
Audit and Accountability in Central Government

**The Government's response to Lord Sharman's report
*"Holding to Account"***

March 2002

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EXECUTIVE SUMMARY

Accountability

1. Lord Sharman's report observes that "accountability in central government is based on an intricate web of relationships". The report summarises a number of key means by which departments, agencies and Non Departmental Public Bodies (NDPBs) are held accountable and notes that "different forms of accountability are best suited to different purposes".
2. The Government agrees with those observations. Much of the variation in the relationship between public sector bodies and Parliament results from a legitimate need to recognise the interests of Parliament and other stakeholders and the different relationships that the wide variety of public sector bodies have with each other. Accountability arrangements need to reflect that variety of interests and relationships.
3. Although public accountability is appropriate to a wide range of bodies, the manner in which that accountability is achieved can vary significantly from body to body. Bodies may need to be publicly accountable even if they deal with private money, while bodies that deal with public money may have quite different accountability arrangements from one another because of their different status and relationships (for example arrangements for central government departments differ from those for public corporations). The Government's response recognises such differences and variations whilst accepting that a greater degree of consistency is possible in some areas.

Stakeholder interests

4. The Government welcomes the recognition by Lord Sharman of the need to provide for the interests of stakeholders through the provision of concordats and other practical measures to underpin new audit and access arrangements.
5. The Government response sets out arrangements agreed with the Comptroller and Auditor General (C&AG) which will help to ensure that those changes do not lead to any reduction in the quality of audit or the level of assurance provided to the various stakeholders. For instance, the response includes proposals for a new client care facility within the National Audit Office (NAO), the establishment of a high level Audit Liaison Group, consultation with NDPBs on the appointment of auditors and involvement of NDPBs' sponsor departments in the audit coverage and outcome. Similarly, the arrangements which are set out in the response surrounding the C&AG's statutory access to documents held by third party bodies will provide assurance to those affected about the extent of such powers and the way in which they will be used.

Audit

6. In the light of the above arrangements, the Government agrees that the C&AG should be eligible to be appointed the auditor of all NDPBs. The Government intends, therefore, to use powers in the Government Resources and Accounts Act 2000 (GRAA) to appoint the C&AG as the statutory auditor of those NDPBs where the auditor is currently appointed by the Secretary of State or the NDPB Board. The Government will also consider how the Companies Act may be amended in order for the C&AG to be appointed auditor of those NDPBs which are also companies.

Access

7. The Government agrees that where access for financial audit purposes is currently provided, or would hitherto have been provided, on a non-statutory basis it should in future be provided on a statutory basis. The only exceptions would be where there are legal barriers or where such arrangements would have an adverse effect, for example, where it would undermine a body's ability to perform its functions. The Government will provide such access using powers in the GRAA, both to the four categories of bodies listed specifically in Lord Sharman's report and also to other bodies, including contractors. The Government will also explore how to provide statutory access to the same bodies for the C&AG's value for money studies.

Innovation and risk

8. The Government supports Lord Sharman's comments about the need to ensure audit arrangements do not discourage innovation, change and well managed risk taking. The Government is promoting measures to develop a robust structure of risk management and internal control in departments and is keen to ensure that due recognition is given to well managed risk.

Performance validation

9. The Government agrees that the introduction of regular performance reporting is a very important step in improving accountability. It is committed to ensuring that the information that underpins reporting on Public Service Agreement (PSA) targets is reliable, and accepts the recommendation that there should be some form of external validation of data systems which relate to these targets. The Treasury-led working group set up to consider this issue has now reported, and the Government proposes to invite the C&AG to take responsibility, under his existing powers, for the validation of data systems used in reporting on PSA targets.

OVERVIEW

1.1 On 28 February 2000 the Chief Secretary to the Treasury announced his intention to set up an independent review to examine the arrangements for accountability and audit in central government in the 21st century. At the same time he said that this was an opportunity for Parliament and Government to work together to make sure transparency and accountability go hand in hand with the modernising government agenda. Lord Sharman of Redlynch was invited to carry out the review. His work was overseen by a steering group chaired by the Chief Secretary and comprising representatives of Parliament and the Executive as well as some independent members. The terms of reference for the review and membership of the steering group are set out at Annexes I and II.

1.2 Lord Sharman conducted the review between September 2000 and January 2001 and published his report, *“Holding to Account: The Review of Audit and Accountability for Central Government”*, in February 2001. This document (Cm 5456) is the Government’s response to his report. The Government is grateful to Lord Sharman and his team and to the Steering Group for producing such a carefully considered report, and believes that his recommendations are likely to have a major and beneficial impact on the relationship between Parliament and the Executive for some time to come.

1.3 Following Lord Sharman’s report the Committee of Public Accounts (PAC) published a report (*“Review of Audit and Accountability for Central Government”*, Sixth Report 2000-2001) welcoming Lord Sharman’s recommendations. The Government, in its response to the PAC report (*“Treasury Minute on the Sixth and the Eighth to Tenth and the Twelfth Reports from the Committee of Public Accounts 2000-2001”*, Cm 5201, July 2001: text at Annex III) confirmed that a fuller response to both the PAC report and Lord Sharman’s report would be produced after consideration of Lord Sharman’s recommendations.

1.4 This present document is a response to both Lord Sharman’s report and the PAC report and comprises three main sections. The first section is an overview and responds broadly to the overall thrust of the report. The second section responds in detail to each of Lord Sharman’s main recommendations in the order in which they appear in the report. The third section is a paper agreed by the Treasury and the National Audit Office which considers the practical implications of implementing certain of Lord Sharman’s recommendations, particularly those relating to audit, access, quality assurance and corporate governance.

The importance of accountability

1.5 An effective system of accountability of the Executive to Parliament, backed up by rigorous processes of audit, reporting and scrutiny, is fundamental to the proper operation of a Parliamentary democracy. The Government therefore welcomes the emphasis which Lord Sharman’s report places on accountability and agrees with the view (*“Holding to Account”*, paragraph 3.26) that “there is no doubt that there are greater expectations (in Parliament, Government and amongst the public) of openness and transparency when dealing with public, rather than private, funds and assets.”

1.6 The Government also endorses the observations of the report (*“Holding to Account”*, paragraph 3.6 et seq) that “accountability in central government is based on an intricate web of relationships”. Box C1 in the report summarises a number of key means by which departments, agencies and NDPBs are held accountable and paragraph 3.8 notes that “different forms of accountability are best suited to different purposes.”

The scope of public accountability

1.7 In initiating Lord Sharman's review the Government recognised that the same systems of audit and accountability designed for the central government of the 19th century have continued into the 21st century. It believed there was a need for review to ensure that audit and accountability arrangements fully take account of the different ways in which public services are delivered and the moving boundaries between the public and private sectors. The Government also wished to respond to concerns expressed by the PAC in their Ninth Report 1999-2000 concerning the audit of NDPBs and Government owned companies, and access to service deliverers. Meanwhile the Government has indicated that some of the variation in the relationship between public sector bodies and Parliament may result from a legitimate need to recognise the interests of other stakeholders alongside those of Parliament and the need for accountability arrangements which reflect those other interests. This is a complex area, and the Government is grateful for Lord Sharman's analysis of these matters.

1.8 Lord Sharman proposes that public accountability and hence public audit should be appropriate for public money and constructs a definition of public money for that purpose (*“Holding to Account”*, paragraph 2.2: “...the underlying assumption is that, where public money is involved, some level of public accountability is required, regardless of the status of the body handling that money”; paragraph 2.22: “[public money is] all money that comes into the possession of, or is distributed by, a public body, and money raised by a private body where it is doing so under statutory authority”). In chapter 3 of his report Lord Sharman considers what degree of accountability and audit is appropriate to public money, and examines a number of key factors such as the role of the Accounting Officer, the use of non-executive directors on the boards of public bodies, the importance of internal controls and the role of audit committees and internal audit.

1.9 There is a great deal here with which the Government agrees. In particular, the Government believes that the form of accountability that applies to a body needs to take account of the relationship of that body to the Government, to Parliament and to other stakeholders. Although public accountability is appropriate to a wide range of bodies, the manner in which that accountability is achieved can vary significantly from body to body. Looked at from this perspective, accountability does not depend solely on whether or not a body is responsible for public money. Bodies may need to be publicly accountable even if they deal with private money, while bodies that deal with

Non-Departmental Public Bodies (NDPBs)

A Non-Departmental Public Body (NDPB) is defined in the Cabinet Office guidance “Non-Departmental Public Bodies: A Guide for Departments” (March 2000) as

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

In the main, they are financed by a grant-in-aid from a sponsoring department, and prepare and publish an annual report on their activities which contains audited financial statements. Some, however, are self-financing through trading receipts or levies on particular sectors of industry. The Treasury issues guidance on accounting and reporting requirements which is updated annually – “Non-Departmental Public Bodies: Annual Reports and Accounts Guidance”. The Cabinet Office has overall policy responsibility for NDPBs and information about their establishment and operation is available on the Cabinet Office website www.cabinet-office.gov.uk

public money may have quite different accountability arrangements from each other because of their different relationships (eg whether they are central government departments, NDPBs or public corporations).

The role of external audit in accountability

I.10 External audit has an important part to play in the process of accountability. The reputation that the Committee of Public Accounts (PAC), supported by the Comptroller and Auditor General (C&AG), has built up over the years for holding Accounting Officers to account is an enormous strength of the British Parliamentary system. The Committee and C&AG have played an important role in stimulating high standards of regularity, propriety and value for money. In central government that role goes beyond the traditional certification of accounts and includes the value for money inspections which the C&AG undertakes.

