



National Audit Office

## **FINANCIAL AUDITING AND REPORTING**

# General Report of the Comptroller and Auditor General 2005-06

The National Audit Office scrutinises public spending on behalf of Parliament. The Comptroller and Auditor General, Sir John Bourn, is an Officer of the House of Commons. He is the head of the National Audit Office, which employs some 850 staff. He, and the National Audit Office, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources. Our work saves the taxpayer millions of pounds every year. At least £8 for every £1 spent running the Office.



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**General Report of the Comptroller and**  
**Auditor General 2005-06**

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***John Bourn***  
**Comptroller and Auditor General**  
**National Audit Office**

**31 January 2007**

This report can be found on the National Audit Office web site at [www.nao.org.uk](http://www.nao.org.uk)

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# FOREWORD

It gives me great pleasure to present my General Report to Parliament, summarising the results of the financial audit work undertaken on my behalf by the National Audit Office in 2006, on the 2005-06 accounts of United Kingdom central government bodies.

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

Overall, I consider that the standards of accountability and probity remain high. In this report I highlight the progress departments have made in improving the timeliness of accounts submitted for audit. The report also summarises the qualified opinions I have issued on resource accounts and other accounts during 2006. While there has been an increase in the number of qualifications, most accounts submitted for audit are of good quality and the vast majority receive an unqualified audit certificate.

I welcome the continuing progress of the Treasury and departments in improving the professionalism of the finance function, and their aim that all departments should have qualified accountants as board level finance directors. I also comment upon developments in corporate governance and how well new reporting requirements on corporate governance and management commentaries have been applied.

I aim to continue to provide an efficient and effective audit service to central government bodies and other stakeholders and to provide independent assurance and comfort to Parliament and the people of the United Kingdom. In doing so I am conscious of the need to ensure that the methodologies employed by the National Audit Office continue to reflect best practice and the current thinking of the wider auditing profession. I am pleased to report that the National Audit Office conducted its work on the audits of 2005-06 accounts in accordance with International Standards on Auditing (UK and Ireland), in line with the timetable for the adoption of these Standards in the private sector.

In conducting my work I am mindful of the need to provide 'added value' advice to audited bodies as well as influencing developments in auditing, accounting and financial management within the wider national and international spheres. Part 4 of this report therefore explores the benefits that our mainstream financial audit work provides beyond its primary objective of providing independent assurance, information and advice to Parliament on the proper accounting and use of public resources. It also considers some of the additional areas of work involving the Office's financial auditors that benefit individual audited bodies, the wider central government sector, Parliament, members of the public and the wider interests of the United Kingdom.

John Bourn

Comptroller and Auditor General

31 January 2007

# EXECUTIVE SUMMARY

**1** This report to Parliament summarises the results of financial audit work undertaken on behalf of the Comptroller and Auditor General in 2006, on the 2005-06 accounts of United Kingdom central government bodies and highlights key issues arising from that work. The Comptroller and Auditor General is the appointed auditor of all United Kingdom central government departments, executive agencies, and a wide range of other public bodies.

**2** The National Audit Office undertakes, under the direction of the Comptroller and Auditor General, the detailed financial audit work necessary to support his duties and statutory responsibilities. In total, the Comptroller and Auditor General audits approximately 470 accounts per year, incorporating total expenditure and revenue of approximately £800 billion.

**3** All financial audits for 2005-06 accounts were conducted in accordance with International Standards on Auditing (UK and Ireland), issued by the Auditing Practices Board, which require an opinion as to whether the accounts are free from material misstatement and show a true and fair view. The audit opinion also requires confirmation that the transactions in the accounts comply with appropriate Parliamentary authority – known as the “regularity” opinion. Audit procedures also have regard to the propriety with which public funds have been handled and the manner in which public business has been conducted.

**4** In reporting the results of audit examinations, this report focuses upon the Comptroller and Auditor General's audits of the receipts of revenue and of public debt and reserves, as well as commenting upon the quality and timeliness of financial reporting and the other information accompanying the financial statements of the spending departments, their agencies and non-departmental public bodies. It also discusses the reporting of significant losses by departments and progress towards the future compilation of whole of government accounts.

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

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

## Quality and Timeliness of Accounts

**7** During 2005-06, departments generally continued to make progress in response to the challenges of resource accounting and, for the most part, the quality of accounts submitted to the Comptroller and Auditor General for audit was of a high standard, although qualified opinions were issued on seven sets of departmental resource accounts. However, there were no instances in 2006 where problems with a department's resource account were so fundamental that the Comptroller and Auditor General had to issue a 'disclaimer of opinion' as he had to do with the Home Office account for 2004-05.

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

**9** In general, departments have made good progress in improving the timeliness of accounts submission. This was reflected in the fact that all departmental resource accounts had been submitted for audit by the statutory deadline of 30 November 2006 and that 47 departments were able to lay their accounts before Parliament's summer recess. This compares favourably to the prior year when only 25 departments were able to lay before summer recess and six departments failed to meet the 30 November deadline for submitting accounts for audit.

**10** Whilst the Treasury's aim to accelerate the preparation and audit of accounts so that all resource accounts should be laid before Parliament by the Summer Recess was not achieved in 2006, the target remains in place for 2006-07 accounts. Fundamental to the success of faster closing is the recognition that the accounts production process is not merely a year end activity. Robust, accurate and timely financial information is pivotal to improved resource planning decision making and should be something that departments produce and utilise throughout the financial year. The National Audit Office will continue to work with audited bodies to help achieve the aims of better financial management and timelier external financial reporting.

## Losses and Special Payments

**11** Departmental losses and special payments – transactions of a type that Parliament cannot be expected to have authorised, are subject to special control procedures and disclosure requirements in resource accounts. Our review of such payments and losses in one major department gave rise to a number of recommendations to improve the process of managing losses and special payments in that department.

## Management Commentaries

**12** A major development in financial reporting for the central government sector for 2005-06 accounts was the requirement for a more extensive 'Management Commentary' statement, broadly following the guidelines set out in the Accounting Standards Board's Reporting Statement: Operating and Financial Review. National Audit Office financial audit teams reviewed the content of their audited bodies' new style Management Commentaries for consistency with the rest of the annual report and accounts and their own knowledge of the client.

**13** We noted a wide variation in the degree to which central government bodies have followed the recommendations of the Reporting Statement or the Government's Financial Reporting Manual, and in a number of instances the commentaries could not be said to provide an understanding of the "development, performance and position" of the entity in question. However, as a new requirement, it may be expected that it may take a while to properly bed in and we are hopeful that compliance will improve in future years.

## Corporate Governance

**14** The development of the wider aspects of corporate governance in the central government sector continues. The 2005-06 financial year saw the implementation of a Code of Good Practice on Corporate Governance in Central Government Departments, containing a number of specific requirements and advice on good practice. The mandatory requirements include reporting on a number of specific aspects of corporate governance.

**15** It is not possible to assess compliance with the new reporting requirements simply from a review of departments' resource accounts as the Code does not specify where or how departments should report on corporate governance. While it says that the account should be in the material accompanying the department's resource accounts, that might include a separate departmental report or a purpose built standalone document. However a number of departments have used their resource accounts for their corporate governance reporting and, as with the new management commentaries, there has been a wide range in the quality of reporting. Again, however, we are hopeful that this will improve as the requirements become more familiar and bed in.

## The Audit of Receipts of Revenue and Public Debt and Reserves

**16** HM Revenue & Customs (HMRC) was established in April 2005 by the Commissioners for Revenue and Customs Act which brought together most of the functions of the Inland Revenue and HM Customs and Excise.

**17** The Comptroller and Auditor General's published 'Standard Report', that accompanies the accounts of HMRC (HC 1159 2005-06) detailed the main outcome of the financial audit work carried out by the National Audit Office at HMRC. This report covered the Department's management of tax credits, the collection of income tax through Pay As You Earn (PAYE) and the strategy implemented by HMRC to tackle Value Added Tax (VAT) missing trader fraud.

**18** The Comptroller and Auditor General continued to note reservations concerning levels of error and fraud by tax credit claimants. HMRC estimated that in 2003-04 tax credits of between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value) were paid to claimants to which they were not entitled. The Comptroller and Auditor General concluded that these levels of error were unacceptably high. There is currently no evidence to justify a lower estimate for 2005-06 and he consequently qualified his audit opinion on the HMRC Trust Statement account.

**19** Arising from his work at the Driver Vehicle Licensing Agency (DVLA), the Comptroller and Auditor General reported on the Vehicle Excise Duty evasion rate which increased from 3.4 per cent in 2004 to 3.6 per cent in 2005. He made observations and recommendations about enforcement measures. His opinion on the Vehicle Excise Duty accounts was unqualified.

**20** The Comptroller and Auditor General's audit of public debt and reserves accounts was conducted satisfactorily, building on the reporting timetable gains made in 2004-05. Work is ongoing to advance further the reporting timetable for the Consolidated Fund and National Loans Fund accounts, with the aim of achieving completion of the 2006-07 accounts prior to Parliament's summer recess.

## Whole of Government Accounts

**21** Following the Chancellor's confirmation in the December 2005 Pre-Budget Report of the Government's decision to proceed with the publication of Whole of Government Accounts (WGA), good progress continues to be made on this significant project. Throughout the period, the National Audit Office has continued to work closely with the Treasury on the first preliminary dry-run WGA for 2004-05, and work is currently underway on the first full dry-run for 2005-06 prior to the envisaged publication of WGA balance sheet information for the 2006-07 financial year.

**22** The central government sub-consolidation process is now well established, and while further improvements in terms of data quality and timeliness are still necessary, advances in this area continue to be made. The incorporation of local government, health and public corporations provides significant technical and logistic challenges however, as over a thousand new bodies are added to the consolidation process. The National Audit Office is responding to this by establishing working protocols with the Treasury and through the establishment of a WGA working group of the Public Audit Forum, bringing together auditors of all bodies within the WGA accounting boundary, including the Audit Commission, the other National Audit Agencies, and representatives from the private sector firms.

**23** WGA will make available for the first time comprehensive, audited public sector information based upon generally accepted accounting principles. This will support enhanced policy formulation and resource allocation, and should contribute significantly to fiscal management. The National Audit Office will continue its commitment to working with the Treasury and other bodies across the public sector to support this significant initiative and contribute to the success of a project that will also increase the accountability and transparency of the whole public sector to Parliament and the wider public alike.

## Lord Sharman's Review

**24** The scope of financial audit work carried out by the Comptroller and Auditor General and National Audit Office continues to evolve. Further progress has been made in implementing the recommendations of Lord Sharman's report into audit and accountability in central government. The Companies Act 2006 which received Royal Assent on 8 November 2006 changes UK legislation to enable the Comptroller and Auditor General and the other UK auditors general to audit companies, as proposed in Lord Sharman's report. The National Audit Office is consulting with the Department of Trade and Industry and the Treasury on the practical arrangements that will be necessary to put this into effect once the new provisions are brought into force. We expect to be in a position where we are able to audit government owned companies by 1 April 2008.

## International Accounting Standards

**25** One of the more significant changes for financial reporting by central government bodies will be the adoption of international accounting standards. While no firm date has yet been set, this might be as early as for 2008-09 accounts. In the meantime the Treasury are in the process of developing a "shadow" Financial Reporting Manual (FReM) based on international accounting standards to allow entities to plan for their introduction – the aim is that this will be complete by May 2007. The National Audit Office will work with the Treasury and the Financial Reporting Advisory Board to ensure the appropriate application of international accounting standards to central government bodies.

