that these improvements will deliver achievable reductions in payment errors of £10 million per annum.

Added Value Assignments

3.13 The Comptroller and Auditor General supplements his annual audit of accounts by a selective programme of project work - the Good Governance Programme. Often, the timescale and tight focus of financial audit prevent the National Audit Office from examining emerging findings in the depth or detail that they, or the client, might like in order to identify how improvements might best be delivered. Good Governance projects offer an opportunity to go beyond the process of 'holding to account' towards more explicitly helping organisations to improve.

3.14 These projects are discrete assignments which examine specific issues in greater depth. The programme of work is designed to enhance the quality of service provided to Parliament and audited bodies by examining key issues of propriety, governance and financial management. It also provides an opportunity to improve financial management and secure efficiency gains that are not essential parts of the financial audit certification process. The main criteria of this work however, is that the assignments are designed to focus on issues where the Comptroller and Auditor General feels he can 'add value' to the audited body.

3.15 The identification of such assignments can arise from a number of sources: as part of the risk analysis that informs the audit planning approach; as a response to a weakness identified as part of the financial audit process; in response to concerns raised by Audit Committees or management; or to address concerns raised by Members of Parliament regarding the propriety or economy of particular areas of public expenditure.

3.16 The results of assignments will be communicated to the audited body by various means; such as presentations, workshops or internal reports to management. Some assignments may lead to the publication of findings particularly where issues of wider application are identified.

3.17 Audited bodies have been very receptive to the assignments performed to date, and have implemented a variety of improvements in their controls and governance structures as a result of the work.

Examples of areas covered by added value assignments related to financial audit work on 2003-04 Accounts

A review of a major department's payroll system

3.18 The National Audit Office examined the progress made since an internal review had highlighted deficiencies in a new payroll system implemented by a major department. As a result of the work undertaken, the National Audit Office highlighted a number of lessons that should be learned so that the mistakes would not be repeated when implementing other similar IT Systems.

A review of the implementation of resource accounting and budgeting in the non-departmental public bodies of a major department

3.19 The National Audit Office assessed the impact of resource budgeting and accounting on a number of non-departmental public bodies and as a result provided a number of recommendations for management which highlighted best practice in resource accounting and budgeting.

A review of the controls and processes operating at Shared Financial Services Centres used by a major department

3.20 The National Audit Office conducted a review of the controls and processes operating at two national Shared Financial Services Centres. This resulted in 57 recommendations for control improvements being made. The Shared Financial Services Centres supply transaction and book-keeping services to in excess of 30 bodies. The implementation of these recommendations enabled the centres to meet industry required standards.

A joint international audit of overseas aid expenditure

3.21 The National Audit Office undertook, with colleagues from other overseas audit offices, a joint audit of overseas aid expenditure in a developing country. The tri-country audit team formed the unanimous opinion that there were sound arrangements in place for the audit of overseas aid. This should lead to benefits for the donors (arising from the streamlining of the audit process) and more importantly, there will be administrative savings for the recipients who include some of the poorest countries in the world.

National Audit Office Contribution to Faster Closing

3.22 Part 1 of this report referred to the Treasury's 'Faster Closing' initiative within the context of commenting upon the timeliness of departments rendering accounts for audit. Although departments have made considerable progress in working to improve the speed of delivery of their accounts, there remain a number of issues which must be addressed if bodies are to deliver their accounts to the timetables communicated to the Treasury. A key problem continues to be the reliance of audited bodies on a small number of technically qualified staff to carry out their accounts preparation. Many audited bodies continue to rely heavily on management information systems which are designed to operate on a cash basis. As a consequence, the year end accounts production process is reliant on a disproportionate level of manual effort.

3.23 The Comptroller and Auditor General has worked continually with both the Treasury and audited bodies in addressing these challenges. During 2004 the National Audit Office issued guidance to departments on faster accounts closure through the publication of the booklet, "Ready, Steady, Go". This guidance aims to highlight best practice in both the public and private sectors in meeting the challenges faster accounts closure brings. A companion publication to "Ready, Steady, Go" has also been issued, which provides updated, practical guidance for those involved in the preparation of resource accounts. Previously, National Audit Office staff were directly involved in consultation on the Treasury's guidance booklet for departments *'Managing Resources – Faster Closing'* and staff have continued to participate in various seminars to help promote the faster closing message to departments.

3.24 As part of the Comptroller and Auditor General's on-going commitment, National Audit Office staff are currently represented on the Treasury's Inter-Departmental Working Group established to identify best practice in the preparation of departmental accounts.