I.11 Lord Sharman rightly pointed out (*“Holding to Account”*, paragraph 4.1) that “External audit provides a key means by which Parliament, on behalf of the taxpayer, scrutinises how Government uses the money voted to it, and holds the Government to account.” He also highlighted in his paragraph 4.4 the importance of certain fundamental principles which are widely adopted throughout the world, namely the organisational independence of the audit office, its ability to decide on its own work programme and to employ the staff it needs, and the right to report freely. In this country, as Lord Sharman pointed out, the C&AG has performed this role for more than 130 years. The C&AG is an officer of Parliament and, as such, is independent of the Executive but part of the democratic political process. The Government values the ability of the C&AG to maintain his authority as an independent and objective auditor free of any possible criticism that his work is influenced by political considerations, whether from government or elsewhere.

Audit and access arrangements

I.12 Although Lord Sharman does not propose radical changes to existing arrangements for accountability and audit as they have evolved, or to matters such as the role and responsibilities of the Accounting Officer, he does suggest changes to the arrangements for the audit of some NDPBs and in the access rights of the C&AG to bodies which he does not audit but which are relevant for his audit of departments and other bodies.

I.13 The Government has made clear its view that there are arguments for and against widening the scope of the C&AG’s audit to include all NDPBs but has emphasised that, whatever decision is made, the interests of stakeholders need to be recognised and the chain of accountability supported. The Government has suggested that, if the audit rights of the C&AG are to be extended to include all NDPBs, then such rights would best be exercised within the framework of a concordat in order to ensure that there is no reduction in the level of assurance that is currently provided to departments and to ensure that the quality of the audit process does not suffer when the ability of departments to select the best auditor through competitive tendering is removed.

I.14 The Government therefore welcomes the recognition by Lord Sharman of the need to provide for the interests of stakeholders through the provision of concordats and other practical measures to underpin any new audit arrangements.

I.15 Following publication of Lord Sharman's report the Treasury has discussed with the NAO the possible content of such measures. The constructive proposals resulting from these discussions are set out in Section 3 and will sit alongside the changes to audit arrangements which the Government proposes to make. The Government believes that the arrangements on audit proposed in Section 3 will form the basis for ongoing improvement in the quality of audit and the level of assurance provided to the various stakeholders. Equally the Government believes that the proposals in Section 3 on access provide positive measures to avoid or minimise any burdens that might arise for the third party bodies to which statutory access would be accorded in connection with the C&AG's financial audits.

I.16 In the light of these proposals the Government intends to accept Lord Sharman's recommendations that NDPBs should be audited by the C&AG and that statutory access should be accorded to the C&AG to designated bodies in connection with these and the other financial audits for which the C&AG has responsibility. The Government also intends that access in connection with the C&AG's vfm studies is accorded to the same designated bodies.

Working together

I.17 The Government is grateful for Lord Sharman's careful examination of the scope for greater joint working between auditor and auditee, and for the helpful suggestions which he makes. Some of the recommendations made in the report are for others, such as Parliament and the C&AG, but the Government supports Lord Sharman's message that there is scope for joint working to improve the quality of public services. The Government agrees that the independence of auditors is a fundamental requirement of the public audit function but that "...within this constraintthere is much that auditors, given their privileged access, can and should offer" (*“Holding to Account”*, paragraph 5.5). The participation of the NAO in the Performance and Innovation Unit's 'Accountability and Incentives for Joined-Up Government' project, the results of which are reported in the *“Wiring it up”* report (see Box), and in the Cabinet Office's ministerial review of major Government IT projects was extremely valuable. The Government attaches great importance to the common agenda of Parliament, the Executive, auditees and other stakeholders in promoting regularity, propriety and value for money. It recognises that there could be considerable value in the NAO developing its thematic work. It will also continue to seek opportunities to work with the NAO to raise departmental performance and to provide greater assurance to Parliament about the control of spending. In pursuit of that objective, and consistent with the agenda envisaged by Lord Sharman, the Government intends to explore with the NAO the matter of delegation to departments of certain Treasury controls.

The “Wiring it up” report on Whitehall’s management of cross-cutting policies and services

This report was produced by the Cabinet Office’s Performance and Innovation Unit and published in January 2000. The report sets out a comprehensive package of measures to improve and modernise the way Government handles cross-cutting issues. It looks at the role of leadership; improving the way policy is formulated and implemented; the need for new skills; budgetary arrangements; and the role of external audit and scrutiny. In particular, it highlights the importance of putting in place the right structure of accountability and incentives for cross-cutting working. Many of the actions proposed in the report have now come into effect.

I.18 The Government welcomes the attention given in Lord Sharman's report to two recent developments in which the NAO's contribution has been, or has potential to be, particularly helpful.

I.19 The first such development is **Resource Accounting and Budgeting** (see Box). Box C2 in Lord Sharman's report sets out the implications of recent major changes for accountability and notes that the Treasury is developing a framework for analysing resource accounts which, as Lord Sharman notes, contain considerably more information on departments' financial results than traditional cash based appropriation accounts. The Treasury has produced a number of booklets in the "*Managing Resources*" series to coincide with the move to the new resource based financial management system from 2001-02. These include the "*Red Guide*" ("*Analysing resource accounts: user's guide*"), published in June 2001, which sets out a detailed framework for interpreting government departments' annual resource accounts. The framework is broadly equivalent to the analysis used for company accounts, but reflects the fact that different measures are needed to interpret central government accounts compared with private sector accounts. The ratios and measures included in the guide are tools for analysing and interpreting the raw figures in departments' accounts, and the results of the calculations are intended to be used to indicate areas where further analysis might be undertaken.

Resource Accounting and Budgeting

Resource Accounting and Budgeting (RAB) is a resource-based financial management system, bringing together central government planning, budgeting, Estimates and reporting on a basis that mirrors the highest standards of financial management and reporting used in the rest of the economy.

RAB translates the Government's policy priorities into departmental strategies and budgets, and then reports to Parliament on the efficiency and effectiveness of the services provided. The results of this process assist the Government in setting priorities for its biennial Spending Reviews.

From 1 April 2001, RAB has been fully implemented in the UK, providing better information for managers and Parliament and better incentives to reward good performance.

More information is available in the "*Managing Resources*" series of booklets produced by the Treasury and on the internet at www.resource-accounting.gov.uk

I.20 The second development concerns **corporate governance**. The introduction of a requirement, following on from the recommendations of the Turnbull Report (see Box), for Accounting Officers to prepare and sign a Statement of Internal Control (SIC) is an important development. Lord Sharman helpfully endorses this, and points out that a great deal of machinery needs to be put in place to facilitate this and to realise the potential of the SIC. Examples of such machinery are formally constituted audit committees, a well resourced and independent internal audit service and risk management arrangements embedded in departmental systems and thinking. The Government accepts Lord Sharman's observations and will continue to give effect to them in ways which recognise the particular requirements of central government.

I.21 The Government would add to the examples of machinery needed to realise the potential of the SIC the importance of the process of external review of the SIC. SICs encompass internal controls and risk management systems beyond purely financial controls. The Government acknowledges that the current lack of generally accepted suitable criteria to define, assess and report on the effectiveness of such controls means that formal audit opinions on effectiveness are unlikely to be feasible for some time. Nevertheless, some broader form of reporting by the external auditors on the effectiveness of internal controls, beyond that currently provided by auditors' management letters, might have significant advantages in highlighting at an early stage potential weaknesses, the possible impact of control failings at the highest corporate level, and the changes which need to be made in response. Such reporting might also give a better insight into those incidents which were within the acceptable tolerance of the controls put in place after a careful assessment of the risks facing the public body concerned. Moreover, since sound systems of internal control should include means of ensuring continuing compliance with the controls in question, a positive assurance on the SIC could give a measure of assurance about the present and the future as well as about the past.

I.22 The Government recognises that broader reporting of this kind would be additional to the external auditor's normal work as currently conducted. The implications of this factor and of the nature of public audit itself would need to be considered carefully. The Government looks forward to working further with the NAO in this area. As part of this work the

Turnbull Report and internal control in the public sector

The "*Turnbull Report*" (published in September 1999) was commissioned to examine the practical implications of putting in place two key provisions of the Stock Exchange's "*Combined Code*" for listed companies. These provisions concerned the directors' annual review of the system of internal control, the associated reporting to shareholders in a "*Statement of Internal Control*", and the annual consideration of the need for an internal audit function where one is not in place.

The issue of considering the need for internal audit is not so significant in government as it is in much of the private sector since the establishment of an effective internal audit function has long been a responsibility of Accounting Officers in government.

A requirement for an annual review of internal control and associated reporting in a *Statement of Internal Control* has, in the light of the *Turnbull Report*, been developed for central government. The *Statement* adapts the principles of the *Turnbull Report* to the particular structures and accountabilities of central government. *Guidance on the Statement of Internal Control* is issued by the Treasury and was promulgated within government in a *Dear Accounting Officer letter (DAO(GEN)13/00)*.

Government is developing risk management standards relevant to government. The Auditing Practices Board's July 2001 briefing paper "Providing assurance on the effectiveness of internal control" will also help to inform progress in this area.

