



DAO (GEN) 13/99

19 July 1999

Dear Accounting Officer

APPOINTMENT OF ACCOUNTANCY FIRMS TO AUDIT AND OTHER ASSIGNMENTS IN THE PUBLIC SECTOR, AND NATURE OF THE AUDITING RESPONSIBILITIES

Purpose of this DAO letter

1. This DAO letter and attachments update the guidance given in DAO(GEN) 2/95, issued in May 1995, which is hereby superseded. Although the main principles described in DAO(GEN) 2/95 remain valid, the updated guidance provides more information concerning the roles and responsibilities of the external auditors of non-departmental public bodies (NDPBs) and has a wider coverage than its predecessor.
2. The paper clarifies a number of issues concerning the extent to which external auditors should be permitted to undertake non-external audit work (such as consultancy or internal audit work), and considers the circumstances in which departments might agree to a firm capping the extent of its liability.

Information

3. The guidance addresses three issues:
 - C the procedures for appointing accountancy firms to audit and other assignments;
 - C various aspects relating to the nature of the assignment; and
 - C the responsibilities of the external auditors of executive NDPBs.
4. This guidance applies in cases where a department or its Minister is responsible for appointing private sector firms to external audit assignments. It applies mainly in respect of NDPBs not audited by the C&AG, public corporations and nationalised industries. It does not apply in cases where the Comptroller and Auditor General is the statutorily appointed auditor, eg in the case of executive agencies, trading funds and some NDPBs.
5. Although the guidance is aimed primarily at external audit appointments, its recommendations may be helpful when considering applications for other assignments such as those for internal audit, corporate finance or taxation advice.

6. Departments which sponsor bodies which are largely dependent upon public funding but which are responsible for appointing their own auditors may wish to encourage the bodies to follow the recommendations in the paper.

7. The guidance on the *responsibilities of the external auditor* of an NDPB will apply to all NDPBs whether the auditor is the Comptroller and Auditor General or has been appointed by the Secretary of State. Although not directly aimed at public corporations and nationalised industries, the guidance will also be of interest to those bodies.

Key points

8. Appointments to audit and other accountancy assignments are in principle no different from any other *public sector procurement* for the supply of a service, and departments should seek the advice of their procurement units when considering the procedures to be adopted.

9. Departments should bear in mind that audit and other accountancy assignments may fall within the scope of the *EC Services Directive* which has been implemented in the Public Services Contract Regulations 1993 (SI 1993/3228). The memorandum does not provide a comprehensive interpretation of the Regulations, and departments should consult their procurement units.

10. Audit appointments should be *formally re-tendered* at least every five years. Where there are statutory provisions for the auditor to be re-appointed annually, the contract should be placed for a period of five years, but include provisions for annual re-appointment.

11. A partner should not remain in charge of an audit for a period exceeding seven consecutive years; the attached annex includes further provisions regarding the *rotation of the audit partner* in the event of the incumbent firm retaining the contract following a re-tendering exercise.

12. Guidance to departments on the circumstances in which they might negotiate with private sector firms over any conditions in the firms' contracts which sought to *restrict their liabilities* was given in a letter to PFOs dated 6 May 1997 *Restriction of Liability in Contracts for Public Sector Auditing and other Financial Assignments*. The conclusions reached in that letter were that departments might accept restrictions on a firm's liability if the overall result was that the contract represented value for money for the department. This was to be demonstrated by evidence of any benefits which the department gained by accepting a limit on the firm's liability.

13. Since that letter was issued, the policy has been refined to the extent that the argument for accepting a limitation on a firm's liability rests on a balance of the risk and cost. The annex to the letter to PFOs sets out in more detail the conclusions reached. It is reproduced as Appendix C below. It should be read in the context of the further guidance set out in paragraph 32 to 35 of the annex below.

14. Firms successful in winning assignments for external audits should not normally be invited to tender for any *non-external audit work*, such as consultancy or internal audit assignments. There is a presumption against firms acting as both internal and external auditors - paragraphs 24 to 26 of the annex to this letter provide further consideration of this issue. Departments may wish to impose restrictions on the value of any non-external audit work which is undertaken by the external auditors (ie where the non-external audit work is not put out to tender).

15. Details of the *responsibilities of the external auditor* in the audit of an NDPB have been revised and are now given in Appendix B to the annex to this letter.

