# Contents

1 Introduction 2

2 Financial Reporting 3
   2.1 The basis for financial statements 3
   2.2 The preparation of financial statements 5
   2.3 Audit opinions 6

3 Financial Standing 7
   3.1 Councils 8
   3.2 Police authorities 9
   3.3 NHS bodies 10

4 Financial Aspects of Corporate Governance 11
   4.1 New ethical framework 12
   4.2 Internal audit 12
   4.3 Anti-fraud and corruption 14
   4.4 Formal audit reports 15

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Introduction

1. Stewardship is concerned with safeguarding and ensuring proper accountability for public money, and financial governance with upholding proper standards of probity and propriety in the conduct of public business.

2. The Audit Commission collects and analyses information from appointed auditors of councils, police authorities and NHS bodies in England and Wales about these core aspects of its public audit regime, and in this part of the annual report brings together the main stewardship and financial governance messages for all those responsible for spending public money.

3. Based on its analysis of auditors’ work over the past year, there are three key messages to which the Commission wishes to draw attention:
   i. The importance of demonstrating public accountability by timely, accurate and appropriate financial reporting.
   ii. The overriding need for councils, police authorities and NHS bodies to achieve and maintain a sound financial position.
   iii. The need to develop appropriate financial governance arrangements to manage the risks facing public bodies.

4. These issues are discussed further below, and the Commission’s views are highlighted in bold type. Councils, police authorities and the NHS face an agenda of change that raises a number of important accountability and financial management issues. The Commission and its appointed auditors are ready to help councils, police authorities and the NHS to meet these challenges.
2.1 The basis of financial statements

5. The aim of financial reporting is to provide information about the financial position and performance of an organisation that is useful to a wide range of users, to enable them to assess how those responsible have discharged their stewardship of the resources entrusted to them. It is important when making comparisons between organisations that information is produced on a consistent and comparable basis. Over recent years the basis of accounting and financial reporting in the private sector (generally accepted accounting practice or GAAP) has increasingly come to be recognised as the most appropriate basis for accounting and financial reporting for the public sector.

6. This is a development that the Commission both welcomes and supports, and in our recently published technical strategy we have reaffirmed our unequivocal commitment to uphold and promote professional accounting standards. The Commission believes strongly that high-quality financial reporting, as a cornerstone of public accountability, requires that financial statements should be prepared in accordance with GAAP, on the basis of financial reporting standards developed in accordance with ‘due process’ under the auspices of the independent Accounting Standards Board (ASB).

7. NHS bodies are required to prepare financial statements on a ‘true and fair basis’ in accordance with GAAP as set out in the Companies Acts, financial reporting standards and statements of standard accounting practice issued and adopted by the ASB. The actual form of the financial statements is determined by the Secretary of State or the National Assembly for Wales (NAW) with the agreement of the Treasury.

8. Councils are required to prepare financial statements on a ‘presents fairly’ basis in accordance with the Code of Practice on Local Authority Accounting in Great Britain. The Code is revised and updated by a joint committee of the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Local Authority (Scotland) Accounts Advisory Committee (LASAAC). The Code is based upon the standards and guidance issued by the ASB, except where these conflict with statutory requirements, and is endorsed by the ASB as a statement of recommended practice (SORP).
9. In the Commission’s view, such external scrutiny and review by the ASB is an important safeguard for proper financial reporting by councils. The Commission wishes to see a robust and rigorous financial reporting regime based upon GAAP developed further for both councils and NHS bodies. The Commission is developing a ‘think piece’ on the future accounting and reporting framework for councils, highlighting the current obstacles to compliance with GAAP and setting out the options for reform. Against this background it welcomes the intended introduction of the ‘whole of government accounts’ (WGA), and is pleased to be a member of the Financial Reporting Advisory Board (FRAB) to the Treasury which is overseeing this initiative.