Audit, accountability and risk management

1.23 Lord Sharman's report contains at paragraphs 5.33 – 5.48 a valuable analysis of the possible influence of the audit process on the civil service culture, which has often been described as risk averse and resistant to change and innovation. Views on this differ widely and Lord Sharman concludes that, while accountability mechanisms are perceived by some as a discouragement to innovate, this appears to be only one of a number of complex factors. He nevertheless exhorts auditors to recognise the dangers of being perceived as discouraging well managed risk taking.

1.24 The Government is grateful for Lord Sharman's dispassionate review of this important area. Government bodies operate in many difficult areas; their performance is often vital to the health and welfare of many sectors of the community; their activities can have major consequences for private sector companies and other organisations; and the scale of their activities is often many times bigger than other organisations. If the services they provide are to meet the needs of their clients, innovation and top quality management are essential.

1.25 The Government has embarked on a programme to modernise the delivery of public services and to recognise and reward staff who manage risk and innovation effectively. It is helpful that the NAO has published reports supporting cases of well managed risk taking (Lord Sharman's report includes examples). The PAC has helpfully acknowledged that "good management reduces but does not eliminate the possibility of adverse outcomes" (*Managing Risks in Government Departments*, First Report, 2001-2002, paragraph 3(i)). In commenting on this report the Chairman noted that the Committee "are prepared to accept the prospect that on occasion, something unforeseeable will happen to scupper even the best planned project" (PAC press notice on the First Report). Departments do not expect to escape criticism where it is due but it is important that where lessons need to be learned they should not lead to disproportionate controls that have the effect of dampening down innovation and of further encouraging a climate where compliance with process, or the desire to avoid minor failures, prevails over the achievement of important outcomes.

Performance validation

1.26 The Government agrees that the introduction of regular performance reporting is a very important step in improving accountability. It is committed to ensuring that the information that underpins reporting on PSA targets is reliable, and accepts the recommendation that there should be some form of external validation of departmental data systems which relate to these targets.

1.27 The Treasury-led working group set up to consider this issue has now reported. In the light of this work, the Government proposes to invite the C&AG to take responsibility, under his existing powers, for the validation of systems used in reporting on PSA targets where measurement of performance depends upon data. It is proposed that all relevant data systems should be examined at least once during the "lifetime" of a PSA, and that where data is already subject to validation because it forms part of National Statistics or because it is within the oversight of the Audit Commission, the C&AG will not normally wish to undertake detailed assessment of the relevant systems in framing his validation conclusions.

Implications for devolved authorities

1.28 In respect of devolved matters it is of course for the devolved authorities to consider how far they wish to implement the arrangements set out in the Government response.

1.29 In respect of non-devolved matters the Government will consult fully with the devolved authorities in taking forward the relevant arrangements.

THE GOVERNMENT'S RESPONSE TO LORD SHARMAN'S INDIVIDUAL RECOMMENDATIONS

ACCOUNTABILITY ARRANGEMENTS

RECOMMENDATION 1

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

2.1 The Government welcomes Lord Sharman's support for the steps which it has taken to promote strong internal controls and risk management systems within departments. The Government will continue to promote these and other steps to strengthen departments' corporate governance.

2.2 The Government believes that the statement on internal control will have an increasingly important part to play in these arrangements, including by providing a clear framework against which any particular failures of control can be gauged. As explained in Sections 1 and 3, standards for risk management, control and governance relevant to central government are being developed which will help to inform both the NAO's review of the SIC and further consideration of the nature of the review as experience is gained, although the Government recognises that such steps will take time to achieve.

2.3 The Government agrees that Accounting Officers (see Box), while ultimately responsible for the management of their department and therefore for signing the SIC, will in practice need to obtain assurances from other senior staff in order to sign the SIC. The Treasury's risk management guidance strongly encourages the clear allocation of responsibility to specified senior staff for the management of risks facing a department.

Accounting Officers

The Treasury is required, under the Government Resources and Accounts Act 2000 and the Government Trading Funds Act 1973, to appoint an Accounting Officer in each Government department and trading fund. Additional Accounting Officers may also be appointed in departments and Accounting Officers are designated in the vast majority of Executive Agencies and NDPBs. By convention the head of an organisation is appointed as its Accounting Officer.

An Accounting Officer has the personal duty of signing the accounts described in his or her letter of appointment and, by virtue of that duty, the further duty of being a witness before the Committee of Public Accounts, to deal with questions arising from those accounts or from reports made to Parliament by the Comptroller and Auditor General under the National Audit Act 1983. Associated with those duties are the further responsibilities which are set out in a Treasury guidance document "The Responsibilities of an Accounting Officer". More detailed guidance for the Accounting Officer and supporting staff is contained in the Treasury manual entitled "Government Accounting".

RECOMMENDATION 2

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

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

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

2.4 It is long-standing Government policy that departments and other central government bodies are strongly encouraged to follow commercial best practice by establishing audit committees (see Box). It is also Government policy that these committees should have an advisory role in relation to the Accounting Officers.

2.5 However, central government is a wide and diverse field, and central government bodies are not identical to companies. In particular, unlike companies, government departments do not have a corporate board structure from which informed non-executives with statutory responsibilities in relation to the organisation can be appointed to the audit committee. Instead the Accounting Officer carries a degree of personal responsibility not replicated in the private sector.

2.6 Existing Treasury guidance will continue to be developed in the light of the above considerations, Lord Sharman's recommendations, and other factors as appropriate.

Audit Committee structures in Government

In central government the Audit Committee exists to advise the Accounting Officer on the assurances available in respect of governance, risk management and control. As a result of the corporate governance initiative, many Accounting Officers have reviewed the composition and remit of their Audit Committee.

The exact composition and structure of an Audit Committee will vary from organisation to organisation depending on the operation and requirements of the particular body and its Accounting Officer. Typically an Audit Committee will include one or more external or "non-executive" members (who, in some cases, may chair the Committee) as well as a number of senior managers. The remit of the audit committee will include advising on risk management and governance issues as well as on direct internal and external audit issues.

RECOMMENDATION 3

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

2.7 It is long-standing Government policy for central government bodies to have access to an independent internal audit service (see Box).

2.8 Treasury guidance requires Accounting Officers to ensure that their internal audit service is adequately resourced; that audit committees are established to review the work programme and results of the internal audit service; and that the head of internal audit has a right of access to the audit committee. These arrangements will be kept under review.

Heads of Internal Audit

An Accounting Officer is charged with organising internal audit in accordance with the definition and standards set out in the “Government Internal Audit Standards” (GIAS) which are supported by good practice guidance. The composition of the internal audit function will vary depending on the size and complexity of the host organisation and, in some cases, its relationship with other bodies. In all cases, a Head of Internal Audit (HIA) needs to be appointed.

The HIA should be of appropriate grade or status, have wide experience of internal audit and management, should hold the Government Internal Audit Certificate and meet the level of competence set out in the Internal Audit Training and Development Handbook.

The HIA reports operationally to the Accounting Officer; this may be done through an Audit Committee.

RECOMMENDATION 4

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

2.9 The Government welcomes this recommendation. As Section 1 makes clear, the Government fully recognises the importance of audit independence, while also valuing the constructive advice which auditors can offer, at both the particular and the general level.

2.10 The Public Audit Forum (see Box) plays an important contribution to this field, and the Government will continue to contribute to its work through membership of its Consultative Forum.

Public Audit Forum

The Public Audit Forum was established in 1998 by the four national audit agencies, that is the National Audit Office (NAO), the Northern Ireland Audit Office (NIAO), the Audit Commission for Local Authorities and the National Health Service in England and Wales, and the Accounts Commission for Scotland. It brings together the audit agencies on a purely advisory basis to provide a focus for developmental thinking about public audit. It has a remit to build on the existing co-operation between the national audit agencies to enhance the efficiency and effectiveness of public audit, to provide a strategic focus on issues cutting across their work and to help develop common standards for public audit.

A key element in the Forum is a consultative forum which draws on the experience and expertise of public auditors, the bodies they audit, the auditing profession and the wider community. Membership includes representatives from Government departments including the Treasury Officer of Accounts.

AUDIT ARRANGEMENTS

RECOMMENDATION 5

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

2.11 Arrangements by which Ministers appoint the auditors of the NDPBs for which they are responsible can increase the assurance that departments may obtain about the stewardship of the NDPBs – which is to the public benefit. The competitive selection of auditors in such circumstances can also help to ensure vfm. Nevertheless, this arrangement has, in practice, been used only in a minority of cases, and there is no clear reason why it has been adopted in those cases but not in other similar cases.

2.12 In recommending that all NDPBs should be audited by the C&AG, Lord Sharman proposes measures to compensate for any reduction in assurance about the stewardship of the NDPBs. The Government welcomes the intention of the C&AG to implement the measures identified by Lord Sharman, together with the practical arrangements underpinning them, which are described in Section 3 of this document, and his intention to contract out extra work to commercial auditors. These arrangements recognise stakeholder interests in NDPB audits and will help to ensure access to any specific expertise needed to audit some specialised NDPBs.

2.13 The Government also welcomes the C&AG's intention to apply more widely the arrangements proposed in relation to NDPBs that he does not currently audit, as well as other improved arrangements as set out in wider practical arrangements described in Section 3. These will help to demonstrate the high quality of the NAO's financial audit and vfm work and to ensure a positive and constructive response to any concerns which stakeholders may have.