Public Audit Forum

16. The Public Audit Forum is a group set up by the four national audit agencies (the National Audit Office, the Northern Ireland Audit Office, the Audit Commission and the Accounts Commission for Scotland) to provide a focus for developmental thinking in relation to public audit. It has published three papers *The Principles of Public Audit*; *The Implications for Audit of the Modernising Government Agenda* and *What Public Sector Bodies Can Expect from their Auditors*, copies of which can be obtained from the Forum's website (www.public-audit-forum.gov.uk).

Further action

17. Departments should send copies of this letter to their sponsored bodies.

Enquiries

18. Enquiries about the accounting aspects of audit and related assignments should be addressed initially to the departmental accountancy adviser or internal audit team, and questions affecting procurement aspects to the departmental procurement unit. Enquiries to the Treasury should be addressed as follows:

- C in respect of accounting issues - to Nick Bailey in the Central Accountancy Team (0207 270 4535);
- C in respect of procurement issues and those affecting the EC Services Directive and the Regulations - to Graeme Beswick in the Procurement Policy Team (0207 270 1560); and
- C in respect of internal audit issues - Chris Butler in the Audit Policy Advice Team (0207 270 1681).

JAMIE MORTIMER
Treasury Officer of Accounts

APPOINTMENT OF ACCOUNTANCY FIRMS TO AUDIT AND OTHER ASSIGNMENTS IN THE PUBLIC SECTOR

1. This annex updates the guidance attached to DAO(GEN) 2/95 issued on 2 May 1995. It addresses three issues:

- C the appointment of accountancy firms to audit and other assignments in the public sector;
- C various aspects of the nature of assignment;
- C the responsibilities of the external auditors of executive Non-Departmental Public Bodies (NDPBs).

A. Appointment of accountancy firms to audit and other assignments

2. Responsibility for appointing external auditors to about half of the number of executive NDPBs, and to most public corporations and nationalised industries is vested by statute in the Secretary of State (or other Minister) of the sponsoring department. The guidance given in this annex is aimed primarily at such appointments, but may prove useful when considering private sector firms for other assignments such as those for **internal audit** and those concerned with **corporate finance** and **taxation advice** (referred to in this paper as “non-external audit” assignments or work). Non-external audit assignments are unlikely to be governed by legislation, and the terms of reference are at the discretion of the department and the body concerned.

3. The recommendations of this annex relating to the appointment of auditors do not apply to:

- C the arrangements for the appointment of auditors to Local Authorities and the National Health Service as these are administered by the Audit Commission and the Accounts Commission for Scotland;
- C those cases where the Comptroller and Auditor General (C&AG) is the statutorily appointed auditor, eg Departmental Resource Accounts, Appropriation Accounts, Supply-financed Executive Agencies, Trading Funds and a number of Non-Departmental Public Bodies.

4. In accordance with the Government’s procurement policy, the procurement of external audit services should be based on value for money. Value for money is the optimum combination of whole life costs and quality to meet the user’s requirement. To that end, services should be acquired by competition unless there are convincing arguments to the contrary. The procedures to be followed should be those adopted in respect of any public sector procurement and departments planning to award audit or accountancy appointments should seek the advice of their procurement units. The paper considers some aspects of the procedures which are peculiar to audit and accountancy appointments.

EC Procurement Rules

5. The EC Services Directive, which has been implemented in the Public Services Contract Regulations 1993 (SI 1993/3228), reinforces Treaty provisions on the free movement of goods and services within the EC. In seeking to ensure non-discrimination and fair competition, it imposes procedural rules which public authorities must follow if they wish to award a contract above specified threshold values (¹). Contracts with a value equal to or in excess of these thresholds must normally be advertised in the Official Journal of the European Communities. Proper planning is essential in such cases; for example to ensure that the minimum periods laid down in the Regulations for expressions of interest and the return of tenders are complied with.

6. This annex does not provide a comprehensive interpretation of the Regulations. Departments which are likely to award contracts to which the rules apply should consult their procurement units on the action needed to comply with the Regulations.

Privatisations

7. The arrangements for appointing advisers - including reporting accountants - to work on the **privatisation programme** are covered in separate guidance (NIP(94)) issued in February 1994, but departments may find this annex provides a useful supplement to this guidance.

Bodies responsible for appointing their external auditors

8. There may be cases where bodies which are substantially dependent on public funds are themselves responsible for appointing their external auditors, although the department may sometimes be given powers to approve the appointment. Departments may wish to treat this annex as indicative of best practice and to encourage bodies to follow its recommendations.