10. A prerequisite for WGA, which will in due course include the financial statements of councils and NHS bodies, is the development and application of common accounting policies and a financial reporting framework across these and other parts of the public sector. It is likely, therefore, that both councils, police authorities and NHS bodies will face changes in how they account for some significant areas of expenditure [TABLE 1]. For councils and police authorities, accounting for pensions is a problematic area, and for police authorities in particular, a key issue is how to show the liabilities to be met by an unfunded pension scheme.

11. However, at the moment neither councils nor the NHS always apply new financial reporting standards issued by the ASB from the effective date specified by the ASB. In the Commission’s view, these bodies should be treated no differently to other organisations and should comply with all relevant new accounting requirements from the effective date, other than in exceptional circumstances.

| TABLE 1 |
| Areas where present accounting practice differs from that in the private sector |
| Councils | Police authorities | NHS bodies |
| pensions | pensions | clinical negligence |
| infrastructure assets |  |  |
| depreciation |  |  |
| group accounts |  |  |
2.2 The preparation of financial statements

12. A key element in proper accountability for public money is the timely preparation, approval and publication of audited financial statements. NHS bodies met the requirement to produce annual reports containing audited financial statements by 30 September each year, and in the case of NHS trusts, to hold a public meeting to present the annual report.

13. For councils and police authorities there is a statutory requirement for the responsible financial officer (RFO) to seek members’ approval of the financial statements by the 30 September and to publish the statements by 31 December each year. The statements should be signed and certified by the RFO before being submitted to members. The Commission regards these processes of certification by the RFO and approval by members and publication as important aspects of the public accountability of councils to taxpayers and service users. It is pleasing to note that all but a small number of councils met these requirements [EXHIBIT 1]. The Commission will continue to support moves to require earlier publication of audited accounts by councils and police authorities, and believes that the introduction of the new annual reporting cycle for the publication of best value performance plans (BVPPs) and performance indicators provides a timely opportunity to review current arrangements.

14. It is a matter of concern that in 40 English councils (10 per cent), 4 Welsh councils (18 per cent) and 3 police authorities (7 per cent) amendments had to be made to the financial statements, as a result of the audit, which were significant enough for the statements to be resubmitted for member approval.

EXHIBIT 1

Percentage of councils approving their accounts by 30 September

Over 97 per cent of councils approved their accounts by 30 September 1999.

Source: Audit Commission
While the timetable for NHS bodies to prepare accounts is shorter than for councils, NHS bodies did produce timely and accurate financial statements. However, there were instances in both England – 16 trusts (4 per cent) and 14 health authorities (14 per cent) and Wales – 4 trusts (15 per cent) and 3 health authorities (60 per cent) where the statements were produced late.

2.3 Audit opinions

The auditor has to give an opinion as to whether or not the financial statements of an NHS body give a ‘true and fair view’, or those of a council or police authority ‘presents fairly’, the income, expenditure and financial position. Where an auditor concludes that this is not the case, to the extent that someone reading the financial statements is likely to be misled, the auditor will give a qualified opinion drawing attention to the deficiencies.

For the fourth successive year in the NHS Wales and the third successive year in England, there were no qualified audit opinions. This is a significant achievement and a matter of congratulation for all concerned.

At councils in England there were 12 qualified audit opinions given, of these 5 were London boroughs that also received qualified audit opinions last year. In Wales, there was one qualified audit opinion. There were no qualified audit opinions at police authorities. The reasons for qualifications at councils included:

- disagreement about the accounting treatment for accruing interest payable on external loans (three councils);
- inadequate provisions for bad and doubtful debts (three councils);
- inadequate provisions for insurance liabilities (three councils);
- insufficient documentation to support balances on the housing revenue account (HRA)(one council);
- non-compliance with capital accounting requirements and insufficient evidence to support the balance sheet valuation of fixed assets (one council);
- insufficient evidence to support figures in the overall statement of accounts (one council);
- insufficient evidence to verify both the value and number of council house dwellings on the balance sheet (one council);
- insufficient evidence to support non-HRA benefits expenditure in the general fund (one council);
- inadequate records to support direct labour organisations’ (DLOs) accounts (one council); and
- illegal use of the provision for credit liabilities (PCL) related to unlawful deferred purchase agreements (one council).
Faced with rising demand and expectation from service users that seem to run ahead of what can be delivered from available resources, the achievement and maintenance of a sound financial position is one of the major challenges facing councils, police authorities and NHS bodies. It is also a key area for auditors who have a responsibility to review the arrangements put in place by audited bodies to ensure that their financial standing is soundly based. The Commission is pleased to note that most councils, police authorities and NHS bodies are meeting this difficult task successfully, but it is aware that hard choices are having to be made about service levels and that the task for those making these decisions is unlikely to become easier in the future.