3.25 The Inter-Departmental Working Group has a broad remit including an assessment of areas of best practice in the National Audit Office audit process, the determination of where additional information and guidance to departments is required from the Treasury, and the identification and monitoring of key milestones in the process.

3.26 The Comptroller and Auditor General is committed to ensuring that the faster closing plans implemented by departments accurately reflect their current capabilities. To this end, recent revisions to the National Audit Office's financial audit methodology are designed to contribute directly to improvements in these capabilities. Faster Closing will depend not only on a more sophisticated year end process, but upon sound financial management operated by departments throughout the financial year. The production of robust and accurate financial information must be a monthly discipline that is not performed for its own sake, but which directly contributes to the financial monitoring and effective management of government departments. This in turn will lead to further efficiencies in the audit process, allowing the Comptroller and Auditor General to undertake large amounts of his audit work before the financial year end, hence further contributing to the accelerated certification timetable.

National Audit Office Contribution to the Efficiency Agenda

3.27 The Comptroller and Auditor General has always been highly supportive of initiatives designed to improve efficiency within central government. The drive for efficiency has gained a new impetus from the review led by Sir Peter Gershon, the then Head of the Office of Government Commerce, of public sector efficiency which aimed to release major resources into frontline services by reducing bureaucracy and undertaking activities more efficiently. The review recognised the key role that financial management has to play in the efficient use of resources and the delivery of efficiency programmes. In response to this, the National Audit Office are raising the prominence of efficiency in their mainstream work and are ensuring that the recommendations which they make to clients are more focussed on demonstrating opportunities to improve efficiency.

3.28 Following the Gershon Review, the government announced, in the July 2004 Spending Review, that all departments would have professional Finance Directors reporting to the Permanent Secretary with a seat on the Departmental Board by December 2006.

3.29 The Government also announced that the Treasury would conduct a department-by-department review of the effectiveness of financial management. The review is led by Mary Keegan (Head of the Government Accountancy Service) and a number of National Audit Office staff are assisting in this project. The Deputy Comptroller and Auditor General sits on the project steering group and there is a National Audit Office representative on each of the study teams. The initial phase of the review commenced in late 2004 and covered those departments with the biggest spending programmes. The reviews include a consideration of the accountability structures, planning and budgeting arrangements, the production and use of financial information and the effectiveness and efficiency of the finance function.

3.30 The Comptroller and Auditor General warmly welcomes these measures designed to improve the level of skills, experience and effectiveness in financial management. National Audit Office staff will continue to work closely with Finance Directors and other senior finance staff to provide advice and assistance where possible in improving the contribution of the finance function to financial management across departments.

3.31 The 2004 Spending Review also introduced departmental efficiency targets. These were supplemented with a wide range of initiatives designed to cut administrative cost and achieve efficiency gains across the public sector of 2.5 per cent a year.

3.32 As part of this initiative, the National Audit Office, in conjunction with the Audit Commission, are undertaking three reviews of service delivery chain efficiency. These focus on childhood obesity (which is being undertaken in partnership with the Health Care Commission), buses and housing and will track funding from central government throughout the delivery chain to citizens to identify potential efficiencies. This is very much developmental work where auditors are joining up to inform and contribute to Whitehall and the wider public sector's planning and implementation of Public Service Agreements. The National Audit Office and the Audit Commission plan to publish three separate reports together with a generic report highlighting principles of good practice.

Working with the Audit Commission

3.33 The National Audit Office have had close contacts with the Audit Commission for a number of years and both bodies consult regularly on common issues. On specific financial audit matters joint discussions have been held over Whole of Government Accounts, the Comptroller and Auditor General's audits of national NHS accounts (where, for example, the National Audit Office will be using Audit Commission auditors to audit most Special Health Authorities over the next three to four years); and our access to Registered Social Landlords.

3.34 There are an increasing number of initiatives either recently completed or currently underway to work more closely together. These aim to maximise the benefits of each body's respective knowledge and experience, and reduce the risk of duplication. For example, in addition to the three delivery chain studies, the National Audit Office are co-operating on a joint report on Financial Management in the NHS to accompany their work on the NHS Summarised Accounts.

Working with Internal Audit

3.35 The internal audit function operates as a service to the management of each audited body by measuring and evaluating the effectiveness of its internal control systems, while also performing an increasingly important role in risk management procedures. Internal audit therefore constitutes an important part of the systems of control within each organisation. To be most effective, internal auditors should be afforded the appropriate independence from management, reporting directly to the Accounting Officer and the body's Audit or similar corporate governance Committee.