2.14 In the light of these assurances, the Government accepts the recommendation that NDPBs should be audited by the C&AG. This is in line with the practice that has been adopted since 1997. The Government therefore intends to use its powers in the GRAA to make the C&AG the statutory auditor of the Environment Agency, the Housing Corporation, English Partnerships and English Heritage as well as those smaller NDPBs currently audited by auditors appointed either by the Minister or by the body itself. The change will take place as existing contracts expire, as recommended by Lord Sharman. Departments will aim to ensure that any extensions to existing contracts will be on a short term basis only.

2.15 Housing Action Trusts are due to be wound up shortly: the existing audit arrangements for these bodies will continue until that time. NDPBs which are companies are discussed in the response to recommendation 6.

2.16 Lord Sharman also recommends that, pending the establishment of arrangements whereby the C&AG takes over responsibility for audit, he should provide a report to the PAC on the major points from the audited accounts and management letters of the executive NDPBs that he does not currently audit. This is essentially a matter for the C&AG and the PAC. However, the Government believes that, for reasons of transparency, there would be merit in reports of this kind.

RECOMMENDATION 6

The Department of Trade and Industry and the National Audit Office (NAO) should work together to identify how best the current obstacles to the ability of the C&AG to be appointed as an auditor under the Companies Act can be removed. The aim should be for the C&AG to be the auditor of NDPBs which are companies, companies owned by a department, or companies which are subsidiaries of a NDPB audited by the C&AG. And he should be eligible for appointment as auditor of companies where a department has a substantial stake or influence (for example, through being able to appoint board members, and influence strategy, or by way of a financial investment of, for example, more than 25 per cent of the shareholding). It seems most appropriate that the above should be public sector or near public sector companies. There may also be cases of other organisations with a 'public interest' role (eg representative bodies, or organisations which play a role in public life) where the C&AG should not be prevented from being eligible for appointment as the auditor, should he be asked to become so. If the C&AG were to become eligible to undertake such work, then such audits would be carried out on behalf of the relevant governing body of the entity, rather than on behalf of Parliament, as is already the case with his international audit work. Similar arrangements should be introduced for the audit of local government, and for the Auditor General for Scotland and the Auditor General for Wales as regards companies in their respective areas of responsibility.

2.17 The Government agrees that the policy that NDPBs should be audited by the C&AG should also be applied to those NDPBs which are companies, and to the subsidiaries of NDPBs.

2.18 Currently this cannot be given effect under company law (see Box), as Lord Sharman explains in his report. The EU Eighth Company Law Directive is also relevant, as Lord Sharman notes.

2.19 The Government is therefore exploring with the NAO how the law could be amended to permit the C&AG to be appointed auditor of companies, assuming that any legal issues arising from EU law can be resolved. This would enable him to be appointed to audit NDPBs which are companies, as well as subsidiaries of NDPBs set up as companies.

2.20 So far as companies owned by departments are concerned, some are NDPBs. The Government considers that the others, such as Consignia (formerly the Post Office), should continue to be subject to existing audit arrangements. Likewise the Government believes that other public sector companies where decisions over appropriate audit arrangements have been taken recently, for example the Financial Services Authority, should continue to be subject to existing audit arrangements.

2.21 Lord Sharman further recommends that the C&AG should be made eligible to audit "companies where a department has a substantial stake or influence"; and possibly "other organisations with a 'public interest' role (eg, representative bodies, or organisations which play a role on public life)". The proposed change to company law described above would make the C&AG eligible to audit any company, including those referred to by Lord Sharman. However, the Government does not in general believe that it is appropriate for the C&AG to audit companies which are in the private sector.

2.22 Lord Sharman also refers to the implications of any changes in this area for the audit of companies owned by local government and for the audit arrangements for publicly owned companies in Scotland and Wales.

2.23 On the first matter, arrangements are already in place to deal with the audit of companies owned by local government and these arrangements are to be reviewed.

2.24 On the second matter, the Government will consult the devolved administrations on the application of the above proposals to the Auditors General of Scotland, Wales and Northern Ireland.

The Companies Act

Section 25 of the Companies Act 1989 restricts eligibility for appointment as the statutory auditor of a company to those registered with a supervisory body recognised by the State for that purpose. The auditor must be an individual or a firm (typically a partnership, limited liability partnership or company). The conditions for registration include (for an individual) possessing an appropriate qualification on the basis of training, examination and experience; (for a firm) control by qualified individuals; and (for both) independence from the audit client and adherence to ethical and technical standards. A change to the Act would be needed to permit the appointment of the C&AG by a company as its auditor for Companies Act purposes.

The 1989 Act implemented in Great Britain the requirements of the 8th Company Law Directive of the European Union (84/253/EEC) on the approval of persons carrying out the statutory company audit function. The Directive permits Member States to approve as company auditors only natural persons or firms of auditors meeting specified requirements. Member States must also ensure that control of an audit firm remains in the hands of registered auditors. Any change to the Companies Act must therefore be compatible with the Directive requirements. Any change to the Directive itself must be proposed by the European Commission and approved by the Council of Ministers and the European Parliament.

Contact point: Company Law Directorate, Department of Trade and Industry (john.grewe@dti.gsi.gov.uk)

RECOMMENDATION 7

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

2.25 Successive governments have recognised the need for the C&AG to have access to documents held by bodies that he does not audit so that he can obtain all the information he needs for his statutory audits and vfm studies. Arrangements have been put in place over many years for him to have such access by agreement, through the terms of contracts or in conditions on the payment of grants.

2.26 By and large these arrangements have worked well and their flexible nature has enabled them to be adapted to new circumstances and new delivery mechanisms as these have developed. Moreover, the majority of the bodies concerned are in the private sector, including many charities and small firms with limited resources and which are already often subject to inspection and regulation to protect the public purse. Non-statutory arrangements have enabled their legitimate interests to be taken into account to ensure that they are not subject to any unnecessary burdens.

2.27 The Government notes the grounds for formalising the arrangements for the C&AG's access where it is currently based on negotiated agreement or conventions. It also notes the C&AG's view that negotiating access has not always been a satisfactory arrangement for him. At the same time the Government is concerned that the legitimate interests of the bodies to which statutory access would be granted should be protected by agreements or protocols, as proposed by Lord Sharman at paragraphs 4.57-58 of his report. It therefore welcomes the C&AG's agreement to the arrangements described in Section 3 of this response designed to provide assurance that statutory access would be exercised with full regard to such matters as the need for prior consultation and the need to minimize additional burdens.

2.28 In the light of these arrangements, the Government will provide the C&AG with statutory access, as recommended by Lord Sharman, to:

1. documents held by the bodies listed in paragraph 4.58 of Lord Sharman's report (as illustrative examples rather than an exhaustive list), namely:
 - bodies and undertakings in receipt of grants
 - registered social landlords
 - train operating companies, and
 - PFI contractors.
2. documents held by other bodies which are currently covered by access arrangements based on negotiated agreement or convention.

Moreover, the Government will provide access, beyond that recommended by Lord Sharman, to:

3. documents held by bodies in relation to contracts they have with organisations where the C&AG is the statutory auditor, including where access is not currently provided on a non-statutory basis. Access will also be provided to associated documents held by sub-contractors.

2.29 When the matter is considered in the future, the C&AG's access will, as recommended by Lord Sharman, be formalised.

2.30 These access arrangements, which are to provide the C&AG with statutory access to documents that he requires for the purposes of a financial audit, are subject to the need to retain, or to create, negotiated arrangements or conventions in a very limited number of cases. Examples are circumstances such as where there is an unacceptable risk of statutory access undermining the body's ability to perform its functions (eg by inhibiting investment in public service projects), or where there are legal barriers to providing statutory access. In addition, it is not intended that an order would cover access to international bodies.

2.31 Lord Sharman proposes a minimum threshold for statutory access. No minimum threshold exists for the current non-statutory access arrangements and the creation of a threshold could generate anomalies at the margin. Moreover, some bodies might move backwards and forwards across the threshold from year to year, which would generate uncertainty about their position. In practice, the C&AG does not in normal circumstances expect to exercise, on a frequent basis, rights of access to recipients of small sums of public money. While the Government welcomes the recognition that unnecessary burdens should not be imposed on organisations, it considers that a threshold would make little difference and could create operational problems. Meanwhile the Government looks to the C&AG to ensure that his new access powers are not used disproportionately, and notes that Section 3 of this document provides for any issue over the extent of inspection to be raised with the NAO under its proposed customer care line mechanism.

2.32 Statutory access will be provided by using the order making provision in the Government Resources and Accounts Act 2000 (GRAA) which relates to the C&AG's statutory financial audit responsibilities. In parallel, the Government is exploring how to ensure that statutory access for the C&AG for his vfm examinations under Section 6(c) of the National Audit Act 1983 can be made available to the same bodies as designated under the GRAA for his financial audit purposes. In the meantime the Government will achieve this objective through an explicit statement of policy. Access to such bodies would not be for the purpose of conducting a vfm examination of the bodies themselves: the access would be exercised solely in connection with vfm examinations of public sector bodies.

2.33 The Government notes Lord Sharman's recommendation that the C&AG should be given access to the BBC as recommended by the 1999 Davies Review on the Future Funding of the BBC. As recorded by Lord Sharman (*"Holding to Account"*, paragraph 4.39), the Government, in responding to the Davies report, accepted the need for greater transparency and improved financial reporting by the BBC. However, the Government felt that it would be inappropriate for the C&AG to be involved in this work. It was concerned to protect the independent status of the BBC, and its editorial freedom. The Government therefore appointed commercial accountants to carry out this work. The Government has reconsidered its decision in the light of Lord Sharman's recommendation but has decided that the reasons underlying its original decision remain valid and therefore does not propose to make any change to current arrangements. The Government also believes that similar considerations should continue to apply in the case of the other broadcasting corporations. However, it will continue to be possible for the C&AG to seek access to particular documents held by any of these bodies to inform his financial audit or vfm work elsewhere, if this proves necessary.