During 1998/99, there were marked differences in the in-year financial performance of the different types of bodies within the Commission’s audit regime [TABLE 2].

<table>
<thead>
<tr>
<th>TABLE 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organisations incurring in-year financial deficits 1998/99 (1997/98 figures in brackets)</td>
</tr>
<tr>
<td>Numbers</td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td><strong>Councils</strong></td>
</tr>
<tr>
<td>England</td>
</tr>
<tr>
<td>Wales</td>
</tr>
<tr>
<td><strong>Police authorities</strong></td>
</tr>
<tr>
<td><strong>NHS bodies (England)</strong></td>
</tr>
<tr>
<td>Trusts</td>
</tr>
<tr>
<td>Health authorities</td>
</tr>
<tr>
<td><strong>NHS bodies (Wales)</strong></td>
</tr>
<tr>
<td>Trusts</td>
</tr>
<tr>
<td>Health authorities</td>
</tr>
</tbody>
</table>


### 3.1 Councils

21. In England, 163 councils (42 per cent) incurred in-year deficits, with the average deficit being £1.4 million. The remaining councils either broke even or made a small in-year surplus. Auditors expressed concerns at 13 councils (3 per cent) where deficits exceeded 10 per cent of their annual operating expenditure. In Wales 8 councils (36 per cent) incurred in-year deficits, with the average deficit being £2.4 million.

22. Councils have the option (resources permitting) of creating financial balances to cushion the impact of sudden or unexpected increases in expenditure, or as a prudent way of building up resources to meet known future liabilities. Auditors’ assessed that balances at over 90 per cent of councils in England and Wales were adequate to meet commitments over and above those to be met from annual revenue [TABLE 3].

23. Over recent years a small number of councils have experienced problems because of deficits incurred by DLOs or direct service organisations (DSOs). The compulsory competitive tendering regime that provided the financial performance framework for DLOs/DSOs was abolished in January 2000. However, under the best value framework it is likely that services will continue to be provided on a trading or contractual basis by the council’s own staff.

24. The Commission’s view is that the maintenance of basic financial disciplines and proper monitoring and reporting systems must remain an important concern of both officers and members.

<table>
<thead>
<tr>
<th></th>
<th>General fund percentage</th>
<th>Earmarked reserves percentage</th>
<th>Provisions percentage</th>
<th>Total percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>London boroughs</td>
<td>6</td>
<td>8</td>
<td>20</td>
<td>34</td>
</tr>
<tr>
<td>Counties</td>
<td>2</td>
<td>4</td>
<td>7</td>
<td>13</td>
</tr>
<tr>
<td>Metropolitan districts</td>
<td>4</td>
<td>6</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Unitaries: England</td>
<td>5</td>
<td>6</td>
<td>6</td>
<td>17</td>
</tr>
<tr>
<td>Unitaries: Wales</td>
<td>3</td>
<td>7</td>
<td>6</td>
<td>16</td>
</tr>
<tr>
<td>Districts</td>
<td>28</td>
<td>48</td>
<td>25</td>
<td>101</td>
</tr>
</tbody>
</table>

**TABLE 3**

Levels of general/council fund balances, earmarked reserves and provisions at 31 March 1999 compared with councils’ annual net operating expenditure

District councils tend to have higher balances compared to other councils.
To assist councils the Commission published a management paper in February 2000 *Getting the Groundwork Right: Financial Health for Local Authority Trading Units*. It stressed the need for:

- summarised annual business plans to be agreed by members;
- a reporting framework that provides the right level of information to managers, chief officers and members; and
- timely and robust in-year accounting and financial reporting processes.