## Reconciling Departmental Resource Outturns with Resource Budgets

**26** 2006-07 accounts will see the introduction of disclosure of information on performance against departmental budgets in Management Commentaries accompanying resource accounts. This should assist Select Committees in their scrutiny of Spending Review settlements, departmental reports and Gershon targets. As part of our audit, we will review the budgetary information to be provided in the Management Commentaries and consider its consistency with the accounts.

## Accounting for Private Finance Initiative Schemes

**27** Accounting for Private Finance Initiative projects remains a difficult area with continuing inconsistency in the balance sheet treatment of projects between different parts of the public sector and between the public and private sectors. We report on progress made in resolving such differences.

## Adding Value: Other Financial Audit Work

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

**29** The Comptroller and Auditor General and staff from the National Audit Office continue to contribute towards the shaping of accounting and auditing best practice through active participation on a number of professional bodies. The Comptroller and Auditor General is Chairman of the Financial Reporting Council's Professional Oversight Board. National Audit Office staff are represented on committees and working groups of bodies such as the Accounting Standards Board, the Institute of Chartered Accountants in England and Wales, the Treasury, the Public Audit Forum, the Chartered Institute of Public Finance and Accountancy, and the International Auditing and Assurance Standards Board.

# PART ONE

## Financial Audit - Quality and Timeliness of Reporting

### Introduction

**1.1** The Comptroller and Auditor General is the appointed auditor of all government departments, executive agencies, and a wide range of other public bodies. This section of the report summarises the results and conclusions of financial audits undertaken during 2006. A summary of all accounts audited by the Comptroller and Auditor General is included at Appendix 2 to this report.

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

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

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

**1.5** The Office has stringent internal procedures to ensure the maintenance of high quality in our financial audit work, which is also subject to annual review by an independent monitoring body, the Quality Assurance Directorate of the Institute of Chartered Accountants in England and Wales.

**1.6** The audit of Receipts of Revenue and Public Debt and Reserves is discussed in Part 2 of this report. The other side of the equation – where and how the money is spent – forms the other major area of the National Audit Office's financial audit work, whether such expenditure is directly via the major departments of state or their agencies, executive non-departmental public bodies or grants to other organisations. Departments submit initial estimates of their expenditure requirements early in the relevant financial year (main supply estimates) adjusted, if necessary by supplementary estimates later in the year (spring and winter supplementary estimates).

**1.7** After the end of the relevant financial year each department submits a 'Resource Account' for audit. Resource accounts comprise financial statements similar to those found in commercial accounts but also including a summary comparing planned expenditure with the actual outturn. In the period covered by this report the Comptroller and Auditor General qualified his opinion on seven sets of departmental resource accounts. An analysis of qualified departmental resource accounts is provided in **Figure 1**, while a full list of qualified opinions is included in Appendix 3 of this report.

**1.8** While the accuracy of financial statements is essential to the Parliamentary control of government expenditure, timely reporting is equally important. Therefore, this part of the report also comments upon progress made by departments in submitting high quality accounts, on a timelier basis to the Comptroller and Auditor General for audit.

**1.9** The remainder of this part of the report provides a commentary on the quality of some other elements of financial reporting information accompanying departments' resource accounts.

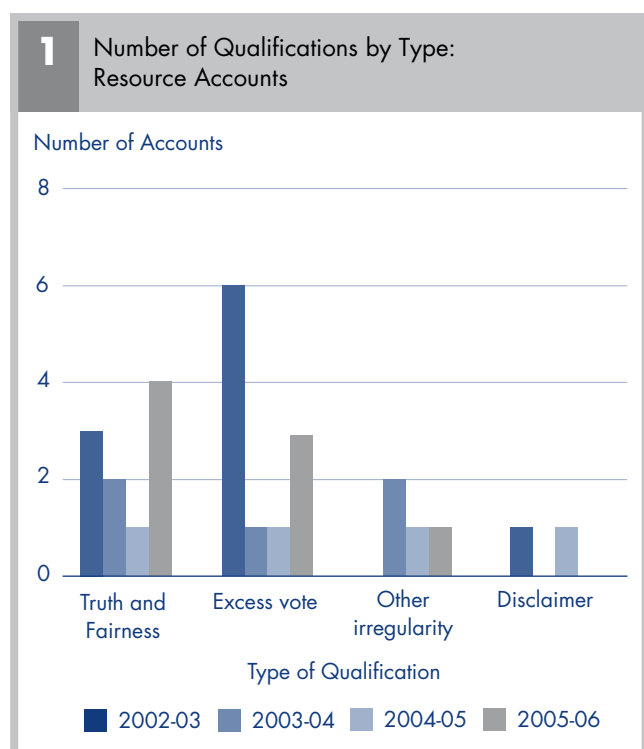
## Qualified Opinions and Reports on Accounts

### Qualified opinions - Departmental Resource Accounts

**1.10** On the whole the quality of the resource accounts for 2005-06 submitted to the Comptroller and Auditor General for audit has been high, but 2006 has seen a rise in the number of departmental resource accounts that have been qualified. Out of 54 resource accounts for 2005-06, qualified opinions were issued for seven sets of accounts, compared to only two qualified opinions issued for 2004-05 accounts.

**1.11** The increase in the number of qualifications is disappointing, although it does not appear to have arisen as a result of Treasury's initiative to accelerate the laying of departmental resource accounts.

Figure 1 illustrates the number and type of qualifications year on year for the last four years.



**1.12** The Armed Forces Pension Scheme resource account includes the Armed Forces Compensation Scheme. The 2005-06 account was qualified due to a limitation in the audit evidence available to support the provision for compensation due for claimable events for which claims had still to be lodged. A new compensation scheme was introduced during 2005-06, and the department does not as yet have comprehensive historical data to enable it to estimate this figure with a sufficient degree of accuracy.

**1.13** The Revenue and Customs Prosecutions Office was established as a separate government department in April 2005. The scope of the Comptroller and Auditor General's audit on the 2005-2006 account was limited due to insufficient evidence being available in respect of the year end accrual and the related expenditure incurred during the year for counsels' fees. In addition, the evidence to support the comparative figures for these items was also limited.

**1.14** During 2005-06, the Assets Recovery Agency expended more resources than had been authorised by Parliament in its supply estimate, resulting in the need for an 'Excess Vote'. Resource based supply estimates were introduced for accounts for periods from 2001-02 onwards and as a result departmental resource accounts can be qualified on the grounds of an Excess Vote. Such excesses, however small, will always result in a qualified opinion, as they are irregular, and require retrospective parliamentary authority in a subsequent Appropriation Act.

**1.15** Similarly, the resource account for the House of Commons Members for 2005-06 and the resource account for the NHS Pension Scheme and NHS Compensation for Premature Retirement Scheme for 2005-06 were subject to excess vote qualifications as more resources were expended than had been authorised by Parliament in the relevant supply estimates.

**1.16** This year the Department for Work and Pensions resource account was subject to a qualification on two separate issues: the substantial level of estimated fraud and error in benefit payments (regularity); and a limitation in the audit evidence available to support the completeness, existence and valuation of the amount recorded in the accounts for benefit overpayment balances (limitation of scope). The National Audit Office continues to work with the Department of Work and Pensions to improve controls in these areas of the accounts. Although this is the seventeenth year in which Department's accounts have been qualified the Comptroller and Auditor General was able to report real progress towards removing or tackling the qualifications.

**1.17** The Home Office encountered serious problems in preparing a cogent set of accounts to the required statutory timetable for 2004-05 and accordingly the Comptroller and Auditor General issued a disclaimed audit opinion on those accounts. Since then considerable improvements have been made by the Home Office, and for 2005-06 the accounts presented for audit were of a much higher quality.

**1.18** However, the audit opinion for 2005-06 was qualified because of a limitation in the audit evidence available to support the accruals figure in the accounts. In addition, it would not have been possible, without undue cost, for the Home Office to provide further evidence for, and for National Audit Office staff to audit, the 2004-05 income, expenditure and cash flow figures and, therefore, it was not possible to express an opinion as to the truth and fairness of the 2004-05 comparative figures for the Statement of Parliamentary Supply, the Operating Cost Statement, the cash flow statement, the statement of operating costs by departmental aim and objectives and their associated notes.

**1.19** The National Audit Office will continue to work with the Home Office as it implements its 'Financial Improvement Strategy' which has an overall aim of ensuring that robust financial systems and processes are embedded in the culture and environment at the Home Office. This should improve the financial control framework and create an efficient accounting system which should enable the Home Office to produce timely, accurate accounts.

**1.20** The majority of departmental resource accounts receive an unqualified audit opinion each year, but the fact that the qualifications described above have occurred is indicative of weaknesses in the relevant departments' financial controls - weaknesses that compromise the ability of the departments to provide sound accountability to Parliament. These departments need to continue to improve their financial controls so that the underlying cause of the qualification is removed, and the National Audit Office will continue to work with them and assist them by recommending financial control improvements.

**1.21** The National Audit Office will also continue to work with departments to help them improve their ability to effectively manage and budget for their resource consumption, and where necessary, assist with the implementation of improvements and enhancements to their financial systems. This will allow departments to adopt a full accruals based system of financial management, and will allow a more sophisticated approach to estimate monitoring and setting.

## Qualified opinions – Other entities

**1.22** During the period covered by this report, the Comptroller and Auditor General qualified his audit opinion on a further fifteen sets of accounts. A full list of these qualified opinions is included at Appendix 3 of this report.

**1.23** The accounts for Energywatch were qualified for 2005-06 as the result of a special severance payment of £30,000 made to one director for which Treasury approval, which should have been obtained via the sponsoring department, had not been sought. Retrospective approval had to be requested from the Treasury through the Department of Trade and Industry. The Department did not support this request as they did not consider the payment to have been in accordance with departmental policy on such payments. The payment was therefore deemed to be 'irregular'.

**1.24** The 2005-06 accounts of the Ordnance Survey continue to be qualified as a result of an on-going disagreement over the accounting treatment adopted in respect of the National Geographic database. The Comptroller and Auditor General considers that the data held in the database should be capitalised and recorded in the balance sheet, but the agency does not consider that the data meets the conditions for capitalisation.

**1.25** The scope of the Comptroller and Auditor General's audit opinion was limited in respect of the accounts of the Marine Fisheries Agency for 2005-06. This was an executive agency created on 1 October 2005 to bring together the service delivery, inspection and enforcement activities provided by the government to the fishing industry. There was insufficient evidence to confirm the existence and value of tangible fixed assets with a net book value of £1.07 million on the accounts, insufficient evidence to support the completeness and accuracy of expenditure on satellite surveillance and IT for fisheries enforcement, and insufficient evidence to support the prior year comparatives, and accordingly the opinion was qualified.

**1.26** The accounts for the Council for Healthcare Regulatory Excellence for 2005-06 were qualified in respect of a payment in advance of need. At the year end a prepayment of £55,000 was made to a supplier in respect of future services. As this did not meet Government Accounting requirements for making advance payments and Treasury approval for this payment had not been obtained, the accounts were therefore qualified on the grounds that the payment was irregular.

**1.27** The accounts for the Nuclear Decommissioning Authority were qualified for 2005-06 in view of the absence of certain prior year comparative figures. The Nuclear Decommissioning Authority was set up with full functions from 1 April 2005, with strategic responsibility for the UK's nuclear legacy. Designated sites and associated assets and liabilities were transferred to the Nuclear Decommissioning Authority from British Nuclear Fuels Limited, the United Kingdom Atomic Energy Authority and the Ministry of Defence. With the exception of the balance sheet, it was not possible to identify the prior year comparative element for the prime statements, as the appropriate information was not available from all the transferor entities, and accordingly the accounts were qualified.

