Public services

National report

July 2006

audit commission

Stewardship and governance 2005

A review of the work of the Audit Commission's appointed auditors in 2005

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Summary

This report summarises the key findings of the Commission's auditors' work in 2005 on the 2004/05 accounts relating to stewardship and governance issues. It identifies a number of important policy issues that need to be addressed in order to improve financial performance, financial reporting and corporate governance arrangements in health and local government bodies.

Issue	The Commission's response
Financial performance	
Financial performance and financial management in the NHS has remained a key concern for auditors in 2005. Local authorities have more flexibility to manage their financial position through, for example, the application of reserves. However, financial management remains a concern at a small number of local government bodies.	Auditors will use their use of resources assessments to drive improvements in financial management. The Commission's joint report with the National Audit Office (NAO) makes a number of specific recommendations to improve financial management in the NHS. We will use the principles of good financial management set out in *World Class Financial Management* to inform our future work in health and local government. We have been invited by the Secretary of State to carry out a fundamental review of the financial management and accountancy regime within the NHS to identify and make recommendations on the underlying issues that contribute to poor financial management at health bodies.

Issue	The Commission's response
Financial reporting	
Local government has responded well to the earlier statutory deadline for the approval of accounts with 97 per cent doing so by 31 July 2005. However, this has been at the expense of quality, with a third of authorities having to submit their accounts for re-approval by members because of significant errors identified at audit, with the result that 13 per cent failed to meet the statutory deadline for publication. This level of performance reflects badly on local government and the accounting profession, and must be addressed as a matter or urgency. In the NHS, strategic health authorities (SHA) improved both the quality and the timeliness of their accounts in 2004/05. However, the quality of primary care trust (PCT) and NHS trust accounts declined with a fifth of bodies' accounts being amended following audit, particularly in relation to differences in balances and transaction streams arising from service level agreements.	Auditors will use their use of resources assessments to drive improvements in financial reporting. We will work with the Chartered Institute of Public Finance and Accountancy (CIPFA) to develop further guidance for local authorities to help them address the common areas of non-compliance with reporting standards. We will publish a paper for audited bodies, setting out what auditors will expect from them prior to the commencement of the audit of the final accounts. The Commission is working with CIPFA to develop an approach to rolling financial forecasting, which will better align the processes for financial reporting with those for in-year financial monitoring and management. We have developed arrangements to enable the identification of material differences in balances and transaction streams between NHS bodies through the audit process. We are also working with the Department for Communities and Local Government (DCLG) and the Department of Health to develop an approach for the preparation of interim accounts.

Issue	The Commission's response
Financial reporting (continued)	
Developments to the *Code of Practice on Local Authority Accounting in the United Kingdom – a Statement of Recommended Practice* are helping to ensure greater compliance with UK Generally Accepted Accounting Practice. However, we are concerned about the length and complexity of local authority accounts and believe that there is a need to develop guidance on summarised accounts, to be issued alongside the detailed statutory accounts, to provide greater accessibility to a wider audience of lay and general readers.	We will develop proposals for discussion with CIPFA and other key stakeholders on the production of summary financial statements by local authorities that will sit alongside the more detailed statutory accounts.
Corporate governance arrangements	
Audit committees have been a requirement in the NHS for a number of years, but auditors' public interest reports highlight failures in corporate governance that point to a lack of effectiveness of audit committees and the need to enhance the financial literacy of non-executive directors. In local government, progress is being made to introduce audit committees, although the core functions are often undertaken either by a committee or panel which also has other functions or by more than one committee.	Auditors will use their use of resources work to help audited bodies to develop more effective audit committees. In local government, this will build upon CIPFA's *Audit Committees: Guidance for Local Authorities*, and in health on the *NHS Audit Committee Handbook*.

Issue	The Commission's response
Corporate governance arrangements (continued)	
Statements on internal control (SICs) have been a feature of NHS governance arrangements since 2001/02 and are well embedded. In local government, good progress was made in the implementation of SICs in 2004/05. Authorities now need to ensure that they have appropriate arrangements in place to enable risks to continue to be properly identified and appropriately disclosed in the future.	Auditors will continue to review statements on internal control to consider whether areas of non-compliance are being adequately disclosed. They will also comment on the adequacy of the assurance frameworks in place to underpin the statements on internal control and provide a flow of information to those charged with governance. The Commission is participating in the revision of the CIPFA/SOLACE publication *Corporate Governance: A Keystone for Community Governance* to provide more guidance to authorities on the development of a sound assurance framework and on reporting of governance issues.
The majority of health and local government bodies have now identified their significant business risks, but some bodies, including a third of police authorities, have yet to do so.	Through their use of resources assessments, auditors will continue to help bodies to identify weaknesses in their risk management arrangements and to develop arrangements to address those weaknesses.
Auditors are generally satisfied with the scope, coverage and quality of internal audit work at many audited bodies. However, audited bodies could make better use of overall audit resources by improving coordination.	Auditors will continue to work with audited bodies to identify how overall audit resources can best be utilised for the benefit of the organisation and will use their use of resources assessments to comment on bodies' internal control arrangements.
Health and local government bodies continue to increase their use of partnerships in working to deliver modern, integrated services. However, one in four audited bodies still have no formal governance agreements in place for partnerships.	Auditors will continue to monitor the performance of partnerships having regard to best practice guidance and will reflect their comments in their use of resources assessments.

1

Introduction

1 This report summarises the key findings of the Commission's auditors' work in 2005 on the 2004/05 accounts relating to stewardship and governance issues. The Commission's appointed auditors play an important role in assuring taxpayers that local public bodies have safeguarded and accounted properly for public money, and put in place arrangements to secure value for money and ensure the proper conduct of public business. Auditors' work lies at the heart of the Commission's regulatory regime and underpins all of the Commission's work nationally.

2 The key findings and messages arising from appointed auditors' work in 2005 at NHS and local government bodies are discussed in the following sections:

- Section 2: Financial performance
- Section 3: Financial reporting
- Section 4: Audit opinions and public reporting
- Section 5: Corporate governance arrangements
- Section 6: Certification and claims and returns

3 Wherever possible, we have compared and contrasted performance between sectors, identifying where and how improvements can be made.

4 The Commission has recently published its joint report with the NAO on financial performance in the NHS. We have not repeated the messages from that report here, other than to use the information to compare performance with local government.

2

Financial performance

5 Financial performance and financial management remained the key concern for auditors in 2005.

6 Financial concerns in the NHS have been well publicised in recent months. Our recent joint report with the NAO on financial management in the NHS looks in detail at the financial pressures in the NHS. In summary, the key findings of that report were that:

- the aggregate overspend for all NHS bodies (including NHS foundation trusts) for the financial year 2004/05 was £251 million (0.3 per cent of total expenditure), compared with an underspend of £65 million (0.11 per cent) in 2003/04;
- 171 NHS bodies out of 615 (28 per cent) failed to achieve in-year financial balance in 2004/05, compared with 106 bodies (18 per cent) in 2003/04. The number of NHS bodies reporting significant in-year deficits (of over 0.5 per cent of income or available revenue resources) increased to 137 (23 per cent) from 78 (13 per cent) in 2003/04. The number and size of significant deficits would have been greater without specific financial support either from within the local health economy or centrally;
- the total cumulative deficit across NHS trusts as at 31 March 2005 was £598 million (2003/04: £276 million); and
- 16 SHA areas (57 per cent) incurred an aggregate overspend in 2004/05, compared with 7 (25 per cent) in 2003/04 and 6 (21 per cent) in 2002/03.