### 3.2 Police authorities

25. Overall, police authorities are managing within budgets but there are a number of serious issues, such as the cost of police pensions, which may adversely affect this position in the future. An in-year deficit was reported by 7 authorities (16 per cent) in 1998/99, compared with 11 (24 per cent) in 1997/98. Only one authority reported a deficit over £1 million and the deficits were generally incurred by either a planned reduction in reserves or greater than expected transfers to reserves. A further 12 authorities reported a balanced position for the year, some by making appropriations to or from reserves.

26. Police authorities face particular issues about how they account for pensions and the potential impact this can have upon financial standing. This is because the police pension scheme is 'unfunded' and not backed by specific investments, and the pensions paid to retired and retiring officers have to be met from the annual revenue allocation to police authorities. Spending upon pensions represents an increasing proportion of police expenditure and can also vary depending upon the numbers of officers who exercise their right to retire in any one year. The latest estimate for 1999/2000 is for pension expenditure to increase by some £50 million over 1998/99 levels to around £740 million or 14 per cent of annual police spending.

27. The Commission's view is that police authorities should be making provisions for identifiable short-term pensions liabilities and creating earmarked reserves to cover additional expenditure arising from unexpected events. While there has been a welcome increase in the number of police authorities creating provisions [EXHIBIT 2, overleaf], there are two authorities without either provisions or reserves and only seven have set up both, highlighting the inconsistent approach towards accounting for pension liabilities.

28. The Commission welcomed the 1998 Home Office consultation document about reducing the costs of the scheme in the longer term, and awaits with interest the outcome of the review. The issue about accounting for pension costs and liabilities will become even more important in the light of the WGA initiative, and it is also the subject of a debate being led by the independent ASB across both the private and public sectors.
**EXHIBIT 2**  
**Pensions provisions at 31 March 1999**  
There is a wide variation in the amount of provision between authorities.

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### 3.3 NHS bodies

29. In England, 115 trusts (28 per cent) reported cumulative deficits totalling £291 million in 1998/99, down from 126 trusts (32 per cent) with cumulative deficits of £304 million in 1997/98. In addition 88 health authorities (88 per cent) reported cumulative deficits of £732 million in 1998/99, compared with 86 health authorities (86 per cent) showing a total deficit of £748 million for 1997/98.

30. In Wales, 10 trusts (38 per cent) reported cumulative deficits totalling £25 million compared to 11 trusts (42 per cent) with £15 million cumulative deficits in 1997/98. In addition, four health authorities (80 per cent) reported a cumulative deficit of £37 million for 1998/99, an increase of £12 million on the previous year.

31. In 1998, the Commission sought to promote better standards of financial management in the NHS by highlighting and disseminating good practice through the publication of its management paper *A Healthy Balance: Financial Management in the NHS*. The paper set out the key processes and procedures for sound financial management including:

- instilling a culture of strong financial awareness through the organisation;
- good financial and business planning; and
- effective monitoring and management information systems.

32. The Commission was also pleased to play an active role in support of the National Assembly when it carried out its financial stocktake of the NHS in Wales.
Financial Aspects
of Corporate Governance

33. Over the last ten years there have been significant developments in governance and risk-management practices in both the private and public sectors. In 1992, the Cadbury committee defined corporate governance as the system by which organisations are directed and controlled. Since then the issues of assessing and reporting upon both financial and non-financial controls have been developed by the Rutteeman, Hampel and Turnbull committees, and in 1998, the London Stock Exchange’s Committee on Corporate Governance published its Combined Code setting out principles of good governance for listed companies.