B. Aspects of auditing assignments

Selection of firms to be invited to tender

9. Departments applying the Restricted Procedure under the EC Procurement rules should specify in the advertisement the number of firms to be short-listed for invitation to submit tenders. The short-list should comprise prospective tenderers who have shown at the selection (pre-qualification) stage that they satisfy the Department's requirements as to their economic and financial standing, ability and technical capacity. Sufficient firms should be invited to ensure genuine competition, with a minimum of three. All firms which have expressed an interest should be told whether or not they are on the short-list.

¹The thresholds are reviewed from time to time. The values introduced on 1 January 1998 and expected to run to 31 December 1999 are:

- entities listed in Schedule 1 of SI 1995/201: £104,435 for most types of service including audit services (previously £108,667) ;
- other public sector contracting authorities: £160,670 (previously £158,018).

Qualifications : audit appointments

10. The statutory framework establishing a public sector body may include one of the following possibilities:

- C that the C&AG should be appointed as the auditor;
- C that the Secretary of State can appoint the auditor, and specifies the qualifications required;
- C that the Secretary of State can appoint the auditor, but does not specify the qualifications required.

11. In the first case, bodies are not at liberty to put the audit appointment out to tender (see also paragraph 3);

12. In the second case, the qualifications required are normally those required of the auditor of a limited company. The Companies Act provides that auditors are to be members of a recognised supervisory body and eligible for appointment under the rules of that body. The Act also requires supervisory bodies to keep a register of individuals and firms who are eligible for appointment as company auditors and only such “registered auditors” may be appointed.

As the C&AG does not meet these requirements, he is ineligible for consideration for audit appointments where the qualification for appointment is specified in this way. He is, however, eligible for appointment if membership of the Chartered Institute of Public Finance and Accountancy (CIPFA) is one of the qualifications required. As noted in paragraph 37, the C&AG should be given inspection rights where he is not appointed as external auditor.

13. Where the legislation does not specify the required qualifications, departments are free to invite the C&AG and/or private sector firms to tender for the appointment. It should be noted that, during the Lords’ debate on the Access to Justice Bill (Hansard col 661-662 16 March 1999), the Lord Chancellor stated that “we believe that the auditor of public bodies should be the C&AG rather than an auditor appointed by the relevant Minister unless there is some special reason why the auditor of a particular public body should have knowledge or experience which can only be found in the private sector.”.

Qualifications : non-external audit appointments

14. For non-external audit assignments, there are no formal requirements relating to membership of a particular professional accountancy body, although departments should ensure that the qualifications of the firm or person tendering for the assignment are appropriate to the task to be performed. Bodies considering whether to invite the National Audit Office to tender for non-external audit assignments should bear in mind that NAO should not be considered for tasks which would require it to be involved in the actual design of accounting or financial management systems.

When to make an audit appointment

15. To allow the new auditors adequate time to plan and complete their work, their formal appointment should be announced as soon as possible after the latest annual audit has been completed.

Conflicts of interest

16. The department should establish whether a particular firm would have a conflict of interest if it were appointed. The ethical rules of the professional accountancy bodies prohibit a firm from accepting an audit assignment in certain circumstances. Comments on conflicts of interest were made in the *Checklist of Points in the PAC's 8th Report on the proper conduct of public business* (DAO(GEN) 3/94). The conclusions reached in that report were:

C there was occasionally a failure to secure arms' length relationships with private sector consultants, leading to conflicts of interest in decisions to spend public money;

C care should be taken to avoid actual, potential, perceived or perceivable conflicts of interest when employing consultants and staff.

17. Departments will need to discuss possible conflicts of interest with potential tenderers. If the firm can demonstrate that there will be an arm's length relationship between the various parties, and that there are adequate procedures to prevent unauthorised access to information, there may, in fact, be no conflict of interest. However, each case must be considered on its merits. As noted in paragraphs 24 to 26, there is a presumption that the same firm should not be appointed as both internal and external auditors.

18. The examples given in Appendix A to this annex give prima facie evidence of a conflict of interest. The list is illustrative only and is not intended to be comprehensive.

19. Departmental staff may face potential conflicts of interest, especially if they are involved in the procurement process; this issue is addressed in CUP Guidance No 16 *Purchasing Ethics*.

20. If departments have any doubt about conflicts of interests, they should consult, as appropriate, the Central Accountancy Team or the Central Unit on Purchasing in the Treasury.