7 The Secretary of State has requested the Commission to undertake a review of the NHS financial management and accountancy regime. The review has been commissioned as a result of the current financial position of the NHS as a whole and in particular the number of NHS bodies with deficits. The objectives of the review are to consider and comment on the current regime and recommend changes that:

- enable and encourage the NHS and individual bodies within it to operate on a sound and sustainable financial footing;
- support the identification of financial problems and facilitate recovery;
- promote clear and transparent accountability; and
- support individual organisations to develop the necessary financial management capacity and capability to operate effectively.

8 The financial performance of local government bodies does not receive the same high profile as the health service. Local government bodies are not subject to the same financial regime as NHS bodies and have more flexibility to mitigate the impact of budgetary overspends in the short term by, for example, drawing on accumulated reserves. However, sound financial management is no less important to the effective delivery of an authority's objectives. In 2004/05, auditors reported that 156 authorities (33 per cent) overspent their budgets compared with 77 authorities (20 per cent) in 2003/04. Of these, 14 authorities (3 per cent) overspent by more than 10 per cent of their revenue budget compared with 7 (2 per cent) in 2003/04.

9 Good financial management is an essential element of good corporate governance and forms part of the firm foundations that underpin the delivery of high-quality services.

10 The key lever available to the Commission to bring about improvements in financial management is the use of resources assessments, qualitative assessments of the effectiveness of different aspects of audited bodies' financial management arrangements, which auditors are required to give at local government bodies (for Comprehensive Performance Assessment [CPA]), fire and rescue, and police authorities, and health bodies (for the Healthcare Commission's Health Check).

11 In developing the key lines of enquiry and related criteria for judgement which underpin these assessments, building on CIPFA's financial management model, we have been able to define the Commission's expectations about the minimum level of performance to be expected in financial management while at the same time setting standards in terms of the level of performance required if an audited body is to be judged as good or excellent. There will thus be an incentive for those audited bodies that aspire to a good or excellent rating to improve their arrangements.

12 Improving financial management and reporting is a key strategic priority for the Commission. In November 2005, we published a discussion paper, *World Class Financial Management*, in order to stimulate debate across public services and among finance professionals about what standards of financial management the public sector should aspire to over the longer term. In doing so, we identified leading edge and best practice examples from around the world. We believe that the principles of good financial management are universal and apply equally across the private, voluntary and public sectors. We are working with partners and stakeholders to take forward the principles

and the ideas set out in *World Class Financial Management*, to define best practice and drive up standards across the public sector. We will also use these principles and ideas to inform our own future work on financial management, including the development of a series of more practical studies and guidance on particular aspects of financial management in local government and the NHS.

3

Financial reporting

Timeliness and quality of accounts

13 The production of high-quality accounts on a timely basis is an essential element in the process of accountability for the stewardship and use of public money. However, the quality of financial reporting was again a significant issue for auditors in 2005 in both local government and the NHS.

14 Over recent years, the deadline within which local authorities are required to produce accounts and have them considered by members has moved forward considerably. The Accounts and Audit Regulations 2003 established a challenging agenda for the earlier preparation and approval of local government accounts:

- 2002/03 by 30 September 2003;
- 2003/04 by 31 August 2004;
- 2004/05 by 31 July 2005; and
- 2005/06 onwards by 30 June.

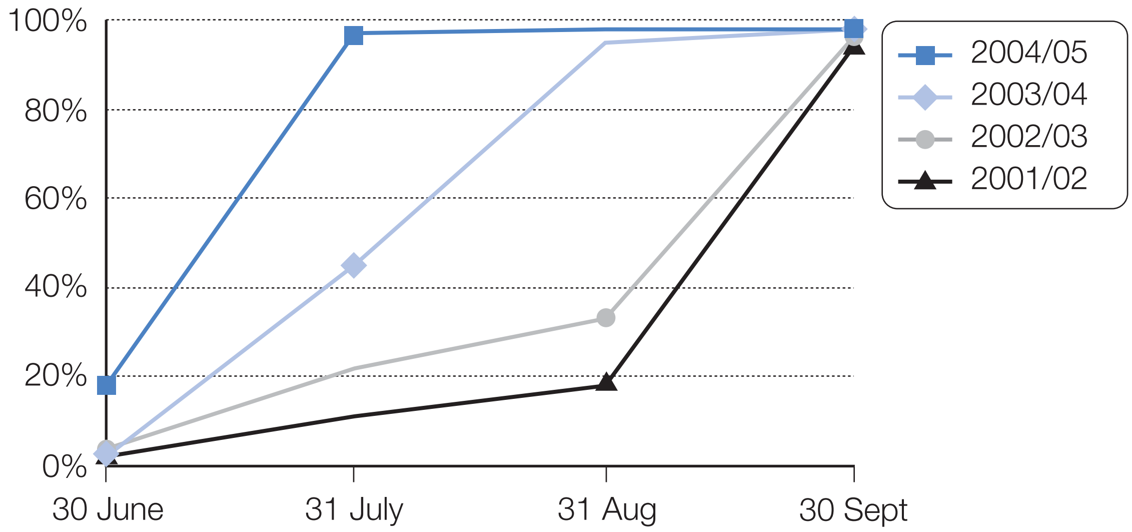
15 A further catalyst for production of more timely accounts has been the government's move to preparing Whole of Government Accounts (WGA). Local authorities were required to complete a data pack for WGA in 2004/05 for the first time, with a submission deadline of 4 November 2005. HM Treasury has indicated that it expects this deadline to be brought forward in future years.

16 This acceleration of the statutory timetable has placed pressure on local authorities, but they have responded well. Overall, 455 councils (97 per cent) achieved the earlier statutory deadline of 31 July 2005 for the approval of their accounts **(Figure 1)**.

Figure 1

When councils approve their accounts

Local authorities have continued to achieve the earlier statutory deadlines for approving their accounts.



