A reform too far

Plans to change the way the NAO operates are not only using a sledgehammer to crack a nut but would also endanger its independence, argues David Heald

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'Independence' is the cornerstone of auditing wherever it takes place, but has specialised dimensions when the audited organisation is in the public sector. The wide scope of audit combined with ambiguities in the measurement of performance mean that governance arrangements are substantively important.

In the private sector, the principal concern about independence is that the external auditor, engaged in practice by the management of the auditee, can report fearlessly to the shareholders who collectively own that company. The public sector context is more complex: independence is not only from the management of the entity but also from government and other politicians who will pursue private interests as well as advance the public interest.

The principle of independence was reflected in 1866 when William Gladstone established the office of comptroller and auditor general, the Exchequer and Audit Department and the Public Accounts Committee. This model of public audit – with auditors working through a specialist committee of Parliament – later spread to many countries. The present National Audit Office was created out of the Exchequer and Audit Department by the National Audit Act 1983, a compromise measure at the end of the 1979–1983 Parliament.

The NAO is not a corporate body and its head (the C&AG) is not an employee but an officer of Parliament, with the legal status of 'corporation sole'. This allows contracts to be signed and the rights and responsibilities to be transferred from one incumbent to the next. Although the terminology is archaic, the system of central government audit generally works well and the NAO makes possible the work of the Public Accounts Committee.

However, this is only part of the UK picture. First, the devolved territories of Scotland, Wales and Northern Ireland have their own audit offices. Second, audit differs between tiers of government. In England, the Audit Commission appoints the auditors of local authorities and of most NHS bodies that are not foundation trusts (the latter being appointed by the foundation trusts' regulator, Monitor). The Audit Commission allocates audits to its own employees (formerly known as District Audit) and to private audit firms with which it has a framework agreement. The arrangements for local authority and NHS audits in the devolved territories have their own particularities, but the distinction between central government and local authorities/health is generally less pronounced than in England.

Significant changes in the way the NAO operates are now planned, following proposals by the Public Accounts Commission, the parliamentary body established by the 1983 Act to oversee the watchdog. These proposals are set out in draft legislation, expected to be included in the Constitutional Renewal Bill in the next session of Parliament. None of this would have happened but for media criticism of the expenses of Sir John Bourn, the C&AG from 1988 to 2008. Developments are now proceeding rapidly: applications for the posts of chair of the NAO and C&AG closed on October 20.

The main elements of the proposed legislation are that the NAO would be established as a corporate body, with a chair and a board with a non-executive majority. The 'employee' members of the board would be appointed by the non-executives, not by the C&AG. The comptroller would have a ten-year non-renewable term and the chair and non-executives would have once-renewable three-year terms. Responsibility for the NAO Corporate Plan and Estimate would transfer from the C&AG to the Board. A code of practice is intended to protect the audit independence of the comptroller.

This insertion of the NAO board between the Public Accounts Commission and the C&AG creates dangers. Governments might use the chair and board as a means of curtailing the activities of the comptroller, particularly in the more judgemental value for money sphere and in relation to the outsourcing of audit work. Also, the attention of the C&AG and NAO top management will be diverted away from managing the business towards managing the relationship with the board. The issue of divided authority permeates the proposed arrangements.

Why should these developments matter to those who are not directly involved? First, independence in auditing is invaluable but fragile. The C&AG enjoys a privileged constitutional position, with dismissal requiring a resolution of both Houses of Parliament. Government ministers might resent particular judgements made by the C&AG, whether about Private Finance Initiative accounting or in VFM reports, but – provided that the audit work is of sufficient quality – a resolute comptroller can fend off criticism, which is usually kept private.

PFI accounting clearly illustrates the value of NAO independence. The situation has developed in the UK whereby many PFI schemes are not accounted for as fixed assets on the balance sheet of either the public sector client or the private sector operator.

Officially, accounting treatment is irrelevant to

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whether the government gives the necessary consents for PFI schemes; the decision criterion is said to be VFM. In practice, it has been common knowledge, particularly in health and education, that there is little public money for conventional procurement and that on-balance sheet PFI schemes would not be approved.

The pattern across functional areas of government is revealing. Prisons and roads, audited in England by the NAO, are typically on-balance sheet. Hospitals and schools, audited in England by the auditors appointed by the Audit Commission, are almost all off-balance sheet. The NAO has given primacy to the Accounting Standards Board's Financial Reporting Standard 5A rather than Treasury Technical Note 1 (Revised), which provided greater scope for off-balance sheet treatment. There is no evidence that hospitals and schools differ objectively from prisons and roads in ways that would lead to off-balance sheet treatment.

The control framework over public expenditure has constrained the independence of auditors with regard to hospitals and schools. The achievement of government policy objectives in health and education depended on off-balance sheet treatment of PFI schemes. Financial advisers on these PFI schemes paid great attention to keeping assets off the public sector client's balance sheet. Appointed auditors accepted off-balance treatment, which then became a kind of 'industry practice'.

Auditors appointed by the Audit Commission make their own professional audit judgements and cannot be instructed by the commission. However, when the NAO outsources audits to private firms, the C&AG remains responsible for audit judgements. The NAO's insistence on on-balance sheet treatment when the C&AG is the auditor played an important role in highlighting inconsistencies in the accounting treatment of PFI schemes across the public sector that derived from control systems and audit arrangements.

There is a trade-off: giving the C&AG such independence enhances credibility but makes it difficult to handle controversies (such as the one over expenses) without institutional damage. The former C&AG's practice of taking on additional roles for the NAO at the request of the government, such as the so-called auditing of the assumptions underlying macroeconomic forecasts, raised issues concerning technical capability, apparent endorsement and a confusion of the roles of the Executive and Parliament.

Another example is the validation of efficiency savings, such as those from the Gershon programme, thereby creating moral hazard as the NAO has proclaimed its own success in terms of 'saving' £9 for every £1 it spends. There should be no ambiguity that the C&AG's primary responsibility is to Parliament; extensions of NAO activity should be subject to the approval of the Public Accounts Commission.

Problems stemming from excessive independence of the C&AG are preferable to those stemming from subservience to the Executive, whether directly through ministers or through the conduit of an NAO chair and non-executive director majority. It would be a serious error if the sledgehammer of the latter were used to crack the nut of lax expenses control.

The worst outcome would be a weakening of the C&AG and of the NAO itself, arising from a hidden transfer of power out of the NAO towards the Executive. Even if that did not happen, too much of the time of the C&AG and senior staff would be diverted to internal governance, to the likely detriment of effective performance.

A modest reform, combining a term limit for the C&AG with Audit Committee surveillance of matters such as expenses, hospitality and external activities, would be more proportional to the actual problem and would sustain the tradition of C&AG independence.

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