Consultancy work

21. There has been considerable debate over whether a firm which has been successful in winning a contract to undertake an external audit assignment should be permitted to tender for consultancy or other non-external audit work from the same organisation. Examples might include consultancy work on accounting systems or acting as accounting advisers on PFI schemes. Arguments which support the separation of the audit and non-external audit work include the need to avoid conflicts of interest, and suspicion that firms may put in low bids for audit work in the hope of obtaining consultancy work. On the other hand, it can sometimes be more cost-effective if a firm which is conversant with an organisation's operations and systems also undertakes additional work of an investigative nature.

22. It would be unnecessarily restrictive to prevent, in all cases, firms from undertaking audit and non-external audit work, especially if the work were conducted by separately

managed divisions of the firm and was of relatively low value ⁽²⁾, but the presumption is that it would be exceptional for one firm to undertake both audit and non-external audit work for the same organisation. Non-external audit work should be subject to the same tendering procedures as for audit work, but the external auditor should not be invited to tender.

23. If, very exceptionally, the size of the consultancy or non-external audit work does not justify a tendering procedure and the body wishes to appoint the external auditors to undertake the non-external audit work, it should consult its sponsor department.

Relationship between internal and external audit

24. The Public Audit Forum's consultation paper *What Public Sector Bodies can expect from their Auditors* states that the same firm should not be appointed to undertake both the internal and the external audit function as this can lead to a loss of objectivity and independence. The Further Education Funding Council goes further in ruling that the same firm can never act as both internal and external auditors for FE colleges. There must therefore be a presumption against appointing the same firm to undertake both roles and departments should consult the Treasury if they feel that a case can be made; it is worth stressing that such cases will be exceptional. It is not possible to give definitive guidance on such circumstances but the following aspects should be taken into consideration - the size of the body (eg, is it too small to justify the separate staffing of the two functions); the number of financial and other staff; and the value of its internal and external audit assignments.

25. If appointing a single firm can be justified, the sponsor department should receive details of the planned internal audit work and a copy of the annual report on the work carried out. It should also undertake a periodic peer review of the work and the working papers of the internal audit activity. In examining the audit arrangements, the sponsoring department should be alert to any indication of a loss of objectivity. Although the C&AG may be the statutorily appointed external auditor of an NDPB he may sub-contract the day-to-day work to a private sector firm, and similar considerations may also apply if the body wishes to appoint that firm to undertake the internal audit function. The NAO's standard conditions forbid firms who act as sub-contractors from taking up internal audit appointments with the same body - were this to happen, the firm would immediately be removed from the external audit work.

26. Departments should also ensure that close working relationships are established between the internal and external auditors. The two types of auditor should consult each other and co-operate in order to seek opportunities to avoid duplication of work and achieve an efficient use of audit resources. Good practice advice on internal and external audit co-operation is available in the HM Treasury/National Audit Office exposure draft *Co-operation between Internal and External Auditors - A Good Practice Guide*.

Review of appointments and periodic re-tendering

²As a very general guide, external auditors may undertake non-external audit work if the value of the assignment is less than £10,000 or 10 per cent of the audit fee (if greater). Departments may wish to impose their own restrictions in any detailed audit specification which they prepare as part of the tendering procedure.

27. Assessment of performance should be a continuous process with any shortcomings being noted by the sponsor department and the body and taken up promptly with the appointed firm. In extreme cases, it may be appropriate to make a fresh appointment. Contracts should include a break clause to facilitate the arrangements for making a fresh appointment should this prove necessary.

28. Even if the performance of the incumbent firm is entirely satisfactory, it is strongly recommended that audit appointments are re-tendered at least every five years. Unless there are unsatisfactory aspects of the performance of the incumbent firm, there is no need to exclude that firm from those invited to tender.

29. Public bodies which have been set up as limited companies have to comply with the provisions of the Companies Act in respect of the appointment of auditors (ie that the auditor holds the office from the end of a general meeting at which the annual accounts are laid to the end of the next following general meeting at which the annual accounts are laid). There are also some NDPBs for which the founding legislation provides for the Secretary of State to appoint the auditors annually. However, these provisions do not require the audit appointment to be re-tendered each year. It is acceptable for the contract to be placed for a period of 5 years, but subject to annual reappointment. Departments are not precluded from adopting this approach even if there are no statutory provisions regarding annual appointments.