Source: Audit Commission

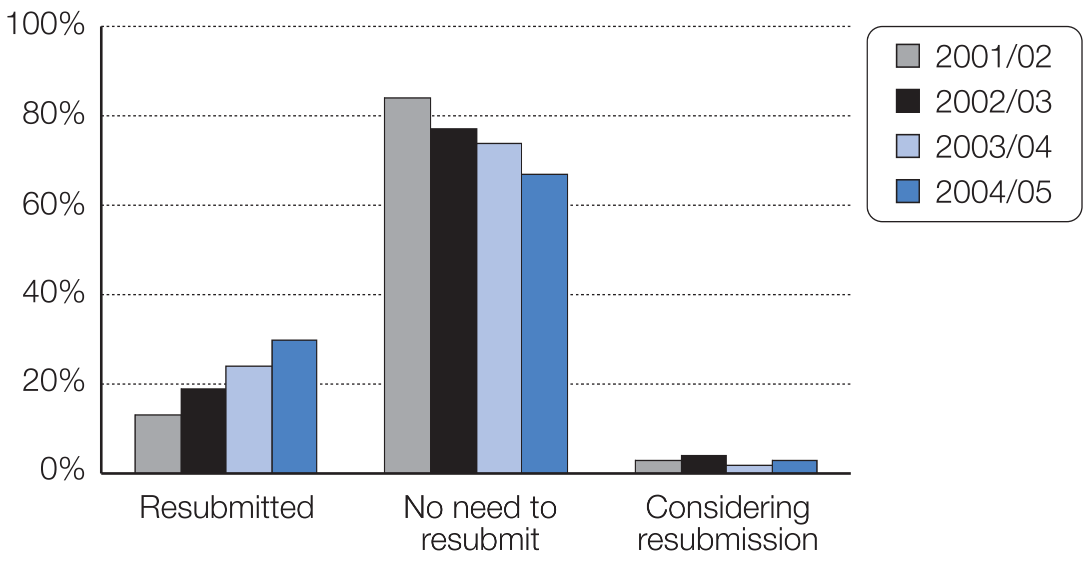
17 Auditors also reported that 407 local government bodies (87 per cent) published their accounts by the statutory deadline of 31 October 2005. However, the failure of 61 authorities (13 per cent) to meet the statutory reporting deadline represents a deterioration compared with 2004, when 44 authorities (11 per cent) failed to meet the then deadline of 30 November.

18 The acceleration of the accounts timetable clearly leads to more timely reporting of financial performance, which the Commission welcomes. But the Commission is concerned that, for many authorities, the achievement of earlier closure of the accounts has been at the cost of quality. In 2004/05, 140 authorities' accounts (30 per cent) had to be resubmitted to councillors for re-approval because of material errors identified by auditors during the audit process. This compares with 92 authorities (24 per cent) in 2003/04, 72 authorities (19 per cent) in 2002/03 and 50 authorities (13 per cent) in 2001/02 **(Figure 2, overleaf)**.

Figure 2

Accounts resubmitted to councillors

There is a continuing deterioration in the quality of accounts submitted for member approval (as at 31 December each year).



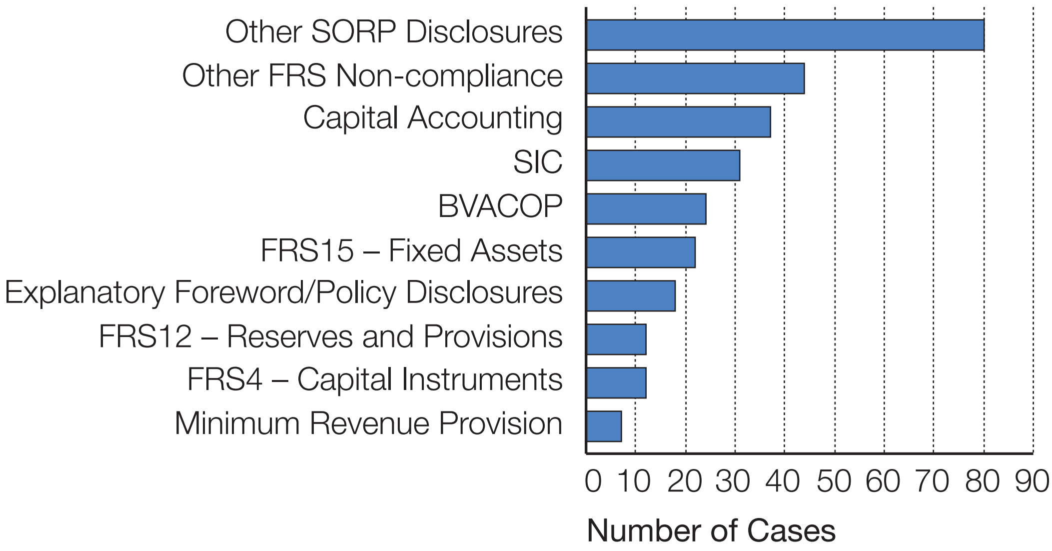
Source: Audit Commission

19 In the great majority of cases, the need for resubmission was because authorities failed to comply with the accounting and disclosure requirements of the Code of Practice on Local Authority Accounting – Statement of Recommended Practice (SORP), which have become more complex in recent years, or relevant financial reporting standards (FRSs) **(Figure 3)**. Accounting and disclosure requirements in 2004/05 changed little compared with the previous year, so the level of error identified indicates an inadequate level of care taken in preparing the accounts and an inappropriate level of review of the accounts by senior management prior to approval by councillors.

Figure 3

Reasons for account resubmission

The main reason for resubmission was because authorities failed to comply with the accounting and disclosure requirements of the SORP or FRSs.



Source: Audit Commission

20 The Commission will use the above analysis to consider, with CIPFA, whether further guidance is needed for local authorities to help them address the common areas of non-compliance.

21 Local authorities' poor performance in this key aspect of financial management is unacceptable. It reflects a continuing failure to take the financial reporting process, which underpins accountability for public money, sufficiently seriously and is something which local government as a whole and the accountancy profession must address as a matter of urgency. For our part, auditors will continue to use their use of resources assessments to highlight areas of weakness and drive improvement. We will also work with CIPFA and others to address some of the underlying issues (see paras 25-28 below).

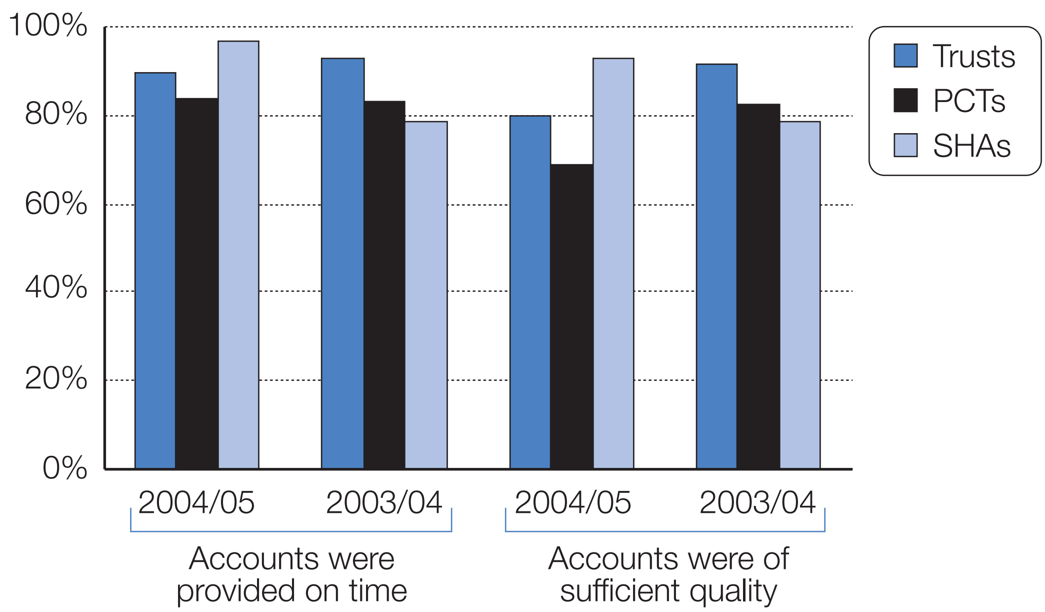
22 In the NHS, the 2004/05 final accounts timetable did not change, providing an opportunity for further improvement in the quality of accounts submitted for audit. As reported in our joint report with the NAO, 513 health bodies (87 per cent) submitted their