34. From the mid-1990s, parts of the public sector began to adopt different aspects of the good practice set out in the reports of the above committees. Perhaps the most notable initiative has been in the NHS, where the NHS Executive and the NAW have sought to establish the highest standards of governance and control. Among the requirements upon NHS bodies are:
   - the establishment of an audit committee with a clear remit of providing an independent and objective review of the financial systems, compliance with law, guidance and codes of conduct, and oversight of the internal audit service; and
   - the introduction of the controls assurance project that is designed to provide evidence that the organisation is doing its ‘reasonable best’ to manage itself and protect patients, staff, public and other stakeholders against risks of all types. Chief executives have to sign, on behalf of the board, a statement about internal financial control as part of the financial statements. This requirement has been extended to non-financial and non-clinical controls for 1999/2000, and will be further extended to clinical risks and controls from 2000/01.

35. Compared with these initiatives, progress in councils has been relatively piecemeal. Aspects of the modernising agenda have raised the profile of the financial aspects of governance, for example, through national standards of conduct and an enhanced scrutiny function. However, there is no specific requirement for councils to explicitly assess, manage and report upon how they have dealt with risks or their arrangements for internal control.

36. In 1996, the Commission published a management paper Called to Account: The Role of Audit Committees in Local Government. It urged councils to establish audit committees, or similar structures, as a way of focusing attention upon financial accounting and reporting issues, accountability arrangements, risk management, and to provide a forum for overseeing the work of internal and external audit. However, the response by councils in England remains disappointingly slow with only
201 councils (52 per cent) making such arrangements. In Wales, 16 councils (72 per cent) have established audit committees or equivalents. Ninety per cent of all police authorities have responded to Home Office guidance that audit committees should be established. The Commission urges those councils and police authorities that have yet to do so to set up audit committees or similar arrangements, as a key element in their governance arrangements.

4.1 New ethical framework

37. The Government expects all councils to review their decision-making structures and adopt one of three possible models for the operation of executive arrangements. Part III of the Local Government Bill includes proposals to create a new ethical framework for local government in response to the third Nolan Report. This framework will consist broadly of new rules (codes of conduct for members and officers) and new means of enforcing them. The Commission therefore asked its auditors to consider whether councils had made significant changes to governance standards in 1999. Some, 43 councils (11 per cent) in England and 5 councils (22 per cent) in Wales have made changes, including:

- the establishment of scrutiny or standards committees and panels;
- the adoption of cabinet-style committee structures;
- the adoption of a whistleblowing and anti-fraud and corruption policy; and
- the introduction of new corporate codes of governance.

4.2 Internal audit

38. These corporate governance developments also have important implications for the role and profile of internal audit. The Auditing Practices Board (APB) adopted and issued guidance for internal auditors in 1990 on the main issues that should be considered about the way in which they conducted their work. Although the requirements on internal audit at NHS bodies and councils are based on the APB guidance, they differ significantly in that with the NHS, they are much more prescriptive in setting out in detail the standards to be achieved for independence, planning, recording, evaluation of internal controls, evidence, reporting and follow-up. Currently, CIPFA is consulting about a proposed Code of Practice for Internal Auditors in Local Government to update its previous advice on the APB guidance. The Commission believes that it is important that this task is completed as soon as possible and that the Code is adopted and fully supported by all councils, and underpinned by clear minimum standards to which internal audit can be expected to work.
Councils are required to maintain an adequate and effective system of internal audit of their accounting records and internal controls. The Commission is concerned that at nearly 40 per cent of councils and police authorities in England and Wales, the internal audit service was assessed by auditors as being only adequate [EXHIBIT 3].

In the NHS, internal audit is meeting its prescribed operational standards and is being encouraged actively to become a key player in the wider corporate governance developments around risk management. There is an opportunity for internal audit at councils to play a wider role in the best value regime. In particular, best value is posing questions for councils about how they can obtain assurance on the adequacy of their corporate systems and processes, to enable them to sign up to the statement of responsibility the government recommends they should include in their annual BVPP. In a recent management paper *An Inside Job? Internal Audit and Best Value* the Commission set out its views on the options available to councils in developing the role of internal audit in relation to best value.

The Commission recognises that it is important for its appointed auditors and internal auditors to work together as closely as possible to ensure the maximum benefit is gained from the total audit resource. The Commission has recently launched a fundamental review of its ‘managed audit’ approach, and is pleased to be working with representatives from councils and NHS bodies, including internal auditors, to find more effective ways of promoting co-operative working.