Rotation of audit partner

30. Ethical guidance issued by the accountancy profession recommends that a partner should not remain in charge of an audit of a listed company or other public interest entity for a period exceeding seven consecutive years. This recommendation should be followed in the case of public sector audit assignments. If the incumbent firm is successful in winning the contract following the re-tendering exercise referred to in paragraph 28, the partner who was previously in charge of the audit may remain until the expiry of the seventh consecutive year of his or her appointment, but a new partner should then take over.

Relationship of auditor and sponsor Department

31. The department, as the “owner” of the body being audited, has the right to receive documents (in particular management letters) submitted by the auditors to the body.

Capping of liability

32. Increasingly, private sector firms are including clauses in contracts which impose a limit on their financial obligations in the event of claims being made against them for negligence or other reasons. A letter to Principal Finance Officers dated 6 May 1997 *Restriction of Liability in Contracts for Public Sector Auditing and other Financial Assignments*, stated that departments and public bodies should not agree to any proposal by a firm to limit its liability in the event of a claim being made against them when the contract is one for **external “certification” audit work**. It went on to say that departments may negotiate with firms over the terms of any restriction of their liability in the case of other assignments, such as (but not confined to) those for **internal audit, consultancy and financial advice, and “due diligence” (including investigations)** if the terms of the contract represent the best value for money and protect the interests of the department and the taxpayer. It concluded by saying that it was unlikely that these interests would be satisfied if restrictions were accepted.

33. Experience gleaned from the practical application of this guidance suggests that more emphasis should be placed on the customer (ie a department or body) being satisfied that the contract represents an appropriate and acceptable balance of risk and cost. This approach has been applied, in particular, to assignments for internal audit. For example, if a private sector firm carries out individual internal audits under the direction of a department's Head of Internal Audit, the degree of risk to the department is low, and the firm has a limited prospect of being sued other than for a sum related to the job being done. It would therefore be reasonable for the department to accept a limit on the firm's liability with consequent advantages to the fee charged for that assignment.

34. In contrast, if the firm is responsible for the full internal audit service, including drawing up an internal audit plan, advising the department on audit need and producing an annual internal audit opinion, it has accepted a high level of risk with potentially high claims. To safeguard the interests of the department, the presumption should be that the firm must accept no capping of its liability, or at least must accept a high level of liability.

35. Although it may be argued that firms will apply more quality control and supervision if they perceive that their exposure to financial loss is high, they are likely to charge more for their services if they bear a higher level of risk. Departments and bodies should therefore weigh up the potentially higher cost of the service provided against the greater confidence that the job will be well done. By reducing their exposure to financial risk, private sector firms are limiting the scope of departments to seek compensation in the case of loss and a balance must be struck between the interests of the department and those of the firm and, while there is advantage to be gained by having the opportunity to seek redress if liability has not been capped, as a generality, the balance of consideration should tilt towards greater satisfaction that the work will be done properly so that the need for redress does not arise.

36. Appendix C to this annex reproduces the annex to the PFO letter referred to above but its conclusions should be read in the context of the approach which has been adopted since that letter was written.

Rights of access by the Comptroller and Auditor General to executive NDPBs

37. Guidance on the C&AG's rights of access to NDPBs is given in a letter to Principal Finance Officers issued in November 1992 (PFO 92/5). In addition, the Treasury's response to the first report by Lord Nolan *Spending Public Money - Governance and Audit Issues* (Cm 3179) noted that the Government will ensure that the C&AG has inspection rights over all executive NDPBs which he does not audit, including the few where they have not so far been agreed, and over companies which are wholly or mainly owned by executive NDPBs. (This latter reference has been taken to apply also to companies limited by guarantee and those to which the NDPB has given an indemnity.) Departments should ensure that these commitments are observed.

C. Guidance on the responsibilities of the external auditors of NDPBs

38. Guidance on the responsibilities of external auditors of NDPBs is given in Appendix B to this annex.

H M TREASURY
July 1999

EXAMPLES OF POSSIBLE CONFLICTS OF INTEREST

(See paragraph 18 of the annex)

1. A partner of a firm of accountants sits on the Management Board of a body which is seeking tenders for its external audit appointment. Board members should also be guided by the provisions on conflicts of interest in *Guidance on Codes of Practice for Board Members of Public Bodies* issued by the Cabinet Office in January 1997.
2. A firm which acts as the external auditor of a body expresses an interest in another assignment within the body (see also the comments on consultancy work at paragraphs 21 to 23 of the main text).
3. A firm which expresses an interest in tendering for the external audit appointment of a body already seconded some of its employees to that body (for example as investigative accountants).
4. A firm which expresses an interest in tendering for the external audit appointment of a body already undertakes accountancy work for the body, eg writing up the books and involvement in the day-to-day operations.