accounts by the deadlines compared with 516 (86 per cent) in 2003/04 with significant progress at SHAs, where only 1 (out of 25) failed to submit accounts on time (6 in 2003/04). However, like local government, the joint report also shows a decline in the quality of the accounts for both PCTs and NHS trusts. Auditors report that only 442 bodies (75 per cent) produced accounts of sufficient quality, compared with 522 (87 per cent) in 2003/04 **(Figure 4)**.

Figure 4

Timeliness and quality of NHS accounts

Like local government, there was a decline in the quality of the accounts for both PCTs and NHS trusts.



Source: Audit Commission

23 The process for the approval of accounts at NHS bodies differs from that in local government with the result that the need to resubmit accounts does not arise. However, in our joint report with the NAO, we highlighted auditors' concerns regarding the level of audit adjustments required in 2004/05 **(Table 1)**. The three most significant areas for movements between the unaudited and audited accounts were prescribing creditors, Agenda for Change and adjustments to service level agreements. Auditors reported that

there were inappropriate adjustments, including the misstatement of accruals and provisions, and / or omissions in 125 NHS bodies' accounts (21 per cent) in 2004/05 compared with 96 (16 per cent) in 2003/04.

Table 1
Comparison of NHS bodies' unaudited and audited outturn for 2004/05

	Aggregate unaudited outturn (£million)	Aggregate audited outturn (£million)	Adjustment (£million)
Strategic health authorities	381.5	372.7	(8.8)
Primary care trusts	(202.7)	(265.3)	(62.6)
NHS trusts	(282.9)	(321.7)	(38.8)
Total	**(104.1)**	**(214.3)**	**(110.2)**

Source: Department of Health and audited accounts of NHS bodies

24 We are continuing to encourage the Department of Health to make the arrangements for the agreement of balances and transaction streams between health bodies more robust. The current process is applied inconsistently, with the result that material differences can occur in the accounts of bodies with related transactions. In the absence of more reliable agreements, the Commission and its auditors have developed arrangements to enable the identification of material differences through the audit process.

Improving the timeliness and quality of accounts: addressing the underlying issues

25 The inability to produce good-quality accounts promptly at the financial year end reflects badly on a body's financial monitoring, reporting and forecasting arrangements. It remains the case that too many bodies see the production of the accounts as a technical year end exercise, undertaken by the finance department and divorced from internal financial management reporting through the year. This can also lead to monthly management reports that give a false picture of the body's financial position as they are not prepared on the same basis as the statutory accounts.

26 In the Commission's view, aligning in-year financial reporting to managers and those charged with governance and external stakeholders with year end financial reporting, on the basis of 'one version of the truth', will provide two key benefits. Firstly, members will be able to make more informed financial decisions based on accurate, accruals-based financial information. Secondly, the re-engineering of the accounts preparation process that is required to enable in-year, accruals-based financial reporting, including the regular reconciliations of balances and reviews of control accounts, would remove many of the time consuming processes that many bodies still only undertake at the year end. As a result, the production of the annual accounts would become an extension of the normal monthly process.

27 For that reason, the Commission is pleased to be working with CIPFA to develop an approach to rolling financial forecasting, which will include the integration of the processes for financial reporting with those for in-year financial monitoring and management. We are also working with the DCLG and the Department of Health to develop approaches for the preparation of interim accounts.

28 It is also our intention to publish a paper for audited bodies, setting out what auditors will expect from them prior to the commencement of the audit of the final accounts. This will clarify the expectation that the draft accounts will have been rigorously reviewed at a senior level for misstatement and compliance with proper practice and guidance, and are fully supported by comprehensive working papers.

Improving accountability

29 Local authorities in the United Kingdom are required to keep their accounts in accordance with 'proper practices'. This is defined, for the purposes of local government legislation, as meaning compliance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom – a Statement of Recommended Practice (the SORP). A number of changes to the SORP have been made in recent years to ensure greater compliance with UK Generally Accepted Accounting Practice (UK GAAP). We welcome these improvements in local government reporting, as we believe a precondition of proper accountability for the stewardship and use of public money is proper accounting in accordance with UK GAAP.

30 We continue to be concerned, however, about the complexity and length of local authority accounts, which contain a great deal of detail, much of which would not be understood by the lay or general purpose reader. We believe that, while there is clearly a

need to prepare full accounts in accordance with statutory requirements to meet the needs of regulators and informed stakeholders, there is a need to develop simplified, summarised statements that are more accessible to a wider audience of lay and general purpose readers. Many NHS bodies already use summary financial statements, the minimum requirements for which are established by the Department of Health through the manuals for accounts, in their annual reports and some local authorities have begun to do so. We will develop proposals for discussion with CIPFA and other key stakeholders relating to the production of summary financial statements by local authorities that will sit alongside the more detailed statutory accounts.

31 In a related development, in January 2006, the Accounting Standards Board (ASB) issued a Reporting Statement on the Operating and Financial Review (OFR). An OFR is defined as 'a narrative explanation, provided in or accompanying the annual report, of the main trends and factors underlying the development, performance and position of an entity during the financial year covered by the financial statements, and those which are likely to affect the entity's future development, performance and position.'

32 NHS bodies are required to comply with this guidance in producing the management commentary which is included in the mandatory annual report which accompanies the financial statements. There is currently no requirement for local authorities to produce an annual report, although a number of bodies do prepare a report on a voluntary basis. The annual reports that are produced differ in terms of content and quality.

33 We believe that annual reports are an essential element in the process of accountability to stakeholders for the stewardship and use of public money. As far as we are aware, local government bodies are the only significant economic entities that are not required to produce an annual report. Given the special accountabilities that attach to the stewardship and use of public money raised by compulsory levy, we think this is a strange omission in the accountability framework for local government.

34 CIPFA has recently issued a discussion paper to promote debate on how narrative reporting may best be improved.[I] We intend to work with CIPFA and others to help develop requirements for local authorities to produce annual reports which comply with best practice guidance for production of an OFR as issued by the ASB.