3.36 The Comptroller and Auditor General considers the work of internal audit and seeks wherever possible to take assurance from its work. This reliance, facilitated by regular liaison and collaboration, provides audit cost savings to the audited body by reducing the overall audit burden.

Secondments to Audit Clients

3.37 The National Audit Office have an active programme of secondments to client organisations. This is an important aspect of our support for other organisations. It has benefits for the individual, for the office and for the host organisation. Such arrangements provide opportunities for the secondee to gain a greater understanding of the operating environment of the client, while at the same time enabling them to contribute to the quality of financial management at the organisation concerned by using their skills and experience to encourage change.

3.38 There are currently 25 National Audit Office staff on secondment to a range of domestic and overseas organisations. These include the House of Commons Select Committees, Her Majesty's Treasury, Department for International Development and the Foreign and Commonwealth Office. Overseas organisations benefiting from the Office's experience include the North Atlantic Treaty Organisation, the International Labour Organisation, the European Commission and the Office of the Auditor General in Australia.

Representation on Professional Bodies

3.39 The Comptroller and Auditor General and staff from the National Audit Office also continue their participation in the development of new accounting and auditing guidance through active participation on a number of professional bodies, while also continuing to work with those bodies tasked with strengthening oversight within the profession.

3.40 The Comptroller and Auditor General has been Chairman of the Review Board from its inception in 2000 and is the Chairman of the Professional Oversight Board for Accountancy. He also has observer status on the Financial Reporting Council and is a member of the Financial Reporting Review Panel.

3.41 National Audit Office staff are represented on a number of committees, such as the Institute of Chartered Accountants in England and Wales' Financial Reporting and Public Sector Audit Committees and the Chartered Institute of Public Finance and Accounting's Accounting and Auditing Standards Panel. The National Audit Office has representation on, the Auditing Practices Board's Public Sector Sub Committee and the Public Audit Forum. In addition, staff have been seconded to the Accounting Standards Board and the Treasury.

3.42 In addition to fulfilling its duties to Parliament, the National Audit Office seek to play a full part in the development of public sector audit around the world on behalf of the United Kingdom. The Comptroller and Auditor General is currently a member of the United Nations Panel of External Auditors, a member of the Governing Board of the International Organisation of Supreme Audit Institutions (INTOSAI) and a member of the Contact Committee of the European Court of Auditors. He also has observer status on the Governing Board of the European Organisation of Supreme Audit Institutions.

3.43 A member of the National Audit Office senior management board has been appointed chair of the Public Sector Committee of the Federation des Expert Comptables Europeans. The Committee promotes the exchange and acceptance of international best practice in public sector auditing and its members include all member states of the European Union, as well as Norway and Switzerland. In addition, National Audit Office staff are active on a number of INTOSAI bodies, such as the Auditing Standards Committee and the Internal Control Standards Committee.

Contribution to National and International Accounting and Auditing Developments

3.44 An important aspect of the role of the Comptroller and Auditor General is to contribute towards the shaping of accounting and auditing best practice within the central government sector. This role also extends to the wider public sector, as well as to the national and international context within which central government bodies operate. This is achieved through the provision of direct advice to client bodies, through the shaping of accounting developments in general, and through active participation in a range of professional bodies.

International Accounting Standards

3.45 From 1 January 2005 listed companies in the EU member states must adopt European Commission endorsed International Accounting Standards (IAS) in their group financial statements. In addition to EU member states, over 70 other countries will permit or require the use of IAS by some or all of their domestic listed companies, or have announced plans to do so. In the UK, the Department of Trade and Industry has decided that listed companies may adopt IAS in their individual accounts as well as their group accounts from 2005 onwards and that non-listed companies can choose to adopt IAS if they wish. In order to minimise the inconsistency and disruption arising from the concurrent use of two sets of accounting standards, the Accounting Standards Board (ASB) intends to bring UK standards into close convergence with International Standards over the next few years.

3.46 Almost all of the 500 or so central government accounts that the Comptroller and Auditor General audits are prepared in accordance with United Kingdom Generally Accepted Accounting Practice, which includes adherence to accounting standards, adapted as necessary by the Treasury to be meaningful in the central government context. The Treasury consider that generally accepted accounting practice could be met by either international or existing UK standards but have decided that the government sector should broadly follow the ASB timetable for convergence rather than the European 2005 deadline for listed companies. There will thus be major changes in accounting standards over the next few years and the Financial Reporting Advisory Board[4], on which

4 The Financial Reporting and Advisory Board is an independent body that advises on the application of financial reporting principles and standards for government. The membership of the Board reflects the relevant spread of interests, as well as ensuring its independence and accounting expertise.

the National Audit Office are represented, and Treasury will have to consider how these should be applied or adapted for use in the government sector. This process has already commenced with the issue of five new UK accounting standards by the Accounting Standards Board in December 2004 that will apply to listed companies for 2005-06 accounts. The National Audit Office will continue to work with the Financial Reporting Advisory Board to ensure the appropriate application of IAS to central government bodies.