RESPONSIBILITIES OF THE EXTERNAL AUDITORS IN THE AUDIT OF AN EXECUTIVE NON-DEPARTMENTAL PUBLIC BODY (NDPB)

1. The auditors of an executive NDPB have two responsibilities. The **first** is to give an opinion on whether the financial statements give a true and fair view of the state of affairs of the NDPB at the end of its financial year, and of its surplus (or deficit); total recognised gains and losses; and cash flows during the year, and to report on whether the financial statements have been properly prepared in accordance with the directions made by the relevant Secretary of State or Minister.
2. The wording of the auditor's opinion should be based on that given in the Auditing Practices Board's (APB) Bulletin 1998/10 *Corporate Governance Reporting and Auditors' Responsibilities Statements* issued in December 1998 (although the reference to giving an opinion on the cash flows and on the total recognised gains and losses goes further than the requirements of the Bulletin).
3. Those NDPBs which are currently producing cash-based receipts and payments accounts will receive an audit opinion which confirms that the statements "properly present" the receipts and payments for the year and the balances at the year end. However, *Executive Non-Departmental Public Bodies - Annual Reports and Accounts Guidance* issued by the Treasury in March 1996, requires NDPBs which report on a cash basis to change the basis on which they prepare their accounts to an accruals basis for 1999-2000 onwards in line with the timetable for the preparation by central departments of accruals-based resource accounts.
4. The **second responsibility** is to give a separate explicit expression of opinion on the regularity of transactions. This will require the auditors to consider whether in all material respects, the body has:
 - C complied with any relevant statutory provisions governing the financial activities of the body; and
 - C complied with the requirements laid down in the Financial Memorandum or elsewhere (eg in *Government Accounting*, circulars, letters or other guidance);
5. The requirement for this separate opinion is given in the APB's Practice Note (PN) 10 *Audit of Central Government Financial Statements in the United Kingdom* - see the letter to accounting officers - DAO(GEN) 4/96 issued on 14 February 1996. PN 10 gives examples of recommended wording for the opinion on regularity.
6. Auditors should also have regard to the booklet *Regularity and Propriety* issued by the Treasury Officer of Accounts team in July 1997, and to the APB's Practice Note 17 *The Audit of Regularity in Central Government* issued in September 1998 - see DAO(GEN) 4/98 issued on 2 September 1998.
7. Auditors should conduct their audits in accordance with the requirement of Statements of Auditing Standards (SAS) issued by the APB. PN 10 considers how SAS should be applied to the audit of public sector entities.
8. Auditors should have regard to the requirements of the APB's Bulletin 1998/10 when preparing the statement of their responsibilities which should be included in the accounts.

9. SAS 600 requires the title of an auditor's report to identify the person or persons to whom it is addressed, ie on whose behalf the audit is being undertaken. In most cases in the public sector, the audit is being undertaken on behalf of Parliament, and the report should normally be addressed to one or both Houses of Parliament. However, there may be exceptions, eg where legislation requires the auditors to report to the relevant Secretary of State, or where the accounts are not laid before Parliament, and auditors will need to consider on whose behalf the audit is being undertaken.

10. As part of their audit, the auditors should:

C consider whether the body has operated an effective system of internal control in order to determine the extent to which they need to undertake transaction testing or other audit tests to ensure the reliability of information given in the accounts;

C judge whether the body has operated effective internal audit arrangements in accordance with the *Government Internal Audit Manual*;

C ensure that the body has progressed matters identified in previous audit reports.

11. Auditors need not report formally to the body and the sponsor department on these matters, unless a significant matter comes to light. Such matters include:

C losses due to failures of internal control, misconduct, fraud or other irregularity;

C occasions when the Board, Chief Executive or any other official has fallen short of the highest standards of financial integrity expected of those responsible for the management of public assets;

C occasions when the body has incurred expenditure of an extravagant or wasteful nature.

12. Where an NDPB makes grants to other organisations, Departments may ask for the auditors to make a separate report confirming that those grants have been used for the purposes intended.