I *Public Benefit OFRs*, CIPFA and RSM Robson Rhodes, 2006.

4

Audit opinions and public reporting

Audit opinions

35 Where auditors decide that a body's annual accounts do not provide a true and fair view of, or in the case of local government do not present fairly, its financial performance they give a qualified opinion on those accounts. In health, auditors did not qualify their opinions at any SHAs, PCTs or NHS trusts in 2004/05, as was the case in 2003/04. In local government, auditors qualified their opinions at 8 authorities (11 in 2003/04), representing 2 per cent of all local government bodies.

36 In health, auditors of SHAs and PCTs also give a 'regularity opinion', which confirms that money has been spent in accordance with the intentions of Parliament. In 2004/05, auditors qualified their regularity opinions at 1 SHA and 92 PCTs (30 per cent) compared with 53 PCTs (17 per cent) in 2003/04. These qualifications arose because of 91 breaches of resource limits and 6 instances of other irregular expenditure (5 of these accounts were qualified both for resource limit breaches and for incurring other irregular expenditure), including 5 which occurred because of problems with the governance arrangements of a partnership entered into under the Health Act 1999 between NHS bodies and local authorities.

Public reporting

37 Where auditors take the view that issues need to be made public and dealt with immediately rather than waiting for the conclusion of the audit they may issue a public interest report under section 8 of the Audit Commission Act 1998. Auditors issued public interest reports in respect of 25 health bodies (4 in the previous year), all in respect of financial standing, and 3 local authorities (5 in the previous year) **(Table 2)**.

Table 2
Public interest reports (previous year's figures in brackets)

NHS bodies	**Local government**
Number	
25 (4) all in respect of financial standing	3 (5)
Issues	
Hampshire and Isle of Wight SHA	Development contract arrangements (Wirral Metropolitan Borough Council)
Thames Valley SHA	
Surrey and Sussex SHA	
Royal West Sussex NHS Trust	Governance arrangements [2] (Corby Borough Council and Manchester City Council)
South Tees Hospitals NHS Trust	
Weston Area Health NHS Trust	
Shrewsbury and Telford Hospitals NHS Trust	
Southampton University Hospitals NHS Trust	
Royal Wolverhampton Hospital NHS Trust	
Scarborough and North East Yorkshire NHS Trust	
Trafford Healthcare NHS Trust	
Queen Elizabeth Hospital NHS Trust	
Maidstone and Tunbridge Wells NHS Trust	
North Tees and Hartlepool NHS Trust	
North Somerset PCT	
Kennet and North Wiltshire PCT	
New Forest PCT	
West Wiltshire PCT	
Hounslow PCT	
Selby and York PCT	
Hillingdon PCT	
Cambridge City and South Cambridgeshire PCTs	
Cheshire West PCT	
East Suffolk PCTs (covers Central Suffolk PCT, Ipswich PCT and Suffolk Coastal PCT)	
Suffolk West PCT	

38 Auditors of local authorities can also make recommendations under section 11 of the Act, which require a public response from the audited body. In 2005, auditors made recommendations requiring a public response to two councils (7 in 2004) **(Table 3)**.

Table 3

Recommendations requiring a public response

Issue	Authority
Severance payments	Portsmouth City Council
Project management	North East Lincolnshire Borough Council

Source: Audit Commission

39 In health, section 19 of the Act requires the auditor to refer matters to the Secretary of State if the auditor has reason to believe that an organisation has made a decision that involves, or may involve, unlawful expenditure. In 2005, auditors made the following referrals to the Secretary of State **(Box A)**.

Box A

Referrals to the Secretary of State for Health

Qualifications of the regularity opinion (as considered above) on the basis of resource limit breaches constitute Section 19 referrals to the Secretary of State. There were 92 referrals corresponding to the qualified regularity opinions in respect of 92 revenue and capital resource limit breaches in 2004/05.

Four referrals have been made in respect of likely resource limit breaches by PCTs. These PCTs have also been issued with public interest reports.

Four referrals were issued in respect of actual or likely future breaches of the statutory duty to break even at three separate NHS trusts. Two of these trusts were also issued with public interest reports.

One referral was issued in respect of potentially unlawful expenditure at a SHA.

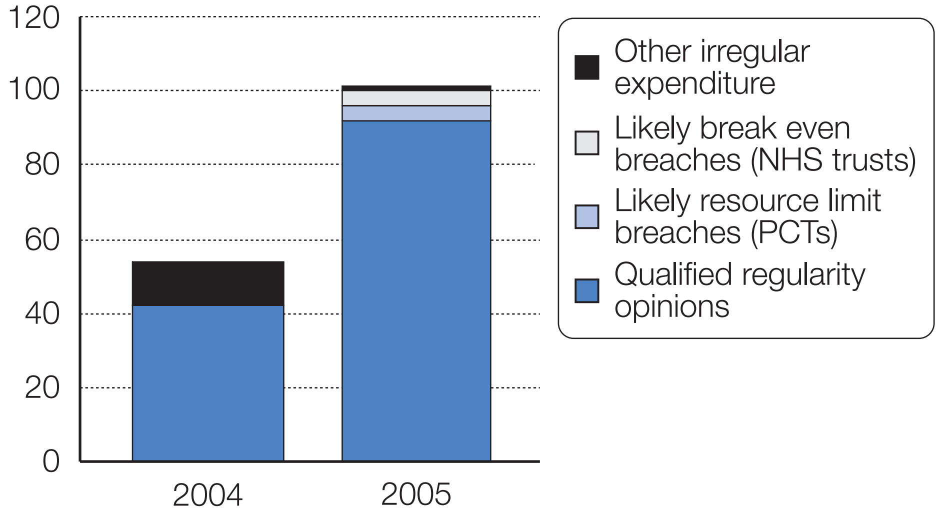
Source: Audit Commission

40 The total of 101 referrals to the Secretary of State in 2005 compares with 54 in 2005 **(Figure 5)**.

Figure 5

Number of referrals to the Secretary of State for Health

The number of referrals to the Secretary of State increased from 54 in 2004 to 101 in 2005.



Source: Audit Commission

5

Corporate governance arrangements

41 Robust governance arrangements, including effective systems of internal control and risk management, underpin an organisation's ability to deliver its strategic objectives.

Audit committees

42 An effective audit committee is a key element of good corporate governance, playing an essential role in raising the profile of financial reporting, and internal control and risk management issues in the organisation, as well as providing a forum for the consideration of the work of internal and external audit. The core functions of an effective audit committee encompass:

- considering the effectiveness of risk management arrangements, the control environment and associated anti-fraud and anti-corruption arrangements;
- seeking assurances that action is being taken on risk-related issues identified by auditors and inspectors;
- being satisfied that the assurance statements, including the statement on internal control (SIC), properly reflect the risk environment and any actions required to improve it;
- approving, but not directing, internal audit's strategy and plan and monitoring performance;
- reviewing reports from internal and external audit and other external inspection agencies and seeking assurance that action has been taken where necessary;
- receiving an annual report from the head of internal audit;
- ensuring that there are effective relationships between external and internal audit, inspection agencies and other relevant bodies, and that the value of the audit process is actively promoted; and
- reviewing the financial statements and the external auditor's opinion and reports to members, and monitoring management action in response to the issues raised.