3.47 During 2004 the National Audit Office issued guidance to staff and departments on International Accounting Standards through the publication of a booklet. The aim of this booklet was to provide clients with general guidance on the development of IAS and to allow them to assess the possible ramifications of IAS implementation to their entities. Further guidance will be issued to staff and clients as the convergence process progresses.

International Auditing Standards

3.48 The National Audit Office, along with auditors in the private sector, will be complying with International Standards on Auditing (ISAs) for audits of accounting periods commencing on or after 15 December 2004. The National Audit Office continue to work with standard setters to ensure that the requirements of the central government sector are fully reflected in any revisions of auditing standards. For example, National Audit Office staff are participating in the International Auditing and Assurance Standards Board working groups responsible for the revision of existing ISAs and the National Audit Office is represented on the Institute of Chartered Accountants in England and Wales' International Standards on Auditing Implementation Sub-Committee.

3.49 The Auditing Practices Board's Practice Note 10 'Audit of Financial Statements of Public Sector Entities' is being revised to reflect the new ISAs. The Practice Note provides additional guidance to auditors of public sector entities. This work is being undertaken by a working party of the Auditing Practices Board's Public Sector Sub-Committee which is chaired by a representative of the National Audit Office.

Provision of Accounting Advice

3.50 The provision of accounting advice to audited bodies is an important aspect of financial audit, and is particularly relevant as government departments continue to adapt to the requirements of resource accounting. Government bodies are increasingly required to exercise judgement in deciding upon the accounting treatment for assets, liabilities and financial transactions, and the Comptroller and Auditor General is responsible for advising on such treatments and for concluding on the appropriateness of the accounting judgements made by the bodies concerned. Looking forwards, it is anticipated that the implementation of International Accounting Standards will give rise to a significant number of enquiries and requests for assistance.

3.51 During the period covered by this report, the Comptroller and Auditor General assisted the management of audited bodies by providing technical advice on a range of issues. An important area of advice was accounting issues surrounding the implementation of FRS 17, Retirement Benefits to central government bodies. A further significant area concerned advice given on accounting for complex transactions such as the private finance initiative.

Accounting for Complex Transactions - the Private Finance Initiative and off balance sheet financing

3.52 Public private partnerships, and more specifically the Private Finance Initiative (PFI), remain a major method of infrastructure procurement in central government, local government and the health service. The Comptroller and Auditor General continues to carry out a wide range of value for money audit work on PFI and associated matters. The use of PFI deals also raises significant issues of accounting judgement in terms of how transaction streams and assets should be treated in the accounts of government bodies.

3.53 Obtaining good quality services at value for money should, of course, be the major incentive of PFI deals. But in addition to that objective, there are also strong incentives for public sector bodies to structure projects so that the assets (and the corresponding liability to pay for the asset) are not recorded on their balance sheet. This has been particularly the case in the local authority and health sectors. For instance, in the local authority sector, 'PFI credits' allowing projects to go forward have been conditional upon the local authority obtaining off balance sheet status for the project. These incentives may present a temptation to public sector bodies not only to diverge from good accounting practice, but also to structure contracts so as to achieve off balance sheet treatment rather than the best possible value for money.

3.54 For those public sector bodies audited by the Comptroller and Auditor General, he works closely with the body concerned to ensure that the accounting treatment for individual projects is appropriate, and he has made it clear to departments that where he considers that the liabilities arising from off balance sheet financing arrangements are not correctly reflected in the financial statements of the bodies that he audits then he will qualify his opinion and report to Parliament accordingly. He has not yet had the need to do so.

3.55 But, in the light of budgetary pressures, and notwithstanding the guidance on PFI accounting from both the Accounting Standards Board and the Treasury, it is clear that differing interpretations of the accounting guidance have been applied to projects in different parts of the public sector. Thus a number of new buildings or refurbishments of buildings in other parts of the public sector which the Comptroller and Auditor General might have expected to be accounted for on the relevant public sector body's balance sheet have not been so accounted for. This may have an impact on Whole of Government Accounts incorporating the local government and health sectors.