**1.28** The Civil Nuclear Police Authority was split out from the United Kingdom Atomic Energy Authority on 1 April 2005. It was not possible to identify the prior year comparative element for the cash flow statement figures relating to the transferred functions, and accordingly the accounts for 2005-06 were qualified.

**1.29** The Social Fund accounts in respect of 2005-06 were qualified during the period. The scope of the Comptroller and Auditor General's audit was limited as a result of the Department for Work and Pensions being unable to provide sufficient appropriate audit evidence to confirm that Crisis Loan payments totalling £84 million had been made accurately and in accordance with the rules and regulations approved by Parliament.

**1.30** The Child Support Agency's Client Funds Account for 2005-06 was qualified because a material proportion of individual debt balances due from non-resident parents were found to be incorrect. This was largely due to historic errors made in earlier years, including errors in the underlying maintenance assessments. However, this year the qualification on the receipts and payments disclosed in the account was lifted as a result of the reduction in the volume of high value maintenance assessment errors for those cases where payments were collected in the year from non-resident parents.

**1.31** The scope of the Comptroller and Auditor General's audit opinion on the NHS Pensions Agency Administration accounts was limited for 2005-06 as a result of insufficient audit evidence to support a material balance relating to bursaries made to students studying towards careers in the National Health Service. This limitation of audit scope also gave rise to a regularity qualification.

**1.32** The Comptroller and Auditor General qualified his audit opinion on the 2004-05 accounts of the Northern Ireland National Insurance Fund on the grounds of regularity. Payments included benefit payments calculated erroneously and benefit payments arising from fraudulent claims. Fraudulent transactions cannot, by definition, be regular since they are without proper authority, and accordingly, the Comptroller and Auditor General concluded that payments arising from erroneous benefit awards and fraudulent benefit claims have not been applied to the purposes intended by Parliament.

**1.33** Accounts for the British Transport Police Fund were first produced for 2004-05 following its operational separation from the Strategic Rail Authority on 1 July 2004. Audit work identified errors in several areas of the financial statements including insufficient evidence to support individual balances and transactions; expenditure recorded in the incorrect year of account; and expenditure of a capital nature recorded as revenue expenditure or vice versa. The problems and errors flowed mainly from the transition to form a separate organisation in 2004 and the legacy of records and processes inherited from the predecessor organisational arrangements. The Comptroller and Auditor General concluded that there were likely to be material errors in the accounts and qualified the audit opinion as to whether the financial statements gave a true and fair view.

**1.34** The audit opinion on the Public Health Laboratory Services Board accounts for 2004-2005 was qualified because payments made to certain staff retained beyond the closure of the laboratory within which they had been working did not comply with Treasury authorities. The contractual payments and consequential pensions liabilities made to these staff were in breach of guidelines for "novel and contentious" payments set out in Government Accounting. The Treasury concluded that these payments and liabilities fell outside the normal delegated authorities and denied retrospective approval. The Comptroller and Auditor General therefore considered the related expenditure, which totalled £233,000, to be irregular.

**1.35** The audit opinion on the NHS Direct accounts for 2004-05 was qualified due to a limitation in audit scope. The Comptroller and Auditor General was unable to confirm that NHS Direct had maintained proper accounting records for certain payroll costs and that all the information and explanations required for the audit had been received. In addition, no evidence was available to support the prior year comparative figures for all aspects of the account.

**1.36** The Comptroller and Auditor General qualified his regularity audit opinion on the 2004-05 accounts of the Health Professions Council. Material irregular expenditure was recorded in the income and expenditure account arising from the misappropriation of funds by the Council's former Director of Finance arising largely from his misuse of the Council's corporate credit cards.

**1.37** Further details on the audit and subsequent qualification of the Inland Revenue Trust Statement for 2005-06 are included at paragraph 2.11 in Part 2 of this report.

## Reports on accounts by the Comptroller and Auditor General

**1.38** The Comptroller and Auditor General has wide ranging powers to issue other reports on accounts to Parliament in addition to his audit certificate. Such powers may be used where there are significant matters associated with the financial statements which the Comptroller and Auditor General believes should be brought to Parliament's attention, even in circumstances where the audit opinion has not been qualified.

**1.39** A report was issued by the Comptroller and Auditor General on the accounts of the Royal Mint (a trading fund) for 2005-06, which showed a loss of £1.6 million for the year. Following on from a report issued by the Comptroller and Auditor General on the accounts for 2004-05, where the Mint reported a loss of £3.2 million, this report outlined further details of the Mint's activities in the year and going forward, covering financial and operating performance, exceptional costs incurred in the year and ensuring future profitability. In 2005-06, the loss of £1.6 million was after taking account of exceptional items totalling £1.3 million, which related to costs incurred in preparation for the conversion to a Government owned company (vesting costs) and severance pay for the Royal Mint's former chief executive. Due to problems in trading and operational performance, the vesting process is currently on hold, pending further consideration of an appropriate timetable going forward. In the meantime, the Mint has carried out a wide-ranging business review, together with a review of the Mint's brand strategy. Senior management, in consultation with Ministers, HM Treasury and the Shareholder Executive, are currently considering how recommendations from these reviews might best be taken forward. Although the audit opinion on the accounts was not qualified, the Comptroller and Auditor General issued a report to summarise developments during the year.

**1.40** Similarly, although the accounts for the Defence Aviation Repair Agency (a trading fund) for 2005-06 were not qualified, the Comptroller and Auditor General issued a report on these accounts. The purpose of this report was to draw attention to a potential going concern issue. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future, and the accounts are prepared on this basis. The intention of the Defence Aviation Repair Agency, following a Ministerial Announcement to close, market test or sell parts of its activities casts doubt on its ability to continue long-term as a going concern, and accordingly a report was issued to highlight this matter.

## Conclusion

**1.41** The majority of departments and other public bodies falling within the remit of the Comptroller and Auditor General are producing good quality, unqualified accounts but there are still a small number that have to do more to prepare accounts for which there is adequate audit evidence to enable the Comptroller and Auditor General to express a clean audit opinion. There is no consistent pattern to the qualifications arising, nor is there any pattern when compared to previous years. However, they are all indicative of weaknesses in internal control, and compromise a body's ability to provide sound accountability to Parliament.

## Departmental Resource Accounts – Timeliness for Rendering Accounts for Audit

**1.42** The statutory deadline for departments to submit their accounts for audit is 30 November following the financial year ended the previous 31 March. **Figure 2** shows departments' performance in delivering signed accounts for audit over the past four years, and illustrates a marked improvement for 2005-06 accounts when compared with previous years.

**1.43** In 2006 departments continued to make good progress in improving the timeliness of their accounts submission. For example, by July 87 per cent of departments had submitted their resource accounts for audit, compared to 51 per cent in the prior year. As **Figure 2** demonstrates, for 2005-06 accounts, for the first time, all departments submitted their resource accounts for audit by the statutory deadline. By comparison, for 2004-05 accounts six departments did not manage to meet this deadline.

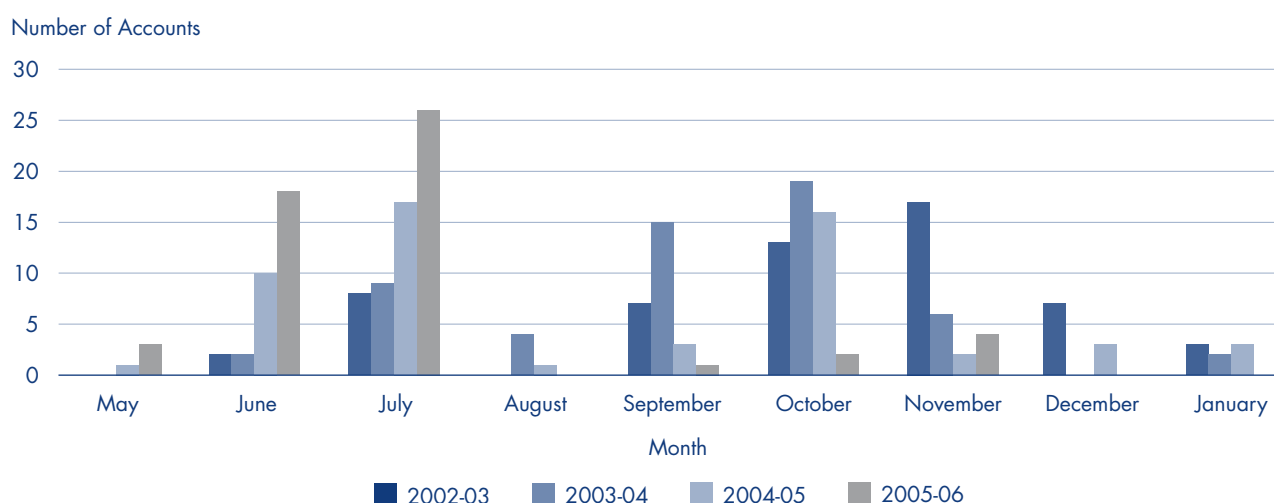
## Faster Financial Closing

**1.44** The Treasury's initiative to accelerate the production and audit of resource accounts has the intention that for the reporting year 2005-06 and subsequent years all departmental resource accounts will be laid before Parliament before the Summer Recess, which is some six months ahead of the statutory deadline. The impetus for the initiative stems from calls made by the Committee of Public Accounts for faster accounts closure and from a desire to mirror what is accepted as general commercial best practice. Additionally, this accelerated timetable is necessary to enable Whole of Government Accounts to be produced in a timely fashion. Further information on Whole of Government accounts is provided in paragraphs 3.1 to 3.15 in Part 3 of this report. The actual proportion

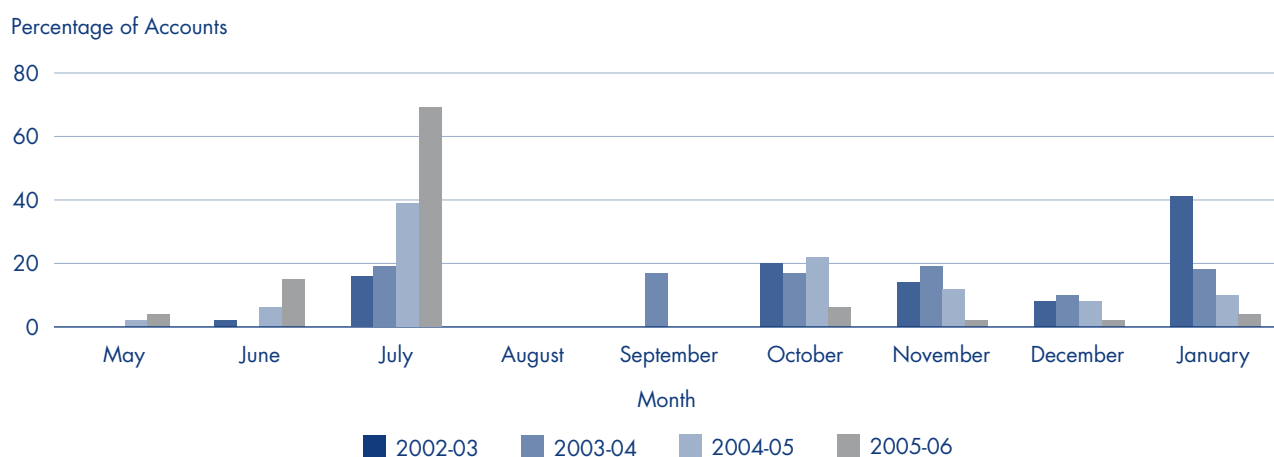
of 2005-06 accounts laid by the Summer Recess (which commences towards the end of July), with the three previous years for comparison is illustrated in **Figure 3**.