43 All NHS bodies have been required to have an audit committee for a number of years. However, in their public interest reports, auditors have highlighted failures in corporate governance that point to a lack of effectiveness by audit committees and the need to enhance the financial literacy of non-executive directors. The Commission welcomes the

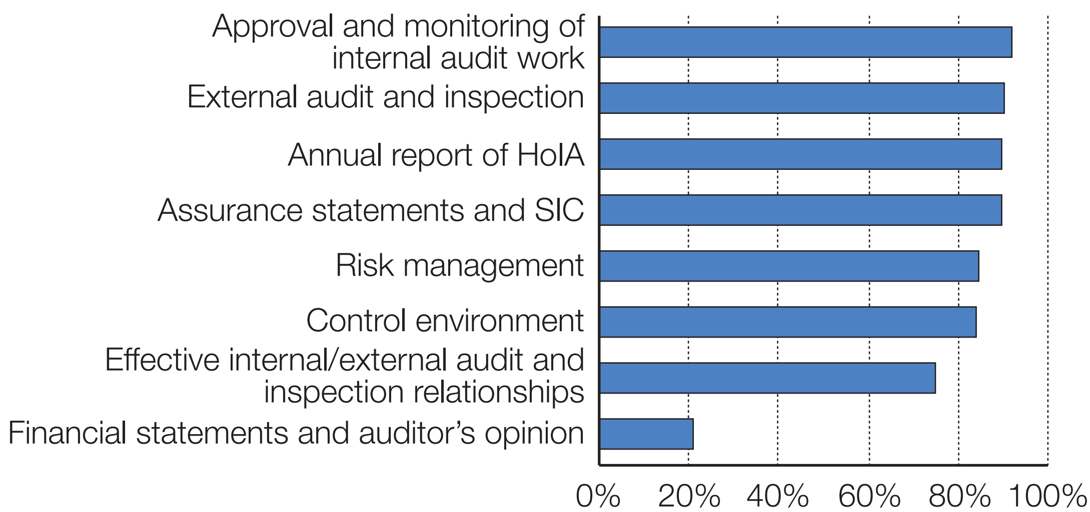
publication of the revised NHS Audit Committee Handbook (October 2005), which will help NHS bodies to review and, where appropriate, improve the effectiveness of their audit committees.

44 In local government, the Commission welcomes the progress that has been made. A growing number of authorities have now established audit committees and the majority of the remainder have at least made arrangements for undertaking the core functions of an audit committee. However, in many cases these functions are being undertaken either by a committee or panel which also has other functions or by more than one committee. In the Commission's view, such arrangements are not as effective as having a dedicated audit committee, which can bring a clearer focus on the broad range of inter-related governance issues. Given the issues we have raised earlier in this report regarding financial reporting, of particular concern is that only 99 local authorities (21 per cent) have identified a specific committee with responsibility for reviewing the financial statements and the external auditor's opinion and reports to members, and monitoring management action in response to the issues raised. Auditors also report that 116 local authorities (25 per cent) do not effectively manage the relationship between internal and external audit **(Figure 6)**.

Figure 6

Authorities carrying out the functions of an audit committee

The majority of local government bodies undertake the core functions of an audit committee.



Source: Audit Commission

45 The Commission supports CIPFA's approach to audit committees, as set out in its December 2005 publication *Audit Committees: Guidance for Local Authorities*, and has reflected this in the criteria for use of resources assessments. In the coming year, auditors will use their use of resources work at local authorities to help them develop more effective audit committees.

Statements on internal control

46 The SIC is the key governance statement demonstrating how a public body is seeking to comply with the highest standards of good governance. It provides an opportunity for an organisation not only to provide an explicit statement that it had internal control and risk management arrangements in place throughout the reporting period, but also to identify the actions it is taking to address any weaknesses it has identified or to ensure that its arrangements remain fit for purpose. As such, the production of the SIC should not be seen as a year end exercise, but as an end of term report that is derived from the organisation's assurance framework that operates throughout the year.

47 Equally, in the Commission's view, the SIC is a positive and open statement on how an organisation is managing its governance arrangements. Disclosures of non-compliance should not be seen as negative issues but as an opportunity for the organisation to demonstrate its commitment to good governance by clearly stating the action it intends to take to address any instances of non-compliance.

48 NHS bodies have been required to provide a SIC as part of the annual accounts since 2001/02. In 2005, 549 bodies (93 per cent) complied with the requirement to have the necessary risk management and control processes, including assurance frameworks, in place throughout the entire financial year. Significant internal control issues were identified at 153 NHS bodies (26 per cent), focusing on financial balance and the need to further develop assurance frameworks.

49 By contrast, 2003/04 was the first year in which local authorities were required to prepare a SIC. In that year, nearly all authorities prepared a SIC that complied with proper practices established by CIPFA. Although in the first year authorities had the option of producing an interim statement under transitional arrangements, 232 authorities (59 per cent) were able to produce a full SIC.

50 For 2004/05, the large majority of local authorities made good progress towards CIPFA's full SIC disclosure requirements. However, only 66 authorities (14 per cent) disclosed that

this was their first year of full compliance and, where appropriate, that full compliance with proper practice was not in place for the whole year, indicating that a number of authorities had not recognised the need for the SIC to reflect the entire financial year. Auditors will continue to monitor disclosures made by local authorities in their SICs to ensure that areas of non-compliance are appropriately identified.

51 Three hundred and fifteen local authorities (67 per cent) disclosed significant internal control issues in their SICs, with many focusing on their risk management and corporate governance arrangements. However, auditors at a number of the remaining 153 authorities (33 per cent) expressed concern that no such disclosures had been made, despite the auditor being aware of significant governance issues, including risk management and financial performance.

52 The production of the SIC should be underpinned by a robust assurance framework that provides a flow of information up to members to enable them to conclude on the effectiveness of the internal control environment and to identify disclosable non-compliance issues. Management provides the main source of that assurance, although information should be drawn from all available sources. A key element of assurance is the head of internal audit's annual report, which should incorporate an opinion on the overall adequacy and effectiveness of the internal control environment and identify any issues of significance for the SIC.

53 For 2004/05, auditors report that the majority of local authorities received an annual report from the head of internal audit. At 43 authorities (9 per cent) however, the head of internal audit did not issue an opinion on the overall adequacy and effectiveness of the internal control environment, although in some instances this reflected local arrangements whereby internal audit provided input to the SIC process by other means. However, there remains a number of cases where the SIC is not appropriately supported by a head of internal audit opinion and, as a consequence, issues relating to the effectiveness of the internal control environment may not have been appropriately disclosed.