13. The auditors' responsibilities in respect of the ***statement on the system of internal financial control*** (see also DAO(GEN) 13/97 and DAO(GEN) 4/99) are set out in the Auditing Practices Board's Bulletin 1995/1, which was updated by Bulletin 1996/3 (October 1996) and Bulletin 1998/10 (December 1998). The auditors should:

C determine whether the statement acknowledges that the accounting officer is responsible for the body's system of internal financial control;

C ascertain whether the statement explains that the system of internal financial control can only provide reasonable and not absolute assurance against material mis-statement of loss. (NB: the wording for the model statement given in DAO(GEN) 13/97 addresses these two issues specifically.)

C consider the description of the key procedures established to provide effective financial control and any related supporting documentation, and compare it to their knowledge of the body's system of internal financial control. Should the statement describe procedures of which the auditors are unaware, the auditors should undertake limited

enquiries to satisfy themselves that the statement is not misleading - but they do not have to review the operation of these procedures;

- C review the documentation supporting the assertion by the accounting officer that there has been a review of the effectiveness of the internal financial control system - but they do not have to assess the conclusions reached in that review;
- C consider whether any comments in the financial statements or auditor's report concerning losses or contingencies arising from weaknesses in the system of internal financial control are consistent with comments made in the accounting officer's statement. The auditors should only consider whether any such losses or contingencies should be so attributable based on information of which they are aware from their audit;
- C review any comments made by the accounting officer regarding any corrective action already taken in respect of losses or contingencies arising from weaknesses in the system of internal financial control system together with any supporting documentation. The auditors do not consider any comments made by the accounting officer regarding action that is intended to be taken, nor do they consider whether they concur with the reasoning behind any statement that no corrective action is considered necessary.

14. As noted in Bulletin 1995/1, the extent to which external auditors examine controls is related to the degree of substantive testing which they consider necessary to undertake. It may be that, as part of their audit of the financial statements, external auditors may not have had reason to examine all aspects of the system of internal financial control referred to in the accounting officer's statement. In such cases, the auditors might need to undertake limited reviews of these other aspects to ensure that the statement is not misleading.

15. The auditors should provide the sponsor department with copies of any management letters and other material correspondence addressed to the body.

16. The auditors should be prepared to meet the sponsor department and the body to discuss issues to which they have referred in any report or other communication made in accordance with paragraphs 9, 11 or 12 above.

17. Details of the normal audit reporting timetable will be agreed between the body, the auditors and, perhaps, the sponsor department. However, they should in any event make early contact with the sponsor department to discuss any matters of importance which arise out of their work (for example, if evidence of fraud, irregularity or impropriety is discovered; if accounting systems have broken down; or if the audit report may be qualified).

18. Where the auditors are appointed by the sponsor department, it is for the department, after consultation with the body, to set out the responsibilities of the auditors in the letter of appointment. It is open to the sponsor department to require the inclusion of tasks not covered above either as part of the normal audit duties or as the subject of a separate investigation. Any such additional tasks should have been agreed when the specification for the assignment was being drawn up.

19. Where the auditors are appointed by the body itself, the sponsor department should seek to ensure that the body similarly sets out the auditor's responsibilities in the appointment letter.

20. Bodies should be aware of 3 papers produced by the Public Audit Forum:

- S The Principles of Public Audit
- S The Implications for Audit of the Modernising Government Agenda
- S What Public Sector Bodies Can Expect from their Auditors.

Copies can be obtained from the Forum's website (www.public-audit-forum.gov.uk).

RESTRICTION OF LIABILITY IN CONTRACTS FOR PUBLIC SECTOR AUDITING AND OTHER FINANCIAL ASSIGNMENTS - BACKGROUND INFORMATION

[NB: this is the annex to the letter to PFOs 6 dated May 1997]

Introduction

1. By way of background, departments and bodies should be aware that the question of restricting liability was raised in Parliamentary questions in 1987 and 1988. The answers were, respectively, that “a contractor may be held responsible without limit for costs arising from any default which would otherwise fall on the public purse as a result of his action” and “under the standard conditions used in departmental contracts, a contractor may have unlimited liability for any costs arising from a default by him”. The use of “may” in these answers gives a degree of flexibility and, although the model form of contract set out in CUP Guidance No 23 advises departments that the conditions should reflect the practice of requiring contractors to accept unlimited liability, it accepts that there might be circumstances where it might be considered advisable to limit liability.