3.56 It is also apparent that a number of property assets built under PFI, such as a number of PFI schools and hospitals, have been accounted for on neither the public sector body's balance sheet nor that of the 'special purpose vehicle' of the consortium delivering the project. While there may be valid reasons of accounting and judgement for this in some cases, it is a cause for concern and at the behest of the Financial Reporting Advisory Board, the Comptroller and Auditor General has been working with the Treasury and the other UK public sector audit agencies to investigate the factors behind the seemingly inconsistent treatments and to consider whether changes to the guidance are necessary.

3.57 These issues are not new and the Comptroller and Auditor General has previously brought attention to them in his General Reports for 2001-02 and 2002-03, and the Financial Reporting Advisory Board has expressed similar concerns in its last two annual reports. The Treasury's response to the last report of the Financial Reporting Advisory Board noted their commitment to reinforcing the message to departments that they should enter into PFI arrangements based on the key determinant of value for money, not the accounting treatment. It has also discussed changes to departmental sectoral guidance and noted that they will consider suggestions from the audit agencies on how the Treasury guidance might be amended in an effort to ensure that there is full compliance with the requirements of the relevant Financial Reporting Standard. All of this is welcome and the Comptroller and Auditor General looks forward to the outcome of these commitments.

APPENDIX 1

Outturn of all Resource Accounts

This summary records the outturn for Resources Accounts as follows:

Resources	**Gross expenditure**	**£000**	**£000**
	Estimates:		
	Original Estimates	398,230,033	
	Supplementary etc. Estimates	63,874,678	
			462,104,711
	Actual		444,883,569
	Saving		17,221,142
	Appropriations in Aid		
	Authorised:		
	Original Estimates	39,092,612	
	Supplementary etc. Estimates	30,179,417	
			69,272,029
	Applied		67,295,821
	Deficiency		1,976,208
	Net Expenditure		
	Estimates:		
	Original Estimates	359,137,421	
	Supplementary etc. Estimates	33,695,261	
			392,832,682
	Actual		377,587,748
	Saving		15,244,934
Cash	**Net Expenditure**		
	Estimates:		
	Original Estimates	303,851,191	
	Supplementary etc. Estimates	17,993,334	
			321,844,525
	Actual		313,831,161
	Saving		8,013,364

Consolidated Fund Extra Receipts Consolidated Fund Extra Receipts Surrenderable recorded in the Resource Accounts amount to £9,054,278,896.56

Actual Outturn The actual net resource outturn is £377,587,751, 116.31 and the actual net cash outturn is £313,831,163,756.66

APPENDIX 2

Accounts audited by the Comptroller and Auditor General

Type of account (2002-03 figures in brackets)	Number audited	Opinion qualified[1]
Resource Accounts[2]	56	4
	(57)	(8)
Executive Agency[3]	87	0
	(88)	(0)
Other UK accounts audited under statute or by agreement[4]	416 (402)	13 (7)
Total 2003-04	559	17
Total 2002-03	547	15

NOTES

1 Appendix 3 provides details of the accounts qualified.

2 Resource accounting is an accruals-based form of financial reporting that has been introduced in all government departments, and is the prime means of managing and reporting government expenditure and maintaining Parliamentary control. 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.

The total of 56 resource accounts includes the House of Lords Resource Account. This is a non-statutory account which is laid in the House of Lords (HC 197).

3 Executive Agencies have been established to undertake operational functions of departments. They are required to produce 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.

4 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 3

Accounts qualified by the Comptroller and Auditor General

Resource Accounts 2003-04

Department of Work and Pensions	Limitation of Scope Regularity
HM Customs and Excise	Regularity
Teachers Pension Scheme	Excess Vote
NHS Pensions	Limitation of Scope

Other Accounts Qualified

Inland Revenue Trust Statement 2003-04

Criminal Records Bureau 2003-04

Criminal Records Bureau 2002-03

Child Support Agency Client Funds Account 2003-04

National Insurance Fund (GB) 2003-04

National Treatment Agency 2002-03 (NHS Summarised accounts)

NHS England: Health Development Agency 2002-03 (NHS Summarised accounts)

NHS England: Dental Practice Board 2002-03 (NHS Summarised accounts)

NHS England: Mental Health Act Commission 2002-03 (NHS Summarised accounts)

NHS England: Retained Organs Commission 2002-03 (NHS Summarised accounts)

NHS England: Litigation Authority 2002-03 (NHS Summarised accounts)

NHS England: National Patient Safety Agency 2002-03 (NHS Summarised accounts)

National Clinical Assessment Authority 2002-03 (NHS Summarised accounts)

177790 03/05 77240