54 Auditors will continue to review the SIC through their use of resources assessments and as part of their work on the accounts and will comment on the adequacy of the arrangements authorities have in place to provide an assurance framework. Additionally, the Commission is participating in the revision of CIPFA/SOLACE's publication: *Corporate Governance in Local Government: A Keystone for Community Governance*, with a view to providing more guidance to authorities on the development of a sound assurance framework to support the publication of the annual SIC and how it can be integrated in the wider governance statement required by that framework.

Risk management

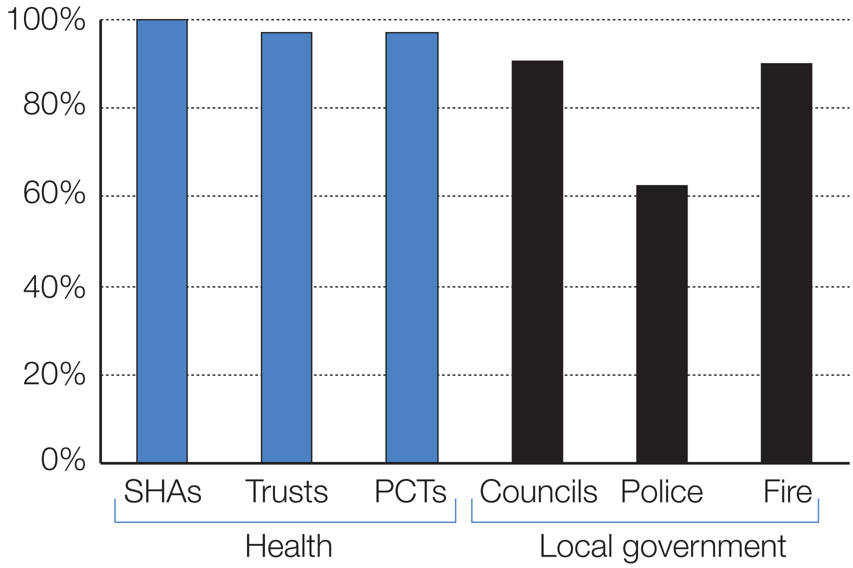
55 The identification and management of risks is a key factor in an organisation's ability to achieve its strategic objectives. Public sector bodies face a wide range of risks, arising from both national and local issues. Organisations need to identify those risks that are most significant to their overall performance and manage those risks effectively.

56 In the NHS, auditors report that 578 bodies (98 per cent) have procedures in place to identify and document the principal risks threatening the achievement of their key objectives compared with 558 (93 per cent) in 2003/04. By comparison, 414 local government bodies (88 per cent) have identified their key risks compared with 71 per cent in 2003/04. An analysis by type of body indicates that, while 394 councils and fire authorities (90 per cent) have identified their key risks, only 20 police authorities (63 per cent) have done so **(Figure 7)**.

Figure 7

Bodies that have procedures in place to identify and document the principal risks threatening the achievement of their key objectives

Police authorities have been less effective at identifying their key business risks compared to other bodies.



Source: Audit Commission

57 Through their use of resources assessments, auditors will continue to help bodies to identify weaknesses in their risk management arrangements and to develop arrangements to address those weaknesses.

Internal audit

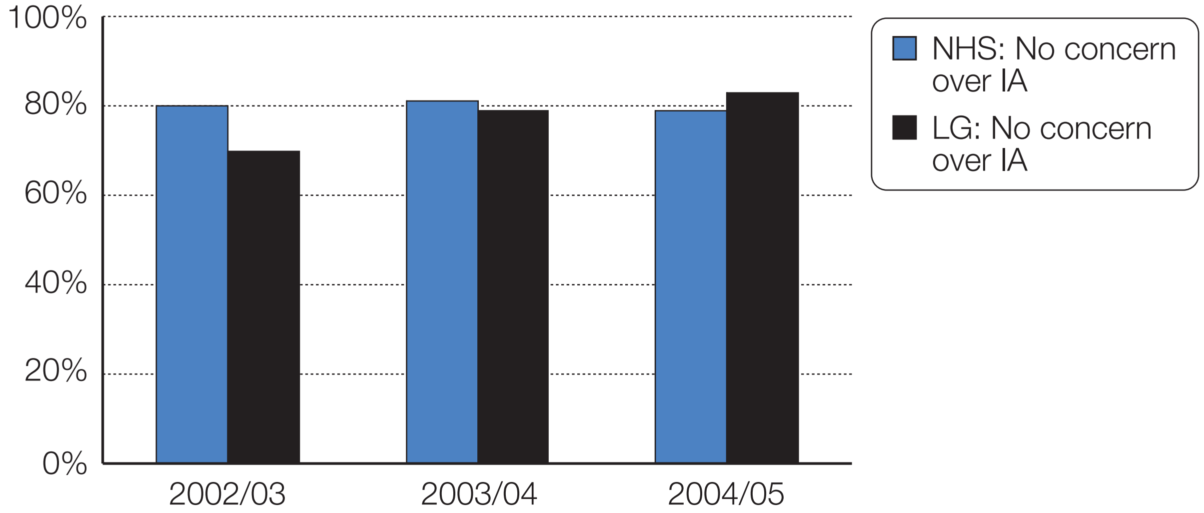
58 An effective internal audit function is an essential element of good governance. The role of internal audit has become broader with the development of the SIC and internal auditors now comment on the effectiveness of risk management and internal control systems across the entire organisation.

59 In 2004/05, auditors reported that they had no concerns about the scope, coverage or quality of internal audit at 464 NHS bodies (79 per cent) and 421 local government bodies (83 per cent). This represents a position of little change in health since 2002/03, but an improvement in local government over the same period **(Figure 8)**.

Figure 8

The level of reported concerns regarding the scope, coverage and quality of internal audit work

The level of reported concerns in local government has fallen in the last three years.



Source: Audit Commission

60 Where auditors have expressed concern, those concerns have, in both health and local government, been focused on the timeliness, coverage, quality and adequacy of internal audit work. In many instances, these concerns reflect the reliance that external auditors seek to place on the work of internal audit when undertaking their audit of the accounts. Delays in the completion of that work, or limited or poor quality coverage, may require external auditors to undertake additional work, which may not represent the best use of resources.

61 Audited bodies have a responsibility, usually performed by an audit committee, to ensure that they have in place an internal audit function that meets the requirements of the relevant internal audit standards, that there are effective relationships between external and internal audit, and that the value of the audit process is actively promoted. In meeting this responsibility, audited bodies should:

- ensure that internal audit has appropriate resources to enable it to develop a plan that meets internal auditing standards, including the production of a head of internal audit opinion on the adequacy and effectiveness of the internal control environment;
- monitor internal audit performance against the agreed plan to ensure that work is completed to an agreed and appropriate standard to an agreed timetable;
- ensure that internal and external audit plans are coordinated to maximise the benefit from the resources available; and
- consider how, where external auditors express concern that they are unable to rely on internal audit's work for the purposes of their audit of the final accounts, the additional assurances required can best be obtained. This may be by requiring either internal or external audit to undertake additional work. There may be cases, however, where, with the agreement of the auditor, the necessary assurance may be obtained by work elsewhere in the audited body. For example, where key financial systems have not been documented, management may be better placed to undertake this task, with some audit input, rather than expecting this work to be undertaken in full by internal or external audit.