**1.45** Figure 3 shows that departments have made considerable progress towards meeting the faster closing target of laying their accounts to a pre-summer recess deadline. In 2006, 47 out of 54 departments were able to lay their 2005-06 accounts to meet this timetable, compared to 25 departments in the prior year. But the seven departments that did not manage to meet the pre-summer recess deadline still have considerable work to do in order to meet the Treasury timetable for 2006-07 accounts. For several of these departments, working groups have been set up which include representatives from Treasury and the National Audit Office with the aim of looking at how the accounts production process can be accelerated.

### 2 Delivery of Signed Resource Accounts



### 3 Timetable of Laying of Accounts



**1.46** The success of meeting the pre-recess timetable depends on the recognition that the accounts production process is not simply a year end activity, but a process that is ongoing throughout the year. Accurate and timely financial information is the key to sound financial management and improved resource planning and should be prepared and utilised by departments throughout the year. Achievement of a pre-recess timetable should be considered as an outcome of wider improvements in financial management.

**1.47** The challenge for 2006-07 and beyond is to maintain and improve on the results achieved to date, and the Comptroller and Auditor General continues to work with the Treasury and departments towards this end and to ensure that the achievement of a pre-recess timetable for the laying of accounts is not met at the expense of the quality of the accounts submitted for audit. Part 4 of this report provides further detail of his work in this area.

## Losses and Special Payments

**1.48** Chapter 18 of the Government Accounting manual issued by the Treasury sets out the definitions and treatments of losses and special payments. This explains how transactions of a type, which Parliament cannot be expected to have authorised such as cash and stores losses, fruitless payments, abandoned claims and frauds, are subject to special control procedures and notation arrangements. Departments are therefore required to make a report to Parliament on their losses and special payments at the earliest opportunity where the total value of those losses exceeds £250,000 (£100,000 until 31st March 2005). Departments are required to report separately those individual losses which on their own exceed the threshold. Typically this is achieved through a

note to the departmental resource account, but for serious losses – whether by value or nature – the department may need to provide a separate written statement to Parliament.

**1.49** During the past year, accounts certified by the Comptroller and Auditor General contained over £900 million of reported losses and special payments. Details of the level of losses and special payments in some of the larger departments over the last five years can be found in **Figure 4**.

**1.50** Examples of these losses include:

- A loss of £105 million from the decision not to proceed into production with a weapons system.
- Overpayment of benefits amounting to £68 million which are not recoverable under Social Security legislation. The overpayments were caused primarily by official error.
- A loss of £148 million due to a new building that was not fit for purpose. £83 million was incurred with respect to plant and machinery within the building and £65 million from the impairment of the value of the building.
- An ex-gratia payment of up to £84.5 million to a contractor on completion of certain contractual conditions related to a construction project.
- Claims for recoverable funeral expenses payments amounting to £42 million abandoned due to insufficient estate or where it was impracticable or impossible to pursue.
- Overpayment of £26 million of benefits made, where the claimant's good faith was not in doubt, where recovery action was not practical.

### 4 Value of Losses and Special Payments by major departments

	2001-02 £000's	2002-03 £000's	2003-04 £000's	2004-05 £000's	2005-06 £000's
Ministry of Defence	116,334	260,202	559,069	432,149	400,450
Department for Work and Pensions	344,746	302,250	298,239	248,706	236,462
Department of Health	644,858	1,141,524	644,955	62,742	195,181
Home Office	10,244	18,403	12,266	23,356	25,084
Department for Transport	18,907	16,166	12,458	17,099	15,880
Department for Education and Skills	2,664	3,153	23,640	14,917	12,180
Dept for Environment, Food and Rural Affairs	14,432	18,887	3,709	1,483	7,833
Office of the Deputy Prime Minister	698	1,686	1,182	7,974	1,848
Foreign and Commonwealth Office	713	5,147	3,260	5,272	1,132

**1.51** Where departments have written off significant amounts of public money as a result of error or poor controls, the National Audit Office will seek to assist the department to enhance controls to reduce the risk of further loss. An example of such assistance for one major department is described at paragraph 4.18 in Part 4 of this report.

## Management Commentaries

**1.52** A major development in financial reporting for the central government sector for 2005-06 accounts was the requirement set out in the Government Financial Reporting Manual (FReM) for a more extensive 'Management Commentary', broadly following the guidelines set out in the Accounting Standards Board's Reporting Statement: Operating and Financial Review. National Audit Office financial audit teams reviewed the content of their audited bodies' new style Management Commentaries for consistency with the rest of the annual report and accounts and their own knowledge of the client.

**1.53** The objective of the Accounting Standards Board's guidance is that the Operating and Financial Review should be a balanced and comprehensive analysis of the development and performance of the business of the entity during the financial year; the position of the entity at the end of the year; the main trends and factors underlying the development, performance and position of the business of the entity during the financial year; and the main trends and factors which are likely to affect the entity's future development, performance and position, prepared so as to assist stakeholders to assess the strategies adopted by the entity and the potential for those strategies to succeed.

**1.54** However, the Accounting Standards Board's guidance is not directly applicable to central government bodies, and its application should be tailored to reflect the fact that they have to provide information to a range of stakeholders for different purposes and that accountability – or stewardship – is a key consideration (rather than the decision to invest in a company as in the private sector).

**1.55** Our reviews revealed a wide variation in the degree to which departments have adhered to the recommendations of the Reporting Statement and the FReM. Some have clearly followed the Reporting Statement using headings that link closely to it; others seem to have largely ignored the suggested headings. The length and detail of the disclosures made also varied very widely and whilst many departments have described their policy on various issues, fewer have recorded their achievements, with many of the narratives relating the processes that are in use but not the outcomes thereof.

**1.56** Few entities have been forward looking in their commentaries and where future developments have been included they have tended to discuss government policy but not the financial or operational outlook for the entity. Matters that might have been expected to be covered but which often were not included:

- available resources;
- long-term risks and uncertainties and the policies to manage them;
- key stakeholder relationships;
- forward-looking analyses of financial position;
- essential contractual arrangements; and
- environmental policies and achievements.

**1.57** Most departments referred to information that was available in other published documents, but sometimes without the summarised information or specific cross-references required by the FReM.

**1.58** In general, the management commentaries, however presented, need to provide more analysis, rather than just description, if they are to provide an understanding of the "development, performance and position" of the department, and in particular the relationship between its spending, activity and achievement. However as a new requirement it may be expected that management commentaries may take a while to evolve and we are hopeful that compliance will improve in future years.

## Corporate Governance

**1.59** Corporate governance requirements and reporting in the central government sector continue to evolve. In July 2005 the Treasury published the Code of Good Practice on Corporate Governance in Central Government Departments. As with the Combined Code for listed companies this contains some mandatory requirements as well as advice on best practice. Whilst the Code of Good Practice on Corporate Governance in Central Government Departments does not formally apply to non-departmental public bodies, it does encourage NDPBs and other entities in central government to consider how far its principles may usefully be applied to them.

**1.60** The Code requires departments to report on four particular matters:

- how the departmental board operates, including its delegations and committees;
- which board members the board considers to be independent;
- the work of the board's audit committee; and
- how the department manages its relationships with the arm's length bodies with which it operates.

**1.61** Additional guidance from the Treasury recommends that departments also make further disclosures to provide a coherent account of their arrangements for corporate governance, including:

- ministerial delegations;
- in non-ministerial departments, the identity of the minister(s) who answer for the department in Parliament;
- key aspects of how resources are allocated and performance monitored to achieve department strategies within appropriate frameworks of standards, values, internal controls and risk management;
- board delegations and arrangements for reporting to it on performance;
- procedures for board appointments and induction;
- arrangements for evaluation of board performance;
- board membership, with any changes through the year, and succession planning; and
- the roles of non-executives on the board.

**1.62** The disclosure requirements and recommendations above are not intended to be exhaustive and departments are encouraged to provide further information of interest and relevance to their stakeholders about their activities, processes and operations and likely developments in their corporate governance.

**1.63** It is not possible to assess compliance with the new reporting requirements simply from a review of departments' resource accounts as the Code does not specify where or how departments should report on corporate governance. While it says that the account should be in the material accompanying the department's resource accounts that might include a separate departmental report or a purpose built standalone document. However a number of departments have used their resource accounts for their corporate governance reporting and, as with the new management commentaries, there has been a wide range in the quality of reporting.

**1.64** A number of departments appear to have only partially complied with the reporting requirements, and there has been a wide variation in further reporting. Whilst this may appear disappointing, experience in the private sector has shown that it can take a few years before such corporate governance guidance and requirements become fully embedded. In the meantime the National Audit Office looks forward to working with the Treasury to assist the process by identifying and disseminating examples of good practice, and we are encouraged by the improvements in corporate governance that have already been stimulated by the Code such as the wider use of independent non-executive board members and the greater level of discussion of risks and their management.

**1.65** The requirement for central government bodies to publish a Statement on Internal Control (SIC) with their accounts has been in place for several years now although, as expected at the time, some bodies took a while before they were able to report that they had implemented the necessary control procedures to ensure full compliance with the requirements for effective and embedded risk management arrangements. A review of a sample of statements from 2005-06 accounts indicated a wide range in the depth of disclosure.

**1.66** The statements varied in length from one to twelve pages. The Treasury provides a suggested template for SICs in the Financial Reporting Manual. This is not intended to be a 'boilerplate statement' however, and audited bodies should tailor and add to the statement to provide relevant disclosure to their own circumstances. Nevertheless a number of bodies follow the template almost to the letter, and provided only minimal detail on their capacity to handle risk, the risk and control framework, and the accounting officer's review of effectiveness. On the other hand some audited bodies had obviously invested resource in modifying the template to better reflect their organisation, and provided detailed disclosures. There was also a wide variation in the type of issues disclosed as 'significant internal control issues'. Some audited bodies appear comfortable with disclosing their significant risks and weaknesses, while others are unwilling to be open about such matters.

**1.67** A well functioning audit committee is key to achieving good corporate governance and ensuring that risk management processes receive the attention that they deserve. Treasury guidance for Audit Committees, in the form of its Audit Committee Handbook, was issued in October 2003. This is currently being updated and the Treasury issued a draft of the revised Handbook for consultation in July 2006. The revised Handbook will support the Code of Good Practice on Corporate Governance in Central Government Departments and in particular its section on internal controls. Some of the more significant proposals in the consultation draft are:

- sponsoring departments and arms length bodies should ensure that the interrelationships between their audit committees are agreed and documented;
- the report on audit committees required by the Code of Good Practice on Corporate Governance in Central Government Departments should include explanation of any non-compliance with the Audit Committee Handbook; and
- audit committees should be resourced as far as possible with independent non-executive board members. Where there are insufficient independent non-executive board members “independent external members” should be appointed to the committee.

**1.68** The National Audit Office is broadly supportive of the proposals in the consultation draft to which we have responded in detail. It is an important part of the role of the National Audit Office’s senior line financial audit staff to support their clients’ audit committees, and the Office has developed a self assessment toolkit for audit committees to allow them to assess their performance against best practice. This will be revamped and updated to reflect the revised Audit Committee Handbook.

