

This final edition of Spectrum for 2004 starts with a review of the forthcoming good governance standard for public services, a joint project of CIPFA and the Office for Public Management, sponsored by the Joseph Rowntree Foundation. The governance of central government financial reporting is the focus of the second article, which examines the role of the Financial Reporting Advisory Board.

The principles that underpin the system of payment by results in the NHS have been tried before – in the fourth century AD to be precise – argue the next contributors. The quest for a future for arms length management organisations (ALMOs) beyond the achievement of decent homes is the concern of the fourth article.

The final piece questions the wisdom of applying the modern UK/US approach to internal audit in public services across the globe.

CIPFA Spectrum is also available at [www.cipfa.org/pt/spectrum.cfm](http://www.cipfa.org/pt/spectrum.cfm). Please send any feedback to [vernon.soare@cipfa.org](mailto:vernon.soare@cipfa.org).

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## A good governance standard for public services Jane Steele

At the beginning of 2004, the Office for Public Management (OPM) and CIPFA, with funding from the Joseph Rowntree Foundation, established an independent commission to develop a common standard for good governance across all public services. The Independent

Commission on Good Governance in Public Services is chaired by Sir Alan Langlands, Principal and Vice Chancellor, University of Dundee and former Chief Executive of the National Health Service in England.

Following two rounds of consultation, the standard is due to be published in January 2005.

This article reviews the need for such a standard, its purpose and key principles.

### Why 'another' governance standard?

Over 450,000 people hold governance positions in schools, hospitals, police, housing associations and national public bodies across the United Kingdom. Their job is to provide the leadership that makes public services effective and accountable to the public they serve.

Different parts of the public and voluntary sectors have devised guidelines for the good governance of their organisations.

However these vary widely and therefore provide a poor basis for the public to compare and assess the effectiveness of governance arrangements or to demand improvement. Many governors appointed to public service organisations feel that they are unable to carry out their jobs fully or effectively<sup>1</sup>, thus undermining the effectiveness of their organisations. Because they lack clear and practical guidance about what their roles and responsibilities should be, governors have little basis for change. ▶

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► **The common code**

In the private sector, a series of high-profile reviews leading, for example, to the Cadbury, Greenbury and Higgs reports, has strengthened governance considerably. These have resulted in The Combined Code: Principles of Good Governance and Code of Best Practice (updated in July 2003). This provides a framework for shareholders and stakeholders to call upon boards to comply with the commonly accepted standards or explain their reasons for not doing so. The code's strength comes in part from its initially being developed independently from regulatory agencies and then being adopted widely by the business community and regulators themselves.

For the public services, there is no equivalent document that sets out shared principles of good governance for adoption by existing public sector bodies, voluntary sector contractors and newly established organisations (such as NHS foundation trusts). In the complex and diverse world of public service provision, no organisation has been charged with developing overarching and common principles to help the many different organisations and their governors work to a common standard.

**Defining governance**

The standard's definition of governance in the public service context is the leadership, direction and control of public service organisations to ensure that they achieve their agreed aims and objectives and in doing so serve the public's best interests. Good governance is a crucial element of effective public services. It leads to good management, good performance, good stewardship of public money, good citizen engagement and, ultimately, to good outcomes<sup>2</sup>. Good governance encompasses both the ends (what is achieved) and the means (how things are done).

The good governance standard seeks to build on the seven principles for the conduct of people in public life established by the Committee on Standards in Public Life. Known as the Nolan principles, these are: selflessness, integrity, objectivity, accountability, openness, honesty and leadership.

The standard is intended to apply to all organisations and partnerships that work for the public, using public money. These include services directly used by members of the public, such as health services, education and public parks as well as less visible activities, such as regulation and policy development. All organisations that receive public money and are charged with serving the public interest fall within the scope of the proposed standard.

**Application and audiences**

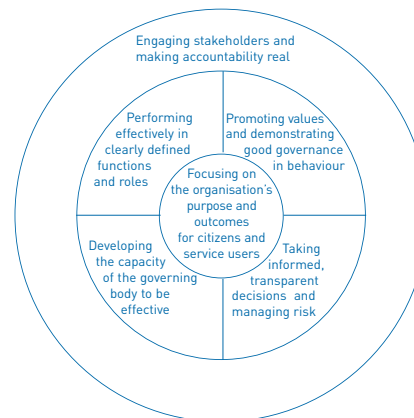
The standard recognises that many different governance structures exist and does not seek to duplicate the codes and guidance that exist for specific types of organisation. Rather, the purpose of the overarching standard is to provide a guide to good governance that will help everyone concerned with the governance of public services not only to understand and apply the principles of good governance that are common to all, but also to assess the strengths and weaknesses of current governance practice and seek to improve it.