RECOMMENDATION 8

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

2.34 The Government agrees that the introduction of regular performance reporting is a very important step in improving accountability. Outcome-focused targets for each department are now published in Public Service Agreements, together with technical notes setting out how they will be measured. Each department reports on progress in its annual departmental report.

2.35 The Government is committed to ensuring that the information that underpins reporting on these PSA targets is reliable, and accepts the recommendation that there should be some form of external validation of departmental data systems which relate to these targets. This is already in place for data systems producing National Statistics. The National Statistician has overall responsibility for the professional statistical quality of all outputs comprising National Statistics, and ensuring that they are produced in accordance with the standards set out in the National Statistics Code of Practice and supporting protocols. The Statistics Commission comments on the quality assurance processes for National Statistics and is able to carry out spot checks on departmental or other National Statistics. If necessary, the Statistics Commission can carry out or commission its own audits.

Performance Validation Working Group

The Chief Secretary to the Treasury established the working group in November 2000. It was charged with developing practical proposals for the external validation of those data systems upon which the measurement of progress against PSA targets depends.

Led by the Treasury, the group was comprised of representatives of the National Audit Office, the Audit Commission and the Office for National Statistics, in addition to experts from a number of government departments. The group gathered and examined evidence on existing validation practice and relevant internal controls, and made recommendations regarding the introduction and development of external validation.

2.36 A Treasury-led working group (see Box), which included representatives of the NAO, the Audit Commission, the Office for National Statistics (ONS) and a number of government departments, was set up to consider the issues and has now reported. In the light of this work, the Government proposes:

- to invite the C&AG to take responsibility, under his existing powers, for the validation of systems used in reporting on PSA targets where measurement of performance depends upon data. The Government envisages that in discharging this role the C&AG will use both NAO and wider expertise, drawing on the work and recognising the independence and authority of the Audit Commission, the National Statistician and the Statistics Commission;
- all relevant data systems should be examined at least once during the “lifetime” of a PSA, and that validation will therefore normally be carried out every three years;
- where a data source is already subject to validation because it forms part of National Statistics (and is thus already within the responsibilities of the National Statistician and the oversight of the Statistics Commission), the C&AG will not normally wish to undertake detailed assessment of the relevant systems in framing his validation conclusions;
- where a data source is already subject to validation by the Audit Commission (for example, performance indicators within the Best Value regime or NHS Performance Assessment Framework), the C&AG will similarly not normally wish to undertake detailed assessment of the relevant systems in framing his validation conclusions;
- when departments report on performance against targets they should make clear when the data systems were, or will be, subject to validation.

2.37 The Government would expect these arrangements to be subject to a period of trial before full implementation.

RECOMMENDATION 9

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

2.38 This recommendation is directed at the PAC and the C&AG. The Government would be happy to cooperate with any changes along the lines proposed by Lord Sharman.

RECOMMENDATION 10

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

2.39 This recommendation is directed at the PAC.

MAKING THE MOST OF AUDIT

RECOMMENDATION II

In order to make the most of audit activity:

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

2.40 As Lord Sharman points out, the NAO has made important contributions to a number of Government initiatives and reports, including the development of resource accounting and the PIU report "*Wiring it up*". The NAO and PAC have also produced valuable overview reports on subjects such as IT and construction. The Government would welcome further development of these activities.

MINIMISING THE COST OF AUDIT

RECOMMENDATION 12

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

2.41 The Government endorses Lord Sharman's view that auditors should find ways to minimise the cost and burden of their work. The Government also welcomes the support offered by Lord Sharman for the steps which the C&AG is taking to encourage competitive tension and benchmark the efficiency of the NAO by contracting out an increasing proportion of its work.

2.42 This and other steps planned by the C&AG to provide assurance to audited bodies about the work of the NAO are set out in Section 3. They include the introduction of periodic general questionnaires to ascertain views on the service provided by the NAO on both financial audit and vfm work, and the creation of a central NAO customer care mechanism to deal with issues which audited bodies would prefer not to raise with their direct audit team.

2.43 These steps are intended to give departments additional assurance on the continuing high quality of the NAO's work and to strengthen the operational links between auditor and auditee. Quality assurances and customer care arrangements are also designed to apply where the C&AG has contracted out audits to the private sector.

2.44 The links between auditor and auditee will be further strengthened by the setting up of the central government Audit Liaison Group, also described in Section 3. This Group will be a small high level body jointly chaired by the Permanent Secretary of the Treasury and the C&AG. The Group will complement rather than substitute for existing liaison arrangements between the NAO and departments. The aim of the Group will be to consider matters of strategic or operational interest between the C&AG and audited bodies, including any arising from the arrangements set out in Section 3 of this document. The Government sees this Group as a crucial part of the arrangements being put in place to underpin the implementation of Lord Sharman's recommendations on audit and access and a positive means of reinforcing the dialogue between auditor and auditee.

RECOMMENDATION 13

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

2.45 The Government endorses this recommendation, and notes that wherever possible, in accordance with professional guidance and auditing standards, the C&AG makes use of the work of internal audit, external audit and inspectors and regulators.

2.46 More generally, the Government agrees that in fields which are subject to the oversight of a number of external bodies all parties should coordinate their activities in order to achieve the most effective allocation of resources and the least burdensome approach. In this context the Government notes the contribution of the Public Audit Forum (PAF), which builds on the existing co-operation between the national audit agencies, and it welcomes the ongoing work of the PAF working group on the respective roles of audit, inspection and regulation.

RECOMMENDATION 14

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

2.47 The Government welcomes this recommendation and has now published, jointly with NAO, the good practice guide on co-operation between internal and external auditors (see Box).

“Co-operation between Internal and External Auditors: A Good Practice Guide”

The Guide was produced jointly by NAO and Treasury to offer good practice advice on internal and external audit co-operation. It recognises that internal and external auditors already co-operate in a variety of ways and draws on actual experiences of effective co-operation to promote development of co-operation and to help maximise the benefits to be gained for particular bodies. Copies are available on NAO's web site (www.nao.gov.uk) or can be obtained free of charge from the Public Enquiry Unit at the Treasury.

AUDIT, ACCOUNTABILITY AND RISK MANAGEMENT

RECOMMENDATION 15

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

2.48 The Government agrees that it is essential for departments to continue to improve their risk management arrangements, and that risk management should become fully embedded in departmental systems and attitudes. Departments are receiving support and advice from the Treasury in this area. Treasury guidance (see Box) recommends that audit committees should consider the adequacy of risk assessment and management decisions and the mechanisms for delivering those decisions. There may also be a role for audit committees in encouraging and monitoring progress in improving risk management, but this should not be at the expense of operational arrangements exercised through eg risk committees and management boards.

"Management of Risk: A Strategic Overview"

Commonly referred to as "*The Orange Book*" this publication is a Treasury produced guidance document which offers broad based guidance on the development of a comprehensive risk management system.

The book does not provide a risk management "model", rather it highlights the key stages of the risk management process at which organisations have to make decisions about how they will manage their risks. It is available on the Treasury's web site (www.hm-treasury.gov.uk) or in hard copy from the Treasury Public Enquiries Unit.

2.49 The Government also agrees that the Treasury and the Cabinet Office should encourage and monitor progress on risk management. Plans on how to monitor progress, particularly in the light of the NAO report "*Supporting Innovation*", are under consideration by the Risk Management Steering Group on which Treasury, Cabinet Office and NAO are represented. The Group brings together a wide range of Government departments to consider risk management issues.

2.50 Lord Sharman's observation that "risk aversion has to be treated as a cultural, rather than a structural or technical issue" is addressed in response to Recommendations 16 and 17.

RECOMMENDATION 16

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

2.51 The Government endorses this recommendation. Better performance management is a key theme of the current Civil Service Reform Programme, particularly the need to link rewards more clearly both to results and to how the results are delivered.

2.52 As part of the Civil Service Reform Programme senior civil servants will be offered the opportunity to earn meaningful bonuses for the relative contribution they make compared with their peers. In addition, a new competence framework has been developed which includes benchmark ranges for judging and rewarding senior managers' attitudes to effective risk management and innovation. The framework is intended to help identify and reward managers who, say, initiate change to make things happen; challenge and are prepared to be challenged; take difficult decisions and measured risks; find new ways of looking at issues and seek new or different ideas and opportunities to learn; and encourage experimentation and try innovative ways of working.

2.53 Similar management reforms for staff below the Senior Civil Service are being progressively implemented in individual departments and agencies.

2.54 In addition, the Cabinet Office has issued guidance on non-pay reward packages covering all aspects of the employment package. These include opportunities for self-development and for increased personal responsibility; postings designed to gain experience or achieve an improved work/life balance; and special leave for sabbaticals. Two developments have helped to develop the approach to non-pay awards: first, the report by the Performance Management Group chaired by Sir Michael Bichard, which highlights the need for greater focus on recognition as a form of reward in the Civil Service, and specifically identifies celebrations and token gifts; and, secondly, John Makinson's report for the Public Services Productivity Panel set up by the Treasury (*"Incentives for Change"*), which recommends increased use of non-pay based incentives as part of the reward strategy.