# PART TWO

## Financial Audit - Revenue, Debt and Reserves

### Audit of Receipts of Revenue

#### Introduction

**2.1** Her Majesty's Revenue and Customs (HMRC) was established in April 2005 by the Commissioners for Revenue and Customs Act which brought together most of the functions of the Inland Revenue and HM Customs and Excise. In 2005-06 HMRC collected £405 billion, including £91 billion of National Insurance Contributions. HMRC also paid out around £17.3 billion in tax credits. The Driver Vehicle Licensing Agency (DVLA) collected net revenue of £5 billion of Vehicle Exercise Duty. Overall this represents approximately 90 per cent of central government revenue for the year.

**2.2** Under Section 2 of the Exchequer and Audit Departments Act 1921, the Comptroller and Auditor General is required to examine the accounts of HMRC on behalf of the House of Commons to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. In addition, the Act requires that he carries out any examination as he thinks fit and reports the results to the House of Commons, together with a report on the resource accounts of the Department concerned.

**2.3** In accordance with the directions given by the Treasury, HMRC and DVLA prepare financial statements of taxes collected on an accruals basis, including estimates and forecasts of taxes collectible, and Vehicle Excise Duty paid in advance, as well as amounts collected.

**2.4** The Comptroller and Auditor General continued to note reservations concerning levels of tax credit claimant error and fraud. This led to a qualification of his audit opinion on HMRC's Trust Statement for 2005-06 (see paragraph 2.11).

**2.5** The Comptroller and Auditor General reported on the Vehicle Excise Duty evasion rate which increased from 3.4 per cent in 2004 to 3.6 per cent in 2005 and he made observations and recommendations about enforcement measures. His opinion on the Vehicle Excise Duty accounts was unqualified.

#### HMRC

**2.6** The Comptroller and Auditor General's published Standard Report, presented to Parliament with the Accounts of HMRC (HC 1159 2005-06) detailed the main outcome of the work carried out by the National Audit Office. This report covered the Department's management of tax credits, the collection of income tax through Pay As You Earn (PAYE) and the strategy implemented by HMRC to tackle Value Added Tax (VAT) missing trader fraud. The National Audit Office made further recommendations to improve controls in letters to management.

**2.7** Whilst recognising that no collection system can ensure that all those who have a tax liability comply with their obligations, the National Audit Office's work in 2006 provided overall assurance that HMRC regulations and procedures continued to provide an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That overall assurance is subject to reservations about the operation of tax credits and other matters discussed below.

#### Tax credits

**2.8** In 2005-06 HMRC paid a net £17.3 billion to tax credit claimants. HMRC uses the latest information it holds on claimants to calculate a provisional tax credit award. It makes a final assessment after the end of the year when the claimant's actual circumstances are known. The final award is often higher or lower than the provisional award, for example because the final income differs from the provisional income.

**2.9** HMRC estimates that it overpaid £1.8 billion and underpaid £556 million in tax credits in 2004-05 and that the position for 2005-06 awards will be similar.

The recovery of overpayments has caused hardship to some families and HMRC has struggled to manage disputes about recovery. It cannot recover all overpayments and in 2005-06 wrote off £397 million and made a provision of £409 million for doubtful debts.

**2.10** The December 2005 Pre-Budget Report announced changes to the tax credits system. One important change will be to raise the threshold for increases in income which will be disregarded when provisional awards are re-assessed from £2,500 to £25,000 for 2006-07 awards. The success of these measures in reducing overpayments and recoveries will become apparent only in 2008 following finalisation of 2006-07 awards.

**2.11** HMRC estimated that in 2003-04 claimant error and fraud resulted in tax credits of between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value) being paid to claimants to which they were not entitled. It also estimates that claimant error resulted in between £190 million and £280 million (1.6 to 2.3 per cent by value) of tax credits not being paid to claimants when they were entitled to them. These are the first full results for the scheme since it was introduced in April 2003. These levels are unacceptably high and there is currently no evidence to justify a lower estimate for 2005-06. Consequently, the Comptroller and Auditor General qualified his opinion on the Trust Statement.

**2.12** In 2005-06, HMRC's compliance checks identified incorrect payments made of £250 million and prevented incorrect payments of £447 million. HMRC has set a target for this compliance work which is based on the number of checks. It needs to consider how these can be developed into outcome based targets, such as reductions in fraud to provide better information on the effectiveness of its compliance work.

**2.13** In 2005-06 HMRC identified total incorrect payments by suspected organised fraudsters of around £131 million. These included a serious attack in late 2005 by organised criminals submitting false claims, which led to fraudulent payments of around £55 million. HMRC closed the tax credits e-portal on 2 December 2005 as a consequence of these attacks and it accepts that additional controls need to be built into the e-portal before it can be re-opened. HMRC needs to ensure that the new system fully complies with established government standards on security.

## The collection of income tax through Pay As You Earn (PAYE)

**2.14** In 2005-06 HMRC collected £114 billion income tax through PAYE. To operate PAYE effectively, HMRC depends on employers and employees providing it with accurate and timely information on income and changes in employment. This does not always happen and can lead to the risk that taxpayers do not pay the right amount of tax.

**2.15** The PAYE computer system was introduced in the 1980s and its records are structured around employments, rather than individual taxpayers. As a result, HMRC can have difficulty ensuring that taxpayers with more than one source of income pay the correct amount of tax because it may not correctly bring together information on all sources of income.

**2.16** The difficulties in the operation of PAYE have been compounded by inconsistent working practices within HMRC. Staff have not always been aware of or followed Departmental policies. Deficiencies in management information have also made it difficult for HMRC to prevent or detect errors made by staff. And several times in recent years HMRC has diverted PAYE resources to other areas of work which it considered had higher operational priority.

**2.17** During 2005-06 HMRC produced new information to provide a better picture of the scale of these problems. Based on a sampling exercise, its Internal Audit Office estimates that each year HMRC may not be pursuing some £1 billion of tax due, taxpayers may have overpaid around £500 million and consequently that 5.7 million taxpayers may not be paying the right amount of tax.

**2.18** HMRC has responded by reminding staff of the importance of following procedures, improving its internal quality monitoring procedures and has introduced a programme to deliver a better service experience for the taxpayer. It has also allocated additional resources to PAYE work. But it recognises that real improvement requires fundamental changes. Accordingly, HMRC plans to improve its internal processes as part of its 'Modernisation of PAYE Processes for Customers (MPPC)' project. This project should also provide a complete view of an employee's tax affairs by making better use of the information HMRC already holds. Successful implementation should reduce a major source of error but HMRC considers the computer changes cannot be achieved before 2008 because of the technical challenges.

**2.19** Effective operation of PAYE also depends on employers and employees meeting their obligations. HMRC needs to target and take further action to improve compliance by employers and employees who do not meet their obligations.

## VAT – Missing Trader Fraud

**2.20** Missing trader fraud is one of the most serious attacks on the tax system ever seen. It is a systematic attack by organised criminal groups on the European Union VAT system. Missing trader fraud has a direct effect on the level of VAT receipts collected. HMRC estimates that for 2005-06 VAT receipts could have been reduced by between £2 billion and £3 billion because of the fraud.

**2.21** The organised criminals involved in the fraud are resourceful and react quickly to measures implemented by HMRC, setting up sophisticated and contrived transaction chains to avoid detection. To address these latest developments, HMRC has further strengthened its operational activities such as the introduction of new scanning equipment. The Government has also announced new legal measures to help tackle the fraud in the Finance Bill 2006. These make explicit HMRC's powers to document and scan goods during checks and require traders to maintain complete records of goods, such as the unique identification numbers of mobile phones. In addition, in December 2005 the Government applied to the European Commission for a derogation to introduce a reverse charge accounting system for goods commonly used in missing trader fraud. The reverse charge, if accepted, will allow HMRC to collect VAT from the person to whom goods are supplied rather than the person supplying the goods. HMRC has estimated that, if approved, this measure will yield an additional £1 billion of VAT receipts over the next three years.

**2.22** HMRC and other Member States, supported by the European Commission, are working closely through administrative cooperation to tackle the fraud. However, whilst the current arrangements in the VAT system remain, fraudsters can obtain goods free of VAT and continue to perpetrate this type of fraud. The Commission has considered an overhaul of the current VAT system, but due to a lack of consensus, Member States have not agreed a definitive system. Within the current framework, improvements could be made to the quality and timeliness of information shared.

**2.23** To tackle the recent changes in the fraud to transcend the European Union, HMRC has established memoranda of understanding with a number of third countries to facilitate the exchange of information. HMRC has also engaged the legitimate trade and several of the large accountancy and tax professional bodies to help raise awareness and develop guidance for their clients that may come into contact with missing traders. These are both approaches that could be adopted in other Member States and HMRC should use its experiences to help develop a community approach.

## DVLA - Vehicle Excise Duty Evasion and Enforcement

**2.24** The Comptroller and Auditor General reports each year on the latest Vehicle Excise Duty evasion figures and the DVLA's initiatives to reduce evasion. The Department for Transport publishes each winter the results of roadside surveys conducted in June each year. Those from June 2005 indicate that the Vehicle Excise Duty evasion rate increased from 3.4 per cent in 2004 to 3.6 per cent in 2005, reversing the previous decrease. The DVLA believes this was partly as a result of the cancellation of advertising usually planned to precede the roadside survey. The DVLA acknowledged that it may not meet its December 2007 evasion target of 2.5 per cent and had set itself an intermediate aim of reducing the June 2006 evasion level to 3 per cent. In late January 2007, the results of the June 2006 survey showed that evasion had instead increased significantly. The Comptroller and Auditor General's report later in 2007 will consider explanations of this unexpected increase. The DVLA had acknowledged, in 2006, that halving the 'vehicle underclass' (vehicle users who persistently do not comply with their obligations) was unlikely to be achieved by its target date of January 2007.

**2.25** The accuracy of the DVLA's vehicle database is key to improving performance overall and traceability of vehicle keepers measured in October 2005 compares well with 2003. Further increases in traceability will be restricted by failure of customers to notify the DVLA of changes, and overall improvements are unlikely without a significant reduction in the vehicle underclass population.

**2.26** In July 2004 the Government published an efficiency target including reducing Vehicle Excise Duty evasion by £70 million per annum by 2007-08. However, this was achieved in 2004-05, based on the June 2004 survey results.

**2.27** The DVLA believes that a better alignment of target dates and measurement arrangements would significantly improve clarity of reported progress, and a reappraisal would be beneficial. The National Audit Office encouraged the DVLA to take its proposals forward with the Department for Transport and the Treasury.

**2.28** Compliant taxpayers' continued willingness to comply underpins the success and efficiency of most tax and duty schemes. It remains a concern that the long-standing and significantly higher evasion rates amongst motorcyclists may threaten the Vehicle Excise Duty-paying public's confidence in the DVLA's even-handedness of treatment and enforcement under the Vehicle Excise Duty regime. The lack of effective action against evading motorcyclists could risk gradually undermining the Vehicle Excise Duty tax base.

**2.29** In 2005-06, Late Licensing Penalty Notices and subsequent County Court action left some 619,000 penalty non-payment cases (48 per cent) that were not pursued at all, and only some 10 per cent of the 216,000 cases taken to court led to payment. The DVLA in 2006 reduced the volume of court cases and in June started a trial using debt collection agencies, supplemented by wheel-clamping teams. The success of this trial will be evaluated next year.