Conclusion

2. For most categories of work undertaken by accountancy firms, departments or bodies are not prevented from negotiating with the firms over any proposal by them to restrict or cap their liability so long as the eventual outcome represents the best value for money and takes into account the wider interests of the department and taxpayers. “Value for money” will in all probability mean a substantially lower price, but the firm may offer other benefits such as greater use of more experienced staff or indicate a willingness to complete the contract in less time. The department will need to assess the likely consequences of any loss suffered by a firm’s negligence; the effect of the terms of any restriction of liability (are there overall financial limits or are certain risks excluded altogether irrespective of the degree of financial loss); and the level of professional indemnity insurance held by the firm. If a department is satisfied that there are value for money benefits in agreeing to a firm restricting its liability, it may negotiate with the firm on the terms of such restrictions.

Specific points

3. It is likely that most work undertaken by accountancy firms for departments and other central government bodies will fall into one of four categories - external audit work, internal audit work, consultancy and “due diligence”. If a particular assignment falls outside these categories, or it is difficult to apply the general conclusions described above, departments should consult the Central Accountancy Team in the Treasury.

External audit

4. Section 310 of the Companies Act 1985 prohibits any capping of an auditor’s liability in respect of external audit opinions given under the Act. Most entities within central government are not companies formed and registered under the Companies Act (the exceptions include a small number of non-departmental public bodies and nationalised industries) and this particular provision of the Act will have only limited application. In theory, firms would be free to negotiate the terms of any assignment for the annual audit of most central government bodies but, in practice, the Treasury considers it appropriate to apply the spirit of the Companies Act. **Departments should not agree to any attempt by a firm to restrict its liability in the case of external audit work, ie the annual “certification” audit of the accounts.**

5. The representatives of the Public Sector Limitation of Liability Working Group indicated that it was unlikely that any of the major firms would, in practice, seek to restrict their liability in the case of external audit work for unincorporated bodies within central government.

Internal audit

6. In cases where the whole of the internal audit function is contracted out to an accountancy firm, the nominated head of internal audit will be responsible for providing an assurance to the accounting officer on the internal control system. Although departments or bodies are not prevented from negotiating with firms over the terms of any restriction on their liability in the case of internal audit assignments, it seems unlikely that the interests of the department or the taxpayers in general would be best served by agreeing to any restrictions in these circumstances. Firms will need to produce very convincing evidence that accepting restrictions on their liability represents good value for money in view of the significance to the department or body of the assurances given on the internal control system and the potential for loss should the firm prove negligent.

7. However, there will be assignments in which the accountancy firm has no direct responsibility for providing the assurance on the internal control system - examples might include support to a Head of Internal Audit or provision of advice to an in-house audit team. The risk of potential losses in these circumstances is likely to be lower and there is a stronger case for accepting a restriction on liability - subject to the overriding considerations of value for money and safeguarding the interests of the department and the taxpayer in general.

8. In the case of assignments for internal audit work, departments are not prevented from negotiating with firms on the terms of any clauses which restrict the firm's liability. However the wider considerations of value for money must be taken into consideration and, in cases where the firm is responsible for providing assurances on the internal control system, it seems unlikely that the wider interests of the department and the taxpayer will be satisfied if restrictions are accepted.

Consultancy

9. Similar considerations to those described above apply also to consultancy work - which include advice from firms on privatisations and contracts under the Private Finance Initiative, and financial advisory work in general. **Departments are not prevented from negotiating with a firm of accountants which wishes to include provisions which restrict its liabilities. Departments must be satisfied that there are value for money benefits and that the position of the department is safeguarded. In the case of some consultancy assignments, eg the design and implementation of computer systems, the risk of loss through negligence might be high and firms must put up a very strong case to justify the value for money aspects resulting from acceptance of a restriction of liability.**

“Due diligence”

10. As due diligence work is involved with the investigation of companies usually on behalf of the providers of equity or debt finance, it seems unlikely that departments or central government bodies would be seeking to appoint firms for such assignments. The firms are making a concerted effort to introduce a standard contract for due diligence work which includes clauses which restrict their liability. A department tendering for due diligence work is not prevented from negotiating with firms over proposals to restrict their liability, but must take into account the wider interests of the department and the taxpayer in general, and be satisfied that the terms represent the best value for money. **Although each case must be considered on its merits, it is thought unlikely that these wider interests would be served by agreeing to restrictions on liability.**