2.55 The Cabinet Office guidance reflects the recent relaxation of the previously restrictive rules on benefits in kind in the Civil Service Management Code (see Box). The Cabinet Office has worked with the Treasury to update existing guidance on the

propriety and regularity aspects of expenditure on staff benefits. The Treasury issued new guidance on this issue in tandem with the Cabinet Office guidance.

Civil Service Management Code

The Civil Service Management Code is issued under the authority of the Civil Service Order in council 1995 under which the Minister for the Civil Service has the power to make regulations and give instructions for the management of the Home Civil Service, including the power to prescribe the conditions of service of civil servants.

The Code sets out regulations and instructions to departments and agencies regarding the terms and conditions of service of civil servants. Where departments and agencies are given discretion to determine terms and conditions, the Code sets out the rules and principles which must be adhered to in the exercise of those discretions. It does not of itself set out terms and conditions of service. Departments and agencies are responsible for defining the terms and conditions of service of their staff and for making these available to staff, for example in departmental or agency handbooks.

The Code is accessible on the Cabinet Office website (www.cabinet-office.gov.uk/civilservice/managementcode/index.htm).

RECOMMENDATION 17

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

2.56 The Government endorses this recommendation. As Lord Sharman recognises, the onus for taking forward the risk/innovation agenda in a constructive way lies with both departments and external auditors.

2.57 The Government agrees that departments need to become more professional in managing their risks in aggregate and at the project level. Developments described elsewhere in this response show how these needs are being addressed across departments.

2.58 The Government believes that external auditors need to ensure that in reporting their findings they do so in a way which is objective, proportionate to faults identified, and positive in acknowledging good practice. It notes that the NAO seeks to ensure that its reports are balanced and fair, include studies of successful programmes, and highlight examples of good practice that might be applied more widely. These are positive ways to support appropriate risk taking and to encourage departmental systems which promote well managed risk taking.

2.59 Lord Sharman's report acknowledges the perception that the risk of criticism for failure outweighs the rewards for success. The Government has embarked on a programme to modernise the delivery of public services and to recognise and reward staff who manage risk and innovation effectively. Departments do not expect to escape criticism where it is due but it is important that where lessons need to be learned they should not lead to disproportionate controls that have the effect of dampening down innovation and of further encouraging a climate where compliance with process or the desire to avoid minor failures prevails over the achievement of important outcomes.

RECOMMENDATION 18

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

2.60 The Government endorses Lord Sharman's comments, and will work with the NAO at the initial stage of joined-up operations to ensure that any emerging problems on accountability are addressed in good time.

2.61 As far as appearing before the PAC is concerned, the Government will continue to work with all interested parties to establish whatever new arrangements are judged most suitable for the effective delivery of Parliamentary accountability in joined-up operations.

2.62 Much will depend on the particular nature of the operation in question. Frequently, a Memorandum of Understanding will be needed to delineate the boundary of responsibilities between the relevant Accounting Officers.

ENSURING ACCOUNTABILITY AND QUALITY OF AUDIT WORK

RECOMMENDATION 19

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

2.63 The Government welcomes the NAO's intention to submit its financial audit work to the scrutiny of the Joint Monitoring Unit (JMU) of the Institute of Chartered Accountants in England and Wales and to share the JMU conclusions with departments.

2.64 This and other initiatives by the NAO, which are set out in more detail in Section 3, will give departments additional assurance on the continuing high quality of the NAO's work.

RECOMMENDATION 20

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

2.65 The Government welcomes the intention of the NAO to make available to audited bodies the conclusions of the external assessors of its vfm work.

2.66 This and other initiatives by the NAO, which are set out in more detail in Section 3, will give departments additional assurance on the continuing high quality of the NAO's work.

RECOMMENDATION 21

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

2.67 The Government supports this recommendation as a further means of demonstrating the quality of the NAO's work.

2.68 The Government therefore welcomes the intention of the C&AG – reflected in Section 3 – to initiate discussions with the Chairman of the Public Accounts Commission on how to take the recommendation forward.

PAPER ON PRACTICALITIES INVOLVED IN CERTAIN RECOMMENDATIONS IN LORD SHARMAN'S REPORT "*HOLDING TO ACCOUNT*"

- 3.1** Lord Sharman presented his report "*Holding to Account*" to the Chief Secretary to the Treasury in February 2001. This paper explores the detailed implications of certain of Lord Sharman's recommendations, in particular those associated with audit, access, quality assurance and corporate governance.
- 3.2** The arrangements set out in the paper reflect discussions between Treasury and National Audit Office (NAO) officials and have been endorsed by Ministers and the Comptroller and Auditor General (C&AG).
- 3.3** The paper covers the following main areas:
- A. NDPB audit and assurances to be provided to sponsoring departments
 - B. Quality assurance
 - C. Customer care of bodies audited by the NAO
 - D. The accountability of the NAO
 - E. Providing statutory rights of access for the C&AG
 - F. Notes on the content of access protocols
 - G. Linking audit work to risk management and corporate governance initiatives
 - H. The Audit Liaison Group.
- 3.4** There is a degree of overlap between the various sections of this paper as a number of actions will apply in more than one area.

A. NDPB AUDIT AND ASSURANCES TO BE PROVIDED TO SPONSORING DEPARTMENTS

3.5 Lord Sharman recommended that the C&AG should be appointed as the auditor, on behalf of Parliament, of all NDPBs, including those where the relevant Minister currently appoints the auditor.

3.6 He also recommended that arrangements should be put in place to ensure that there is no reduction in the level of assurance that is currently provided to departments or in the coverage of the audit, and that the C&AG's suggestion that he would contract out an equal number of audits as are currently awarded by departments to private firms should be taken up.

3.7 The Government supports these recommendations. For his part, the C&AG, in taking over responsibility for the audit of all NDPBs, intends that sponsoring departments should continue to look to the external auditor for similar assurances on their NDPBs to those provided by commercial auditors. In approaching the audit of an NDPB, the C&AG will consult the sponsoring department and other relevant stakeholders, such as the board of trustees of an NDPB which is a charity, as well as the NDPB itself and consider their views on who – the NAO itself or a commercial auditor – should undertake the audit. The final decision will rest with the Comptroller and Auditor General but he will, of course, explain its basis.

3.8 Sponsoring departments have a range of interests in the audit of their NDPBs and at present, in cases where they have appointed the auditor they will have agreed, in advance of the audit, requirements which might include clarity as to what is being covered by the audit and appropriate documentation surrounding it. The audit report and any other outputs are addressed to the sponsoring department as it is the department that appoints the auditor. This enables the department to require, as part of the audit, an assurance on the financial systems within the NDPB.

3.9 Where the C&AG is the auditor of an NDPB, the department is not the client. However, the C&AG intends to share with sponsoring departments and other relevant stakeholders the kind of information noted in the previous paragraph, subject to appropriate agreement between himself and the departments, and also between the departments and the NDPBs, to allow such disclosure. These arrangements would normally include agreement that information identified during the audit process will be shared with the department at the end of the audit. This would apply, in particular, to issues which impact on the department's responsibilities in relation to financial systems within the NDPB. The Treasury will be taking steps to ensure that such an agreement is included in all Financial Memoranda between departments and the NDPBs they sponsor.

3.10 The C&AG contracts out a proportion of financial audit work via Framework Agreements which have been set up with a panel of eight major accountancy firms. The agreements specify the terms on which the firms provide services. These firms are then invited to tender for individual assignments as and when audits to be contracted out are identified. In future, NDPBs will have an opportunity to meet potential auditors and provide comments during the tender process. This will be done in a way that minimises the delays and additional costs in completing the tendering. The decision on whether to contract out an audit will take account of a variety of factors including cost and the views of the NDPBs themselves. The final decision about whether to contract out in any particular case, and if so to which commercial auditor, will, as noted above, remain with the C&AG.

3.11 As noted above, some departments that currently appoint private firms to audit their sponsored NDPBs require the firms to provide reports in addition to normal certification procedures and management letters. The provision of additional assurance-type reports to departments does not substitute for the responsibility on departments to ensure that effective systems for monitoring their NDPBs are in place. These reports (sometimes termed "Regulatory Compliance Reports") may, for example, provide additional assurance that grants made to NDPBs are used for the purposes for which they are granted and that proper financial controls are in place in the organisation. These reports are, therefore, an important part of assurance arrangements in departments. When the C&AG becomes the statutory auditor, the management letter will be addressed to the NDPB and the audit certificate will be addressed to Parliament. Where asked, however, the C&AG will continue to provide departments and other relevant bodies with Regulatory Compliance Reports and other similar reports which departments may request at the commencement of the audit and which are compatible with the independent external auditor's role. Where existing audit contracts provide for an auditor to supply specialist advice (for example, on taxation), the NAO may arrange, for a fee, for the service to be continued if requested.

3.12 The arrangements set out in paragraphs 3.6-3.11 above will be put in place for the audit of all NDPBs audited by the C&AG.