**2.30** There is potentially a reputational and credibility issue if repeat non-payers of Vehicle Excise Duty sense that nothing further will happen to them, and the DVLA is hopeful that the use of debt collection agencies will address this perception. The DVLA has also agreed to consider a suggestion by the National Audit Office for a trial of further reminders targeted at longer-term non-payers, and to consider its effectiveness.

## Audit of Public Debt and Reserves

### Introduction

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

### The Consolidated Fund and the National Loans Fund

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

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

**2.33** The 2005-06 accounts show that total receipts and payments into and out of the Consolidated Fund were over £392 billion, including gross receipts of £304 billion from HM Revenue & Customs. Payments for supply services came to £355 billion while the total for standing services was £32 billion.

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

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

**2.36** The 2005-06 accounts for the National Loans Fund show that at 31 March 2006 the Government's net liabilities through National Loans Fund borrowing were £484 billion, compared to £436 billion at the end of the previous financial year. In total, the Fund's liabilities were £567 billion, and included £443 billion in long term borrowing through gilt-edged stock, £72 billion borrowed in the retail savings market by National Savings and Investments, and a further £10 billion financed through the Debt Management Account and its money market borrowing operations. The Fund's assets were £83 billion, and included £47 billion advanced to the Public Works Loan Board to finance loans to local authorities. The 2005-06 accounts also show that the total cost of financing the Government's borrowing through the Fund of £28 billion was offset partly by income from lending operations of £4 billion and other income of £4 billion.

**2.37** Both the Consolidated Fund and the National Loans Fund are operated by the Treasury. However, except for transfers between the two funds, the Treasury can only make issues from them with the authority of the Comptroller and Auditor General. The financial statements for 2005-06 of both funds were certified with unqualified audit opinions.

## Debt and Cash Management

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

**2.39** The Debt Management Account facilitates the management and reporting of the activities of the UK Debt Management Office in pursuit of its debt and cash management activities. At 31 March 2006, the Account held £47 billion in assets, for example – debt securities and loans, for the purpose of debt and cash management.

**2.40** The UK Debt Management Office also administers functions relating to the Commissioners for the Reduction of the National Debt and the Public Works Loans Board. The main function of the Commissioners for the Reduction of the National Debt is to invest funds on behalf of certain government entities. Financial statements are prepared for each investment fund and these are audited by the Comptroller and Auditor General.

**2.41** At 31 March 2006, the Commissioners controlled funds with a market value of some £46 billion. This included £35 billion, £5 billion and £2 billion on behalf of the National Insurance Fund, Court Funds (England and Wales) and the National Lottery Distribution Fund respectively.

**2.42** The Public Works Loans Board considers loan applications from local authorities and other prescribed bodies and, where loans are made, collects the repayments. The 2005-06 accounts show that the Public Works Loans Board had loans outstanding of £48 billion at 31 March 2006. The accounts also show that the Board's income from interest receipts and premiums amounted to £3 billion in 2005-06.

**2.43** All financial statements prepared by the UK Debt Management Office for 2005-06 were certified with unqualified audit opinions.

## Foreign Exchange Reserves

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

**2.45** As at 31 March 2006, the Account held total assets of £29 billion including some £20 billion of debt securities, £3 billion of loans and advances to banks and £3 billion of gold. The 2005-06 financial statements for the Exchange Equalisation Account were the first government accounts to apply Financial Reporting Standards 25 (Financial Instruments: Disclosures and Presentation), 26 (Financial Instruments: Measurement) and 29 (Financial Instruments: Disclosures). This coincided with the introduction of a new general ledger for the Exchange Equalisation Account by the Bank of England. The Exchange Equalisation Account was certified with an unqualified audit opinion by the Comptroller and Auditor General.

## Accounts certification timetable

**2.46** The commentary above notes that unqualified audit opinions were provided on the debt and reserves suite of accounts. For 2005-06 the audits have been further characterised by advances in the timetable for the certification of the accounts. In 2006-07 we will, for the first time, aim to certify the Consolidated Fund and National Loans Fund accounts prior to Parliament's summer recess.

# PART THREE

## Financial Audit - Looking Forward

### Whole of Government Accounts

#### Introduction

**3.1** The Chancellor's 2005 Pre-Budget Report and the associated document 'Delivering the benefits of accruals accounting for the public sector' confirmed the Government's decision to proceed with the publication of Whole of Government Accounts (WGA), beginning with the publication of balance sheet information for the year ending 31 March 2007.

**3.2** WGA will be commercial-style group accounts for the whole of the public sector, prepared by the Treasury and audited by the Comptroller and Auditor General. The main aim of the Treasury's WGA programme is the provision of better quality financial information on the Government as a whole, underpinning the decisions of government fiscal planners, helping with policy formulation and resource allocation, and improving the accountability of government to Parliament and the wider public.

**3.3** The WGA programme builds upon preliminary central government sub-consolidations for the financial years 2001-02 and 2002-03 and a more complete central government consolidation process for the financial year 2003-04, all of which have been subject to NAO dry-run audit procedures. Although this process has been valuable in identifying learning points regarding the timeliness of the consolidation process and issues concerning the quality of data, the government has decided to focus preparations for publication on whole of government data.

**3.4** The extension of the WGA project to include local authorities, health trusts and public corporations within the accounting boundary has begun, with the Treasury performing a preliminary WGA dry-run for 2004-05. While this process did not involve dry-run audits of the new bodies themselves, the National Audit Office did perform a high level review of this process, while continuing its dry-run audit of the consolidation

returns of central government bodies. This will be built upon in 2005-06 with a second dry-run which will be subject to full dry-run audit procedures, incorporating the co-ordination of the work of auditors other than the Comptroller and Auditor General. Work is currently underway on this process.

#### Results of the central government sub-consolidation process

**3.5** The WGA programme has been designed with clearly defined "milestones" intended to identify and make necessary changes regarding accounting policies, systems and procedures in a progressive, manageable way. The central government sub-consolidation encompasses the devolved administrations, central government departments and agencies, funds and non-departmental public bodies (NDPBs).

**3.6** HM Treasury and the NAO have been engaged in the central government sub-consolidation for the financial years 2001-02 to 2004-05, and the process has been marked by significant progress in a number of key areas as previously reported:

- the ability to produce robust accruals figures in accounting for the major taxation income streams on an accruals basis;
- recognising the assets and liabilities of the Central Funds on a full accruals basis; and
- compiling and validating pension schemes' liabilities in order to meet the implementation of FRS17 across the central government sector.

**3.7** The 2004-05 central government sub-consolidation again demonstrated incremental improvement over previous years. However, there still remain a number of key issues to be addressed:

- a number of bodies fail to deliver within the timeframes set by Treasury. This is a significant issue, and will become more relevant as Treasury continues to accelerate its submission timetable. To be relevant and useful for fiscal management, consolidated data has to be timely;
- a number of bodies have difficulty in identifying transactions and balances with other government bodies, and further work needs to be carried out in establishing systems to identify these items throughout the financial year. Without this there is a risk that the overall picture of government finances will be distorted through the inclusion of internal balances and transactions that should have been eliminated; and
- a number of bodies submit consolidation returns of poor quality, reflecting a lack of appropriate supervision and prioritisation of the consolidation process, combined with an inappropriate allocation of resources.

**3.8** The National Audit Office and Treasury continue to work together to address these issues. As part of this programme, Treasury have identified a number of key departments which require close monitoring to improve the timeliness and quality of the data they submit, and are meeting with them as part of its wider project of developing improvements in government-wide financial management. In this way the WGA project can be seen to have direct individual benefit for the financial systems and controls of individual bodies themselves.

## Emerging findings from the 2004-05 WGA process and taking the project forward

**3.9** The move to WGA adds significant extra work and complexity to the consolidation process and entails the addition of nearly one thousand new bodies (in excess of six hundred local authorities, over three hundred NHS and Foundation Trusts, and approximately sixty Public Corporations including trading funds) to the consolidation process.

**3.10** The first WGA dry-run for the fiscal year 2004-05 was by design incomplete, and did not involve the audit of local government, health, or public corporation returns. Consequently, the National Audit Office performed only a high level review of the 2004-05 consolidation processes, the aim being to identify improvement areas going forward. As detailed below, these review procedures identified a number of learning points, many of which have already begun to influence the 2005-06 dry-run:

- a significant number of local government bodies did not submit consolidation returns to facilitate the local government sub-consolidation. In response, new escalation procedures have been introduced to alert Treasury of instances on non-submission, and early results indicate that the submission rate for 2005-06 has improved noticeably;
- reporting of transactions and balances with other government bodies within the WGA accounting boundary was incomplete, most notably within local government bodies and NHS trusts, but also impacting on central government bodies that have transactions with the wider public sector. In response, Treasury are currently working with the Audit Commission, CIPFA, and the departments involved to attempt to address the issue for 2005-06;
- as local government accounts are based upon accounting policies not fully in compliance with UK GAAP, this entails the preparation of a number of complex accounting journals to bring the consolidation returns into line with the rest of the WGA sector. Overall these were prepared to a high standard, although a number of minor improvements were recommended to inform the 2005-06 process; and
- the COINS IT system as it relates to WGA was reviewed, indicating that, overall, the IT control environment provides a reasonable degree of assurance over the integrity of WGA data. However the National Audit Office recommended a number of minor improvements, most notably in respect of change control and exception reporting over submitted data, which will further strengthen the control environment.

**3.11** Moving forward to the 2005-06 WGA dry-run audit, the first time that non-central government bodies will have their consolidation returns audited, the logistical challenges of data collection, compilation and audit are significant. Many of the bodies to be included within WGA are not audited by the Comptroller and Auditor General, and as such he will need to rely on the work of other auditors. Building upon working protocols already established with Audit Scotland, the Northern Ireland Audit Office and the Wales Audit Office as part of the central government sub-consolidation, the National Audit Office has established a working group of the Public Audit Forum (PAF).

**3.12** Comprising representatives from the National Audit Office, the Treasury, the National Audit Agencies, the Audit Commission, the Audit Commission appointed auditors (for local government and NHS trusts) and private firms (for public corporations and foundation trusts) the PAF working group has already met on a number of occasions to determine the scope of work and reporting protocols necessary to facilitate the successful dry-run audit for 2005-06, and will represent a vital means of communicating and assessing the results of the dry-run audit as it progresses. The National Audit Office has found this an extremely helpful forum.

**3.13** Running in parallel with the consolidation process itself, there are also a number of other significant issues that will need to be addressed as part of the wider WGA project. The National Audit Office and the Treasury continue to work together to address these issues, the most notable being:

- the convergence of different accounting policies, such as different methods of accounting for fixed assets where local authorities record roads and other infrastructure assets at historic cost as opposed to current cost, and ensuring the consistency of PFI accounting across the various WGA sectors; and
- finalisation of the bodies to be included within the WGA accounting boundary.

**3.14** The NAO, in being actively involved at all stages of the WGA process, will strive to ensure that the responses to the challenges faced adequately balance the costs of additional audit work with the need to protect the robustness of the Comptroller and Auditor General's audit opinion.

## Conclusion

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

## Lord Sharman's Review

**3.16** In February 2001 Lord Sharman published his review of Audit and Accountability for Central Government, to recommend suitable audit and accountability arrangements for central government in the 21st century. Among the recommendations of the review was that the Comptroller and Auditor General should be appointed statutory auditor of all non-departmental public bodies (NDPBs), and that he should be able to audit non-departmental public bodies that are companies and companies which are subsidiaries of non-departmental public bodies.