62 Auditors will continue to work with audited bodies to identify how overall audit resources can best be utilised for the benefit of the organisation and will use their use of resources assessments to help bodies improve their internal control arrangements.

Partnerships

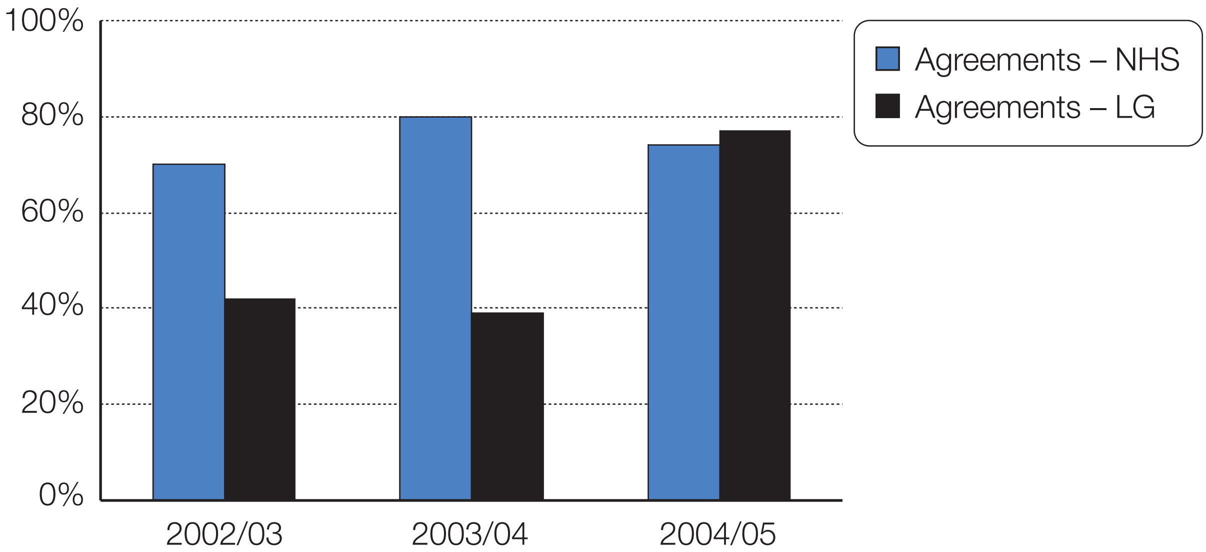
63 Health and local government bodies continue to increase their use of partnership working with a range of partners, to deliver modern, integrated services. In many instances, health and local government bodies are working together through such arrangements. Comprehensive partnership agreements form the basis for better governance and management of risks in partnerships. In health, auditors reported that 26 per cent of PCTs involved in partnership arrangements did not have a comprehensive, signed partnership agreement in place throughout the financial year, representing a slight deterioration from the 20 per cent reported in 2003/04.

64 For 2004/05, the picture in local government is similar, with auditors reporting that 117 local authorities (23 per cent) had no agreements in place for any of their partnerships, with only 154 (30 per cent) having agreements in place for most or all of their partnerships. However, this still represents a significant improvement compared with 194 (61 per cent) in 2003/04 and 197 (58 per cent) in 2002/03 **(Figure 9)**.

Figure 9

Partnership agreements

There has been a significant improvement in the number of local authorities which have agreements in place for any of their partnerships.



Source: Audit Commission

65 Where auditors have reported problems with the governance arrangements of partnerships, these most commonly include:

- deficiencies in budgetary controls, resulting in overspends;
- inadequate performance monitoring arrangements; and
- lack of financial monitoring and reporting by the host organisation.

66 The Audit Commission published *Governing Partnerships: Bridging the Accountability Gap* in November 2005 which addresses issues relating to governance of partnerships and considers how this can be improved. Auditors will continue to monitor the performance of partnerships having regard to this best practice guidance and will consider audited bodies' arrangements in this area through their use of resources assessments.

6

Certification of claims and returns

67 Each year, auditors certify a wide range of claims and returns to provide assurance to government departments and other agencies that the grants and subsidies they have made available to audited and inspected bodies have been claimed in accordance with the terms and conditions attached to schemes. Auditors certify claims and returns in accordance with arrangements made by the Commission under section 28 of the Audit Commission Act 1998. Auditors have reported certifying 6,507 claims and returns for 2004/05 with a total value of £42.6 billion.

68 From 2004, the Commission implemented new arrangements for certifying claims and returns as part of our commitment to strategic regulation. 2004/05 was the second year of the new risk-based, more proportionate approach. Under this new approach, claims and returns below £50,000 are not subject to auditor certification, claims and returns up to £100,000 are subject to limited procedures, and claims and returns over £100,000 may be subject to limited procedures if the auditor decides, for a particular claim or return, that reliance can be placed on the control environment for its preparation. Additionally, the Commission will also refuse to make certification arrangements where, in our view, grant paying departments are able to obtain the assurance they require by other means.

69 Prior to the introduction of the new arrangements on 1 April 2004, the number of government grant schemes requiring auditor certification had been steadily increasing – from 133 in 2001/02, to 166 in 2002/03 and 191 in 2003/04. Since then it has steadily reduced – to 154 in 2004/05, 82 in 2005/06 and 67 in 2006/07. Some of this reduction relates to the transfer of our functions in Wales to the new Wales Audit Office, as 50 of the claims included in the figures for years prior to 2005/06 relate to grants to Welsh authorities.

70 The Commission's new approach has resulted in a 52 per cent reduction in the number of schemes requiring auditor certification, excluding those relating to Wales, and an associated 20 per cent reduction in the Commission's income from this activity. In 2003/04 audited bodies were paying the Commission £33.4 million in fees for certifying grant claims, of which £2.5 million related to Wales; this year the figure in England has reduced to £25.5 million, delivering a key element of our commitment to strategic regulation.

71 Where auditors are not satisfied that claims or returns are fairly stated and/or that grant conditions have been met, they may agree adjustments with the authority. Where this is not possible, they issue a qualification letter to the grant-paying body, setting out the basis of any disagreement or uncertainty. For claims and returns for 2004/05, auditors issued 1,852 qualification letters and agreed increases to claims and returns totalling £34.9 million and decreases totalling £73.4 million. The Commission is concerned that almost 30 per cent of all claims are qualified by auditors and by the level of adjustments. Given that each claim must be certified by the chief financial officer before being submitted to the auditor, this level of error reflects an inadequate level of management review. There is an urgent need for chief financial officers to improve the level and rigour of their review of claim forms before they sign them and submit them for audit.

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