B. QUALITY ASSURANCE

3.13 The C&AG, in carrying out all financial audit work, does so in accordance with professional auditing standards set by the Auditing Practices Board. The NAO has identified a number of additional arrangements for providing the level of assurance to which Lord Sharman referred in his recommendation (paragraph 3.6 above). These arrangements, which will apply to all bodies audited and/or subject to vfm examination by the C&AG, are as follows:

- **formalising existing consultation practice.** In undertaking an audit on behalf of Parliament, the NAO recognises that auditees, and departments sponsoring NDPBs, are stakeholders in the audit process. The NAO intends to formalise the existing consultation practice to ensure that views are sought, for example, when an audit of a department, NDPB or other body is considered for contracting out (see also section A of this paper), and will continue to discuss with relevant stakeholders the conclusions arising from its audit work;
- **continuing to contract out a selection of its audits to private firms.** The NAO has done this for some time and has been able to compare its own audit delivery standards and service with those of commercial auditors, and identify improvements to be adopted for its own and the private sector's work. The C&AG has indicated that this will continue at an enhanced level. Common standards of quality are important, regardless of whether the work is undertaken by the NAO or is contracted out to private firms. One way of promoting high quality common standards will be to obtain feedback from audited bodies and sponsors. Tender requirements will continue to include quality standard requirements which are monitored as part of the contract management process;
- **using quality controls to provide further assurances about the standards of the NAO's audit.** In addition to Parliamentary scrutiny of the work and performance of the NAO through the Committee of Public Accounts and the Public Accounts Commission (see Part D below), the NAO will undertake the following:
 - ◆ **scrutiny by the Joint Monitoring Unit (JMU)** of the Professional Institutes of Accountancy which monitors the work of registered auditors under the Companies Act 1989. The NAO will initiate annual scrutiny of its financial audit work by the JMU, thereby subjecting itself to the same process used for private sector accountancy firms. The JMU will examine, amongst other things, compliance with SAS 240 (as revised) on quality control for audit work. The NAO will share JMU conclusions with departments.

- ◆ **assessment of vfm reports by external reviewers.** The C&AG's vfm reports are subject to a range of quality assurance arrangements. A key part of this is scrutiny currently undertaken by a team of independent experts at the London School of Economics (LSE) (who were appointed following a competitive tender) who assess published reports against a range of agreed criteria, including the appropriate use of methods and the robustness of conclusions and recommendations. In addition, the NAO seeks feedback from departments on their view of each vfm study undertaken on them and about how improvements might be made to the process. As the basis for a better informed dialogue with departments on the quality and usefulness of published reports, the C&AG has offered to make the conclusions of the LSE's assessments available to departments.
- **reinforcing arrangements for client feedback** (see Part C below);
- **continuing to compare the NAO's financial audit approach** with best commercial practice, and (for vfm work) by maintaining regular contact with other major national audit offices and with other audit bodies such as the Audit Commission; by active participation in international organisations and their working groups; and by remaining alert to developments in the academic and evaluation communities. In addition the NAO will continue to look for new opportunities to compare its performance with other organisations (for example, through forms of peer review); and
- **adhering to and building on the content and spirit of the helpful Public Audit Forum booklet: "What public sector bodies can expect from their auditors".**

C. CUSTOMER CARE OF BODIES AUDITED BY THE NAO

3.14 As part of a process of assessing the quality of the services provided, the NAO seeks views formally and informally, for example, at working level, through Principal Finance Officer and Accounting Officer contacts, and through vfm questionnaires. The NAO intends to develop further the means of gauging the views of auditees by:

- the introduction of post-audit "client questionnaires" for financial audit to elicit structured views on the service provided across a range of headings (described in Part B). This will help the NAO to assess how it is perceived, what has worked well and what can be improved, and to track progress over time. Client questionnaires are used following the completion of every vfm examination;
- the use of a more general questionnaire, sent on a periodic basis, to ascertain views and suggestions on general issues relating to the service provided by the NAO on both financial audit and vfm work; and
- the introduction of procedures to provide a central NAO reference point with responsibility for dealing with issues arising out of NAO work. This is considered in more detail below.

A central reference point

3.15 Under these arrangements, any issues arising between the NAO and audited bodies or their sponsors will continue, normally, to be resolved through direct contact between audit teams and audited bodies. Audited bodies that wish to raise issues about the audit service should seek to resolve them with the NAO Director responsible for their audit. If this proves unsatisfactory the Principal Finance Officer may wish to raise it with the relevant Assistant Auditor General or the Accounting Officer with the C&AG.

3.16 Exceptionally, however, there may be issues which are not best pursued up the line. The NAO is therefore creating a mechanism to allow audited bodies to express their views outside their direct audit team.

3.17 If an audited body feels that it needs to raise an issue, other than matters of audit judgement, separately from those responsible for the audit then it should contact the NAO's Director of Corporate Policy. The Director of Corporate Policy is a senior member of staff with direct access to the Deputy Comptroller and Auditor General. In performing the role of Director of Corporate Policy, he/she has no direct oversight of either financial audit or vfm work.

3.18 Audited bodies will need guidance on the types of issue that can be dealt with through this mechanism. Issues that the guidance might include are:

- the conduct of staff employed by the C&AG (including consultants and contracted firms);
- the management of the audit; and
- the quality of communications between the NAO and the audited body.

3.19 On matters of audit judgement, auditors would expect to explain their approach, listen carefully to the views of audited bodies, and provide a considered, professional response. Failure to do this might be raised legitimately by audited bodies. Ultimately, however, the auditor's conclusions remain a matter of professional judgement, giving due weight to all relevant factors, including the views of the audited body.

3.20 The Treasury will ensure that audited bodies are familiar with what they should do in the event of concerns about the NAO's or other auditors' work. Guidance will be produced and circulated to audited bodies. Possible measures to be taken by the NAO include the insertion of relevant paragraphs in Client Liaison Memorandums sent out prior to each financial audit and the inclusion of details on the NAO web-site.

D. THE ACCOUNTABILITY OF THE NAO

3.21 The C&AG is an Officer of the House of Commons and head of the National Audit Office, and is independent of Government.

3.22 The NAO is held accountable in a number of ways that reflect its position as a body working for Parliament. In particular:

- the C&AG appears before the Public Accounts Commission – a committee of MPs established to oversee the NAO's performance – twice a year, firstly when the Commission consider the NAO Corporate Plan, and also when it examines the NAO's own Supply Estimate;
- the C&AG appears before the Committee of Public Accounts (PAC) to be examined on the NAO Estimate;
- the PAC meets annually to discuss the NAO's work programme. Under the National Audit Act 1983, the C&AG is required to consult with the PAC on subjects for examination;
- the NAO produces a Corporate Plan and an Annual Report. The Annual Report includes performance data relating to impact, which is agreed with client departments; and
- the NAO's accounts are audited by private sector auditors appointed by the Public Accounts Commission and are presented to Parliament, along with an annual value for money study on the operations of the Office.

3.23 In the interests of transparency and to help explain the arrangements by which the NAO is held accountable, Lord Sharman recommended that the Public Accounts Commission include additional information on the work of the NAO in its reports. The C&AG will invite the Commission to discuss whether or how the recommendation could be taken forward, as well as the suggestion that the NAO's Corporate Plan memorandum, which the C&AG presents to the Commission, is published. The C&AG also intends that the NAO be a part of the wider developments towards validation of performance information, in line with Lord Sharman's recommendation in this area, through the mechanisms of external audit and accountability to the Public Accounts Commission.

3.24 Lord Sharman also commented that, as well as formal accountability arrangements through Parliament, it was appropriate that the work of the NAO was subject to professional quality control arrangements. He, therefore, welcomed the C&AG's proposal that the NAO be subject to review by the JMU, and that the conclusions of independent quality review of published vfm reports be discussed with departments (see paragraph 3.13).

E. PROVIDING STATUTORY RIGHTS OF ACCESS FOR THE C&AG USING THE GOVERNMENT RESOURCES AND ACCOUNTS ACT (GRAA) ORDER MAKING POWERS

Bodies to be covered by the access order

The Government has indicated that documents held by the following categories of bodies would be covered by the order:

1. documents held by the bodies listed in paragraph 4.58 of Lord Sharman's report (as illustrative examples rather than an exhaustive list), namely:
 - bodies and undertakings in receipt of grants
 - registered social landlords
 - train operating companies, and
 - PFI contractors;
2. documents held by other bodies which are currently covered by access arrangements based on negotiated agreement or conventions;
3. documents held by bodies in relation to contracts they have with organisations where the C&AG is the statutory auditor, including where

access is not currently provided on a non-statutory basis. Access will also be provided to associated documents held by sub-contractors.

The Government has also indicated that

- (a) when the matter is considered in the future, the C&AG's access will, as recommended by Lord Sharman, be formalised;
- (b) these access arrangements, which are to provide the C&AG with statutory access to documents that he requires for the purposes of an audit, are subject to the need to retain, or to create, negotiated arrangements or conventions in a very limited number of cases. Examples are circumstances such as where there is an unacceptable risk of statutory access undermining the body's ability to perform its functions (eg by inhibiting investment in public service projects), or where there are legal barriers to providing statutory access. In addition, it is not intended that an order would cover access to international bodies.

3.25 What kind of bodies would be covered by the order? The Government's response to Lord Sharman's recommendations on this point is summarised in the Box above.

3.26 What would the C&AG's rights of access allow him to do? The C&AG would have rights of access to the bodies listed in the order(s) made under the Government Resources and Accounts Act 2000 so that he can obtain information for the purposes of the financial audit of departments or other bodies which he audits. This would be accompanied by access to the same bodies listed in the order so that he can obtain information from them for vfm studies on a department or other body he audits.