**3.17** Further progress has been made in implementing the recommendations of Lord Sharman's report into audit and accountability in central government. The Companies Act 2006 which received Royal Assent on 8 November 2006 changes UK legislation to enable the Comptroller and Auditor General and the other UK auditors general to audit companies. The National Audit Office is consulting with the Department of Trade and Industry and the Treasury on the practical arrangements that will be necessary to put this into effect once the new provisions are brought into force. We expect to be in a position where we are able to audit government owned companies by 1 April 2008.

## International Accounting Standards

**3.18** One of the more significant changes for financial reporting by central government bodies will be the adoption of International Accounting Standards. International Accounting Standards have been mandatory for European Union listed companies in their group financial statements from 1 January 2005. While no firm date has yet been set for their application by central government bodies, this might be as early as for 2008-09 accounts. At its meeting on 8 May 2006, the Financial Reporting Advisory Board agreed to a proposal that the Treasury and the devolved administrations should prepare a Government Financial Reporting Manual based on international financial reporting standards (IFRS) as adopted by the European Commission.

**3.19** This "shadow" Financial Reporting Manual (FReM) should help entities to plan for the introduction of international standards – the aim is that it will be complete by May 2007. The shadow FReM will take a similar form to the current FReM in that it will focus on interpretations and adaptations of Generally Accepted Accounting Practice. The development process also considers the possible impact on entities of adopting international standards.

## Reconciling Departmental Resource Outturns with Resource Budgets

**3.20** The House of Commons authorities have consulted the Comptroller and Auditor General on a proposal that resource accounts include information on performance against departmental budgets. This would bring information on financial results relevant to the work of Select Committees together in one place, and would assist Select Committees in their scrutiny of Spending Review settlements, departmental reports and Gershon targets. In the light of this, the Treasury have agreed that such information will be included within the Management Commentaries accompanying accounts from 2006-07.

**3.21** Departments' resource budgets form the basis of the Treasury's management of public expenditure, and although essentially on an accruals basis, there are various differences in form and content compared to resource accounts. As part of our audit, we will review the budgetary information to be provided in the Management Commentaries and consider its consistency with the accounts.

## Accounting for Private Finance Initiative Schemes

**3.22** Accounting for private finance initiative (PFI) schemes has been a difficult issue for a number of years and the Comptroller and Auditor General has brought attention to his concerns in this regard in all of his General Reports since 2001-02. The Financial Reporting Advisory Board has expressed similar concerns in its last four annual reports.

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

**3.24** In the central government sector the National Audit Office has worked closely with its audited bodies to ensure that the accounting treatment for individual projects is appropriate. The Comptroller and Auditor

General has made it clear to departments that where he considers that the liabilities arising from PFI arrangements are not correctly reflected in their financial statements he will qualify his opinion and report to Parliament accordingly. He has not yet had the need to do so.

**3.25** But, in the light of budgetary pressures, and notwithstanding the guidance on PFI accounting published by the Accounting Standards Board (Financial Reporting Standard No 5 (FRS 5), Application Note F), it is clear that differing interpretations of the accounting guidance have been applied to projects in different parts of the public sector. Thus a number of new buildings or refurbishments of buildings in other parts of the public sector which the Comptroller and Auditor General would have expected to have been accounted for on the relevant public sector body's balance sheet have not been so accounted for. This will have an impact on Whole of Government Accounts incorporating the local government and health sectors.

**3.26** It is also apparent that many property assets built under PFI, such as a number of PFI schools and hospitals, have been accounted for on neither the public sector body's balance sheet or that of the 'special purpose vehicle' of the consortium delivering the project. While there may be valid reasons of accounting and judgement for this in some cases, it has been a cause for concern for the Financial Reporting Advisory Board.

**3.27** The presence of such inconsistent accounting practice may in part be attributable to the application of the Treasury's own accounting guidance for PFI (Treasury PFI Taskforce Technical Note no 1), and it was agreed at the Financial Reporting Advisory Board's March 2006 meeting that a group comprising the Treasury, the National Audit Office and the Audit Commission, with representation from the major accountancy firms, should consider how the Technical Note might be amended or withdrawn. The group is expected to report its recommendations to the Financial Reporting Advisory Board in early 2007. The Financial Reporting Advisory Board has also been keeping a watching brief on the development of accounting guidance for PFI-type arrangements by the International Accounting Standards Board, although this is directed at the private sector operators rather than the public sector purchasers. In the longer term the International Public Sector Accounting Standards Board also has a project to develop accounting guidance for this area. We are pleased to note that there finally appears to be some progress in obtaining wider recognition of these issues and some first steps towards attempting to resolve them.

# PART FOUR

## Adding Value

### Introduction

**4.1** This part of the report describes some of the additional financial audit related services provided by the National Audit Office. Such work continues to evolve reflecting the commitment on behalf of the Comptroller and Auditor General to further contribute to the improvement of financial management and effective financial control across the United Kingdom central government sector.

**4.2** This contribution can be made in many ways, most directly by reporting to the audited body on issues identified through the audit process and added value work such as 'good governance' projects. In addition, active participation by staff in relevant external bodies and organisations helps shape the auditing and accounting framework for the central government sector, at the same time as influencing the wider United Kingdom and international environment that central government operates within.

### Reporting to the Audited Body

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

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

### Management Letters

**4.5** Throughout the course of an audit National Audit Office staff provide advice - often orally - to their audit clients. And at the end of the audit the National Audit Office formally raises the more significant issues in a management letter to each audited body. The management letter reports the results of the audit, informs the client of the internal control and financial management weaknesses that have been identified as a result of the audit work, and makes recommendations on how those controls and management procedures may be improved. It will also comment, where necessary, on the client's accounts production process and make recommendations to improve the quality and timeliness of the draft accounts produced for audit.

**4.6** The overall results of the Comptroller and Auditor General's financial audit work in the period covered by this report indicate that, in general, the standards of financial control in audited bodies remains high. However, the Comptroller and Auditor General has made a number of recommendations for improvements to the majority of clients' control environments and accounting processes.

**4.7** Whilst the recommendations raised are tailored to the particular circumstances of each client, a number of common themes emerged during the audit of the 2005-06 accounts. The most significant of these related to the clients' response to the requirements of the faster closing initiative. This initiative demanded that clients accelerate the production of resource accounts so that they may be audited and laid before Parliament before the Summer Recess, some six months ahead of the statutory deadline and more in line with normal commercial best practice. The progress in meeting this challenge is discussed in Part 1 of this report.

**4.8** Whilst the management letters acknowledged the efforts and success of clients who achieved this demanding target, we noted that further improvements in the speed and accuracy of the preparation of the accounts could be made. A principal concern is that in attempting to meet the tighter timetable, some clients appeared to sacrifice the depth and breadth of their quality assurance procedures, with the result that the accounts first presented for audit were sometimes subject to errors, omissions and inconsistencies. Amongst the recommendations made in the management letters were the need for clients to ensure that high level management review of the accounts is integral to the preparation of the accounts presented for audit, that difficult or contentious accounting issues are resolved at the earliest opportunity; that non-financial processes are also completed at an early stage and that year-end processes continue to be extended to and embedded in the production of in-year accounts.

**4.9** Complementing the issues raised in respect of the faster closing initiative, there were some other common themes to be found in a number of the management letters, including recommendations that audited bodies should:

- ensure that all the documentation underpinning information disclosed in the financial statements is made easily available to the auditors and in a timely fashion;
- obtain appropriate and adequate assurance that amounts provided as grants and grants-in-aid, and expenditure under Local Area Agreements, had been used in accordance with Parliament's intentions and the terms and conditions of the grant or agreement;
- institute procedures for the comprehensive and accurate identification, recording and monitoring of related party interests;
- ensure compliance with Treasury and departmental instructions and guidelines on such matters as accounting for losses, and the appropriate level of hospitality that may be accepted;
- institute, and develop controls over, reconciliations of various sets of data – particularly of cash and bank balances – to strengthen financial control of key balances;
- improve the identification, calculation and accounting of accruals; and
- improve the controls over and depth of quality of review of balance sheet items, in particular in respect of fixed assets and provisions.

**4.10** Audited bodies are generally proactive in implementing recommendations raised by the Comptroller and Auditor General, though in some cases recommendations arising from the previous year's financial audit are ongoing or have as yet only been partially actioned. The Comptroller and Auditor General continues to work with clients, and where relevant their audit committees, to follow up and review the process of implementation of his recommendations.

## Financial Impacts

**4.11** Our financial audit approach is designed to provide us with the robust, risk-based means of providing the Comptroller and Auditor General with assurance to allow him to give his opinion on the financial statements and to recommend process and financial management improvements. However, securing financial impacts as a result of our work is also important.

**4.12** These impacts, which are agreed with the department to which we have made recommendations and which are subject to review by both our internal and external auditors, demonstrate the benefit of our work in terms of savings to the United Kingdom taxpayer. Currently our work overall generates savings of £8 for every £1 that we cost. In 2005, the impacts identified by our financial audit teams contributed around £120 million to total savings of £555 million. We are in the process of finalising the impacts for 2006. From 2007, the Comptroller and Auditor General has made a commitment to increase the target to £9 for every £1 that we cost.

## National Audit Office Contribution to Faster Closing

**4.13** Part 1 of this report referred to the Treasury's 'Faster Closing' initiative within the context of commenting upon the timeliness of departments rendering accounts for audit. During 2005-06 departments made considerable progress in meeting the accelerated timetable for the delivery of their accounts for audit and the laying of their resource accounts before Parliament to the pre-recess timetable of 25 July 2006. 47 out of 54 departments were able to meet the summer recess timetable for their 2005-06 resource accounts which compares to 25 departments for 2004-05.

**4.14** The Comptroller and Auditor General has worked closely with both the Treasury and departments during the year to try to ensure that they are able to meet the challenges posed by the faster closing deadline. In 2005 the National Audit Office issued a guidance booklet ('Ready, Steady, Go') to highlight best practice in both the public and private sectors in meeting the challenges of faster accounts closure, and staff have continued to offer guidance and assistance to those involved in the production of resource accounts to help them to meet the pre-recess timetable.

**4.15** As part of the Comptroller and Auditor General's on-going commitment to the initiative, National Audit Office staff have maintained close contact with Treasury during the year to review progress against timetable. We will continue to work closely with Treasury and the departments to monitor progress in future years.

**4.16** The achievement of the pre-recess timetable depends not only on sophisticated year end processes, but also upon sound financial management operated by departments throughout the financial year. The production of robust and accurate financial information has to be a monthly discipline which directly contributes to the financial monitoring and effective management of government departments. This in turn leads to further efficiencies in the audit process, and allows the Comptroller and Auditor General to undertake substantial amounts of his audit work before the financial year end, hence further contributing to the accelerated certification timetable.

**4.17** In this respect, for 2005-06 accounts' audits the National Audit Office undertook 'hard close' audits where possible, under which the majority of the audit testing is carried out before the financial year end, thereby reducing the time required to complete the final audit. This is an important tool in meeting the pre-recess deadline, but is only feasible where departments have a robust management accounts function that enables them to produce timely, accurate and complete monthly financial statements.

## Good Governance Projects

**4.18** The Comptroller and Auditor General supplements his annual audit of accounts and Value-for-Money studies by a selective programme of project work - the 'Good Governance Programme'. The timescale and tight focus of financial audit does not always allow the National Audit Office to examine emerging findings in the depth or

detail that they, or the audited body, might like in order to identify how improvements might best be delivered. Good Governance projects offer an opportunity to go beyond the process of 'holding to account' towards more explicitly helping organisations to improve. As well as arising from the risk analysis that informs the audit planning approach, or in response to weaknesses identified as part of the financial audit process, such projects may be prompted by concerns raised by the audit committee or management of an audited body or by Members of Parliament regarding the propriety or economy of particular areas of public expenditure.