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**EXHIBIT 3**

**Auditors’ assessment of internal audit at councils and police authorities**

Auditors assessed internal audit as adequate at 40 per cent of councils and police authorities.

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**Source:** Audit Commission
4.3 Anti-fraud and corruption

42. In December 1999, the Commission published two annual updates, one relating to councils and the other covering the NHS: *Protecting the Public Purse*, about the level of fraud and corruption being detected by councils and NHS bodies. Councils are to be commended for detecting more fraud than ever before, over £100 million in 1998/99 [TABLE 4].

43. In addition, councils have uncovered another £26 million of housing benefit fraud by their active participation in the Commission’s anti-fraud data matching exercise, the results of which were published in May 2000 in *A Perfect Match: The National Fraud Initiative 1998/99*.

44. All public bodies have a responsibility to protect themselves against fraudulent and corrupt behaviour. For councils and NHS bodies these risks are ever present. The Commission welcomes the creation of the Directorate of Counter Fraud Services (DCFS) by the Department of Health and supports the aim of increasing the awareness of NHS bodies to the risk from fraud and corruption. In order to assist in targeting anti-fraud resources most effectively the Commission and the DCFS have agreed a protocol covering the way in which we intend to work together.

<table>
<thead>
<tr>
<th>TABLE 4</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Housing benefit fraud perpetrated upon councils by claimants remains the biggest area.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>England</strong></td>
</tr>
<tr>
<td>Number of fraud cases</td>
</tr>
<tr>
<td>Total value</td>
</tr>
<tr>
<td>Housing benefit fraud</td>
</tr>
<tr>
<td>Number of corruption cases</td>
</tr>
</tbody>
</table>
4.4 **Formal audit reports**

45. Where auditors conclude that a matter concerning the conduct of a council’s business is so significant that it deserves to be brought to wider public attention, they have the statutory power to issue a report in the public interest. Auditors also have statutory powers to make formal recommendations to councils about areas requiring attention, and the council has to consider these at a full council meeting and give a public response. Auditors highlighted a wide range of issues in these formal reports [TABLE 5].

<table>
<thead>
<tr>
<th>REPORTS IN THE PUBLIC INTEREST AT COUNCILS AND FORMAL RECOMMENDATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reports in the public interest</strong></td>
</tr>
<tr>
<td>Number issued</td>
</tr>
</tbody>
</table>
| Areas covered | • Conduct of officers and members  
• Recovery of sums awarded in court  
• DSO losses  
• Members allowances  
• Award of contracts  
• Transfer of housing stock  
• Financial management | | • Future of a historical asset |

<table>
<thead>
<tr>
<th>FORMAL AUDIT RECOMMENDATIONS</th>
<th><strong>England</strong></th>
<th><strong>Wales</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number issued</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>Number of councils</td>
<td>5 (1%)</td>
<td>1 (4%)</td>
</tr>
</tbody>
</table>
| Areas covered | • Poor budget arrangements  
• Accounting for national non-domestic rates  
• Low levels of balances | | • Financial management |
46. Where auditors conclude that a matter concerning the conduct of a NHS body is so significant that it deserves to be brought to wider public attention, they also have the statutory power to issue a report in the public interest. Auditors also have a statutory duty to refer a matter to the Secretary of State if they have reason to believe that an audited body has made, or is about to make, decisions involving potentially unlawful expenditure, or has taken, or is about to take, potentially unlawful action likely to cause a loss or deficiency. Auditors highlighted a wide range of issues in these formal reports [TABLE 6].

| TABLE 6 |
| Reports in the public interest at NHS bodies and referrals to the Secretary of State |
| Reports in the public interest | England | Wales |
| Number issued | 2 | None |
| Areas covered | • Provision of management services to GPs by HA staff |
| | • Joint venture arrangements between a trust and a private company |
| Referrals to the SoS | England | Wales |
| Number issued | 2 | None |
| Areas covered | • Payments to staff on leaving the NHS |
| | • Secondment of NHS staff |
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