3.27 What would the process for awarding access rights be? The process would have four key steps as follows:

- I Treasury and the NAO would agree a general protocol to apply when the C&AG was granted statutory access to bodies (see Part F below for details). This protocol would be available publicly.
- II The C&AG would present a list of bodies, or groups of bodies, for inclusion in GRAA Order making powers to the Treasury.
- III Treasury would consult the bodies concerned, relevant government departments and other bodies as appropriate, as part of the procedures for scrutinising such changes.
- IV Once agreement has been reached Treasury would make a Statutory Instrument, noting the existence of the general protocol in the explanatory notes.

3.28 Details of the proposed content of an access protocol are set out below in Part F to this paper. Coverage of any bespoke protocols would be determined on a case by case basis as appropriate in the light of the particular circumstances of the body or group of bodies concerned.

3.29 The Government will also continue to provide access through administrative means, where this proves necessary, and existing arrangements relating to bodies not included within the Order will not be affected.

F. NOTES ON THE CONTENT OF ACCESS PROTOCOLS

Please note that references in this part of the paper to the NAO should be taken to apply equally to any other auditor appointed by the C&AG.

3.30 Statement of purpose of protocol: the protocol will state that it is a code of practice that aims to ensure that statutory access rights, as established by order under the GRAA, are exercised in the same way as existing access rights ie in a professional manner in order to ensure that sufficient information is obtained for the purposes of the examination being undertaken without placing unnecessary burden on those subject to access. While it is anticipated that the bulk of situations will be covered by a single generic protocol, amendments to this "template" may be required to take account of prevailing circumstances at different categories of body.

3.31 Who is covered by the protocol: the protocol concerns the relations between the NAO, bodies that are subject to the C&AG's right of access, and sponsoring public bodies.

3.32 Notification: the C&AG shall have a right of access at all reasonable times to all such documents as he may reasonably require, as he does elsewhere under existing statutory provisions. The NAO will normally consult bodies and sponsoring bodies on its intention to exercise statutory access rights. The need for consultation may not apply in exceptional circumstances (see under **Exceptional circumstances** below).

3.33 Explanation of work: the NAO will explain the basis of the decision to exercise its right of access, set out the purpose and scope of the intended examination, and consider comments from the accessed body and the sponsoring organisation.

3.34 Reporting back: the NAO will inform relevant parties eg accessed bodies, sponsoring departments or regulatory bodies of the results of its work within a reasonable period of completion and take into account comments on factual accuracy and fair presentation.

3.35 Access for value for money work: The C&AG has statutory powers to report to Parliament on the economy, efficiency and effectiveness with which the bodies he audits use their resources. Vfm studies are selected taking account of factors such as the concerns of the PAC, the likelihood of beneficial impacts both directly and more widely, and relevance to a wide range of stakeholders. The C&AG produces around 50 vfm reports a year.

3.36 The Government is committed to ensuring that the C&AG has suitably robust powers of access to obtain the information he considers he needs for vfm examinations. In its response to Lord Sharman's recommendations the Government has indicated its intention to ensure that where the C&AG has access to external bodies under an order made under the GRAA for the purposes of the financial audit of a department or other public body, access will also extend to the same bodies for the purpose of the C&AG's vfm studies of a department or other public body. This will be outlined in a policy statement. Departments and NDPBs should provide for this linkage in contracts and grant conditions involving the bodies to be listed in the statutory order(s) made under the GRAA.

3.37 The NAO will make clear that statutory access is needed solely to enable the C&AG to carry out his statutory duties in relation to the audit or vfm study of a department or other public body or to carry out his duties under other statutory power – for example under the Public Interest Disclosure Act; that his access will be limited to papers and records which relate to the public body, not to the business of the accessed body; and that the NAO will not be seeking to conduct a certification audit of the accessed body or to report on its financial affairs; or to conduct a vfm examination of the business of the accessed body itself. Any other information which the C&AG might request on a voluntary basis should be clearly identified as such, allowing the body to decide whether to provide such information or not.

3.38 Extent of work: the NAO applies professional auditing standards and professional judgement when determining the level of work necessary to complete an investigation. In doing so, the NAO seeks to use the most efficient techniques to obtain the evidence required and minimise the impact on the body concerned. Where possible, the NAO will place reliance on relevant work completed by other parties – for example, by working with or making use of the work of internal audit, external audit and inspectors/regulators – or will seek to accompany the department on its own inspections, rather than visiting separately.

3.39 Aside from any net increase in the number of accounts to be audited, the National Audit Office foresees no increase in the overall volume of its financial audit work. Thus any increase in inspection activity would entail a corresponding reduction in the quantum of accounts certification work, through efficiency savings, and vice versa. The new access and inspection rights will not therefore increase the audit load on publicly funded bodies as a whole. As in the past there are bound to be shifts between bodies as needs and priorities change. Corporately the NAO will aim to balance its work to avoid excessive burdens on any individual body. Any concerns on this score can be raised with the NAO's Director of Corporate Policy under the arrangement outlined in Part C.

3.40 Facilitation of access: accessed bodies will provide the C&AG with access at all reasonable times to all such documents as he may reasonably require, in line with arrangements under existing statutory provision.

3.41 Resolution of issues: audited bodies who wish to raise issues about the audit service should seek to resolve them with the NAO Director responsible for the audit. If this proves unsatisfactory the Principal Finance Officer may wish to raise the issue with the relevant Assistant Auditor General or the Accounting Officer with the C&AG. In addition, where an audited body feels that it needs to raise an issue other than audit judgement with the NAO separately from those responsible for the audit, a central reference point service will be provided (as explained in Part C of this paper). Where a body subject to access has concerns about the approach taken by an auditor it will similarly be able to discuss such concerns with the NAO or make representations through the audited body.

3.42 Exceptional circumstances: there may be exceptional circumstances that will override the commitments given, such as alleged fraud or impropriety. However, before exercising rights of access in such circumstances the C&AG will consult sponsor bodies to check whether investigations are being undertaken by other authorities.

G: LINKING AUDIT WORK TO THE RISK MANAGEMENT AND CORPORATE GOVERNANCE INITIATIVES

3.43 The NAO, PAC and Government have stated that they support well thought through and well managed risk taking. This increased emphasis on good risk management highlights the importance of ensuring that departmental internal control systems are based on a proper risk assessment. That, in turn, places additional emphasis on the Accounting Officer's responsibility to put in place governance arrangements that will ensure that this process takes place.

3.44 These governance arrangements will be described in the Statement of Internal Control (SIC), which will be reviewed by the NAO. The SIC is the statement made by the Accounting Officer outlining how he/she has discharged his/her responsibility for maintaining a sound system of internal control that supports the achievement of departmental policies, aims and objectives set by the department's Ministers, whilst safeguarding the public funds and departmental assets for which the Accounting Officer is personally responsible. The system of internal control is designed to manage rather than eliminate the risks of failure, and can therefore provide only reasonable and not absolute assurance of effectiveness.

3.45 The Treasury intends to revise the AO Memorandum to clarify the AO's responsibilities for risk management, control and governance which are reflected in the SIC. In addition, arrangements will be established – involving the NAO, departments and other interested parties inside and outside government – to develop “standards” for risk management, control and governance relevant to central government. These standards will help to inform not only the NAO's review of the SIC but also further consideration of the nature of the review as experience is gained. In addition the Treasury will develop and promulgate further guidelines and examples of good practice to support those who are responsible for the processes which will be described in the SIC.

3.46 The NAO's review of departmental SICs is an assessment of whether the audited body's description of the processes adopted in reviewing the effectiveness of the system of internal control appropriately reflects those processes. Work for this includes attendance at audit committee meetings at which corporate governance, internal control and risk management matters are considered; consideration of whether disclosures to Parliament and the public made by the department are consistent with knowledge obtained by the NAO during its audit work; and consideration of how well Accounting Officers have conducted their effectiveness reviews.

3.47 In addition, in carrying out his vfm studies, the C&AG will consider and report, as appropriate, on how his findings reflect the governance arrangements in the body examined.

H. AUDIT LIAISON GROUP

3.48 It is proposed to establish a high level Audit Liaison Group (ALG). The ALG would form an essential part of the overall structure of relationships between central government and its auditor, by providing an effective vehicle to drive forward improvements in audit and accountability in the light of Lord Sharman's recommendations and more generally.

3.49 The purpose of the Group would be to consider how to ensure that maximum value is obtained from the external audit process and provide a forum to discuss wider issues of accountability in which external audit plays a role. Formal terms of reference would be agreed by the Group once established.

3.50 The Group would be chaired jointly by the Permanent Secretary of the Treasury, who is responsible for accountability structures and key accountability appointments across central government, and by the C&AG. Other members of the group would include two representative departmental Accounting Officers appointed on a rotating basis, the Deputy C&AG, and an independent external member drawn from the private sector. The ALG would be supported by a joint Treasury/NAO secretariat and meetings would occur perhaps twice a year.

3.51 The ALG would complement, rather than substitute for, other vehicles of discussion which are already in place. Regular contact and discussion between the Government and the NAO would continue at a range of levels – including conferences for Accounting Officers arranged by the NAO and regular bilateral discussions between Principal Finance Officers and Assistant Auditor Generals. The Group would be well placed to monitor how well the arrangements set out in this paper were working; to resolve issues which could not be resolved through other routes; and to consider longer term or more strategic issues of audit and accountability across central government.

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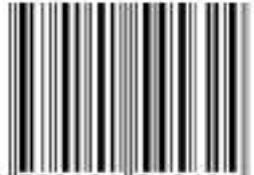
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