### Example of a Good Governance project – the management of losses and special payments

The National Audit Office examined the management of losses and special payments in a major department. As a result of the work undertaken, the National Audit Office highlighted a number of areas of good practice and areas where improvements could be made, to ensure that losses and special payments are systematically identified and reported to Parliament.

The main recommendations from this review were for the department to:

- rationalise guidance on losses and special payments to ensure that it is easily accessible to all;
- carry out high level challenge of material losses and analysis and investigation of trends of all losses;
- clarify the role of Audit Committees in the management of losses and special payments;
- ensure that factors likely to trigger losses or special payments are identified and tracked;
- raise the awareness of the need for timely and accurate handling of losses and special payments; and
- ensure that lessons are learned from losses and special payments with particular attention to future training and risk management.

**4.19** Good Governance projects are discrete assignments which examine specific issues in greater depth. As well as using such assignments to improve financial management and promote beneficial change for individual audited bodies the Good Governance programme offers the National Audit Office the opportunity to perform reviews focussed on specific areas of governance or financial management that cut across central government. This enables the National Audit Office to communicate areas of good practice identified at one audited body across the relevant departmental family or the wider central government sector.

**4.20** A major outcome of such work has been the development of a number of generic ‘toolkits’ to support Good Governance project work at individual audited bodies on matters such as efficiency, attendance management, tackling external fraud and procurement.

**4.21** Audited bodies have been very receptive to the use of such toolkits, and have implemented a variety of improvements in their controls and governance structures as a result of the work.

#### Examples of Good Governance work supported by National Audit Office toolkits

##### 1 Efficiency Toolkit

The National Audit Office carried out an organisational assessment of a public sector body and identified weaknesses in areas of the organisation’s systems and operations. These weaknesses were agreed with the body and a series of workshops and seminars to address the weaknesses are underway.

##### 2 Attendance Management

Launch of a CD-ROM toolkit for use by any government organisation to assist in tackling the problem of sickness absence. The toolkit is a step-by-step guide from identifying if sickness absence is an issue through to achieving financial impacts.

##### 3 A Guide for School Governors

Launch of a guide for school governance designed to contribute towards the wider goal of improving school performance. The guide offers governors a framework for assessing their maturity and relevant position against benchmark data, and offers sources for further information and good practice across a number of areas.

## National Audit Office support to the agenda of the United Kingdom Presidency of the European Union

**4.22** During 2005, the European Commission developed a ‘roadmap’ designed to move the European Union towards a clear audit certificate (known as a positive Statement of Assurance). The roadmap was published in June 2005, just prior to the start of the United Kingdom’s Presidency of the European Union for the latter half of 2005. The National Audit Office provided support to the United Kingdom Presidency to help develop the roadmap. Specifically, we worked with the Treasury to analyse the Commission’s proposals. This analysis informed a meeting of an expert panel in September 2005 which met to discuss the proposals. The expert panel was supported by three working groups, one of which we chaired jointly with the Commission.

**4.23** Following the publication of the European Council’s conclusions on the roadmap, the European Commission published an Action Plan designed fill the gaps between the current system of internal controls and that proposed by the Commission. One action relates directly to the work of state audit institutions (SAIs) like the National Audit Office, suggesting that Member States should invite their Parliaments to ask their SAIs for audit and assurance on European Union funding.

**4.24** In response to this Commission Action Plan suggestion, the Comptroller and Auditor General, in giving evidence in June 2006 to the House of Lords Select Committee on the European Union, introduced a proposal for a single account for each Member State to disclose national use of European Union funds. Following the Committee’s subsequent report (Financial Management and Fraud in the European Union - HL Paper 270) the Economic Secretary to the Treasury announced in November that an annual consolidated statement on the United Kingdom’s use of European Union funds, prepared to international accounting standards, would be audited by the National Audit Office and laid before Parliament. We are currently considering, with the Treasury, how this can be taken forward.

## National Audit Office support to the Accounting and Auditing Professions

**4.25** The Comptroller and Auditor General and staff from the National Audit Office continue their participation in the development of new accounting and auditing guidance through active participation on a number of professional bodies, while also continuing to work with those bodies tasked with strengthening oversight within the profession. The Office’s input into the work of such bodies helps increase the assurance provided to Parliament from financial audit work, through the development of appropriate auditing and accounting guidance for the central government sector, and by ensuring that the accounting and auditing regime in the United Kingdom is robust.

**4.26** The contribution to the development of professional thinking includes:

- direct involvement of members of staff in relevant professional committees and working groups; and
- formal responses to consultation documents issued by the professional bodies (e.g. exposure drafts of proposed accounting and auditing standards).

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

**4.28** A member of the National Audit Office senior management board is chair of the Public Sector Committee of the Fédération des Experts Comptables Européens. The Committee promotes the exchange and acceptance of international best practice in public sector auditing and its members include all member states of the European Union, as well as Norway and Switzerland. In addition, National Audit Office staff are active on a number of INTOSAI bodies, such as the Auditing Standards Sub-Committee and the Internal Control Standards Sub-Committee. And in September 2006 the Comptroller and Auditor General hosted the 13th meeting of the INTOSAI Privatisation Working Group bringing together representatives from 29 Supreme Audit Institutions to discuss issues related to public private partnerships, privatisation and regulation.

## Correspondence with Members of Parliament and members of the Public

**4.29** The Comptroller and Auditor General receives a wide range of correspondence from MPs and members of the public. Some letters require significant amounts of detailed research, but for straightforward cases he aims to reply to MPs within fifteen working days and to members of the public within a month. The Office also receives a number of requests for information under the Freedom of Information Act.

**4.30** The C&AG is also designated (section 43F of the Employment Rights Act 1996, as amended by the Public Interest Disclosure Act 1998) as a 'prescribed person' to whom 'whistleblowing' disclosures may be made by employees suspecting malpractice in the workplace where they reasonably believe that the allegations made are substantially true. He is responsible for receiving disclosures in areas which fall under his jurisdiction. Schedule 2 to the Public Interest Disclosure (Prescribed Persons) (Amendment) Order 2003, made under the Act, defines his remit as 'the proper conduct of public business, value for money, fraud and corruption in relation to the provision of centrally-funded public services'. The Office hosts a dedicated telephone line for whistleblowers, the number for which is publicised on the Office website.

### Examples of staff involvement in professional committees and working groups

#### 1 The Financial Reporting Council

The Comptroller and Auditor General is a member of the Council, and the chairman of its Professional Oversight Board and a member of its Financial Reporting Review Panel. The Council and its Professional Oversight Board have taken over major elements of the regulatory regime for the accountancy and auditing profession.

#### 2 The Public Audit Forum

The Comptroller and Auditor General, together with the heads of the other national audit agencies, make up the Forum. The Forum plays an important role in enabling the audit agencies to share and promote good practice and to develop a common line on issues that cut across the different parts of the public sector.

#### 3 The Institute of Chartered Accountants in England and Wales

One member of staff serves on the Institute's Council and another is a member of the Public Sector Audit Committee. A number of other members of staff contribute to various working groups or committees.

#### 4 The Chartered Institute of Public Finance and Accountancy

A member of the NAO's senior management board is a member of the Council and another chairs its Accounting and Auditing Standards Panel. Other members of staff participate on its other professional panels and committees.

#### 5 The Auditing Practices Board

A member of the NAO's senior management board is a member of the Public Sector Sub Committee.

#### 6 The Financial Reporting Advisory Board

A member of the NAO's senior management board is a member of the Financial Reporting Advisory Board.

#### 7 Accounting Standards Board

A director is a member of the Committee on Accounting for Public Benefit Entities. A member of staff is on secondment to the Board as a project director.

#### 8 The Audit Commission

A member of the NAO's senior management board is a member of the Commission's Technical Advisory Group.

# APPENDIX ONE

## Outturn of all Resource Accounts

This summary records the outturn for Resources Accounts as follows:

Resources	Gross expenditure	£000	£000
	Estimates:		
	Original Estimates	481,339,281	
	Supplementary etc. Estimates	<u>13,370,659</u>	
			494,709,940
	Actual		<u>477,679,779</u>
	Saving		17,030,161
	<b>Appropriations in Aid</b>		
	Authorised:		
	Original Estimates	45,561,235	
	Supplementary etc. Estimates	<u>239,471</u>	
			45,800,706
	Applied		<u>45,202,963</u>
	Deficiency		597,743
	<b>Net Expenditure</b>		
	Estimates:		
	Original Estimates	435,778,046	
	Supplementary etc. Estimates	<u>13,131,188</u>	
			448,909,234
	Actual		<u>432,476,816</u>
	Saving		<u>16,432,418</u>
<b>Cash</b>	<b>Net Expenditure</b>		
	Estimates:		
	Original Estimates	352,556,975	
	Supplementary etc. Estimates	<u>12,315,437</u>	
			364,872,412
	Actual		<u>352,921,035</u>
	Saving		<u>11,951,377</u>
<b>Consolidated Fund Receipts Resource</b>	Consolidated Fund Extra Receipts surrenderable recorded in the Resource Accounts amount to £13,749,856,000.00		

## APPENDIX TWO

## UK accounts audited by the Comptroller and Auditor General

Type of account	Number audited	Opinion qualified <sup>1</sup>
Resource Accounts <sup>2</sup>	54	7
Executive Agency <sup>3</sup>	75	2
Other UK accounts audited under statute or by agreement <sup>4</sup>	313	13
Total	<u>442</u>	<u>22</u>

### NOTES

1 Appendix 3 provides details of the accounts qualified.

2 Resource accounting is an accruals-based form of financial reporting that has been introduced in all government departments, and is the prime means of managing and reporting government expenditure and maintaining Parliamentary control. Resource accounts comprise financial statements similar to those found in commercial accounts but additionally include a statement designed for Parliamentary reporting purposes and a further statement analysing income and expenditure by objectives.

The total of 54 resource accounts includes the House of Lords Resource Account. This is a non-statutory account which is laid in the House of Lords.

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

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

## APPENDIX THREE

### Accounts qualified by the Comptroller and Auditor General

#### Resource Accounts 2005-06

Armed Forces Pension Scheme	Limitation of Scope
Assets Recovery Agency	Excess Vote
Department for Work and Pensions	Limitation of Scope Regularity
Home Office	Limitation of Scope
House of Commons Members	Excess Vote
NHS Pension Scheme and NHS Compensation for Premature Retirement Scheme	Excess Vote
Revenue and Customs Prosecution Office	Limitation of Scope

#### Other Accounts Qualified

Energywatch 2005-06  
Ordnance Survey 2005-06  
Marine Fisheries Agency 2005-06  
Council for Healthcare Regulatory Excellence 2005-06  
Nuclear Decommissioning Authority 2005-06  
HM Revenue & Customs Trust Statement 2005-06  
Civil Nuclear Police Authority 2005-06  
Social Fund 2005-06  
Child Support Agency Client Funds Account 2005-06  
NHS Pensions Agency Administration Account 2005-06  
Northern Ireland National Insurance Fund 2004-05  
British Transport Police 2004-05  
Public Health Laboratory Service Board 2004-05  
NHS Direct 2004-05  
Health Professions Council 2004-05