The standard is intended for use by:

- members of the public, to understand the purpose of governance, to assess its effectiveness and to demand improvement if necessary
- governing bodies, to review their own effectiveness and to use as a basis for public reporting on their performance against the six principles of good governance
- public services working in partnership, to share a common approach to good governance which has currency with their private and voluntary sector partners
- organisations that appoint governors, to serve as a basis for the induction of new governors
- governors themselves, to ensure they receive the guidance and support they need to perform well in complex and demanding roles
- those who set up new organisations and design their governance arrangements, to lay the foundations of good governance
- those who develop codes of governance for specific sectors, to review and update their guidance.

**Principles of good governance**

The standard comprises six core principles of good governance, each with its supporting principles.



The supporting principles for each core principle are:

**Good governance means focusing on the organisation's purpose and outcomes for citizens and service users**

- Being clear about the organisation's purpose and its intended outcomes for citizens and service users
- Ensuring that users receive a high quality service
- Ensuring that taxpayers receive value for money

**Good governance means performing effectively in clearly defined functions and roles**

- Being clear about the functions of the governing body
- Being clear about the responsibilities of non-executives and the executive and ensuring those responsibilities are carried out
- Being clear about relationships between governors and the public

**Good governance means promoting values for the whole organisation and demonstrating the values of good governance through behaviour**

- Putting organisational values of good governance into practice
- Individual governors behaving in ways that uphold and exemplify effective governance

**Good governance means taking informed, transparent decisions and managing risk**

- Being rigorous and transparent about how decisions are taken
- Having and using good quality information, advice and support
- Operating an effective risk management system

**Good governance means developing the capacity of the governing body to be effective**

- Ensuring that appointed and elected governors have the skills and experience they need to perform well
- Developing the capacity of people with governance responsibilities and evaluating their performance, as individuals and as a group
- Striking a balance, in the membership of the governing body, between continuity and renewal

**Good governance means engaging stakeholders and making accountability real**

- Understanding formal and informal accountability relationships
- Taking an active and planned approach to dialogue with and accountability to the public
- Taking an active and planned approach to responsibilities to staff
- Engaging effectively with institutional stakeholders

**Conclusion**

In drawing up the standard, the commission aimed to capture the spirit and ethos of good governance, which cannot be achieved by rules and procedures alone. It also focused on the ways different functions of governance can support each other. Governance is dynamic: good governance encourages the public trust and participation that enables services to improve; bad governance fosters the low morale and adversarial relationships that lead to poor performance or even, ultimately, to dysfunctional organisations.

Organisations providing public services vary enormously in size and purpose, however all types will be encouraged to apply these principles in a way that is appropriate and proportionate. The commission recommends that governing bodies should report publicly on the extent to which they live up to the standard and explain why and how they have adapted any of the principles to suit their type of organisation. It also recommends that organisations should highlight key areas in which improvements are planned. ●

*The Good Governance Standard for Public Services* will be published in January 2005. For more information on the work of the independent commission visit <http://www.opm.co.uk/ICGGPS/research.htm>

<sup>1</sup> See, example, research by OPM (Rubber Stamped?)

<sup>2</sup> For example, standards of corporate governance have a central place in the Audit Commission's Comprehensive Performance Assessment of the quality of services provided by local authorities

# Policing the application of GAAP in the central government sector: the work of the Financial Reporting Advisory Board

David Watkins

'A working democracy needs transparent Government accounts that cannot be fiddled to present the Government as well as possible.' 'Nobody in their right mind will be confident – to put the case at its weakest – that the accounts are transparent if the people who are responsible for setting the standards, or rather for setting the deviations from the independently set standards, are the very people who have an interest in ensuring that the deviations occur when it is convenient for the Government, and do not when it is not.'<sup>1</sup>

Just before 11 pm on 29th February 2000, the House divided over the question of whether a new clause, introduced by the Opposition, should be inserted into the Government Resources and Accounts Bill requiring the establishment of a new independent body to oversee the setting of accounting standards for government departments preparing resource accounts.

The Government argued that there was no need for a new body – because the Treasury already had one. As the Economic Secretary put it towards the end of the debate: 'All accounting policy issues are subject to the oversight of the Financial Reporting Advisory Board which provides an independent scrutiny and which can, and does, report to Parliament.'

As a result, however, section 24 was inserted into the Government Resources and Accounts Act 2000. Section 5 of the Act requires government departments to prepare their resource accounts in accordance with directions issued by the Treasury, following generally accepted accounting practice (GAAP) adapted as necessary for the public sector context. Section 24 requires the Treasury, before issuing any directions, to 'consult a group of persons who appear to the Treasury to be appropriate to advise on financial reporting principles and standards.' That group is the Financial Reporting Advisory Board (the Board or FRAB).

The Board uses its reports to the Committee of Public Accounts and the Treasury Committee to explain any adaptations of, or departures from, UK GAAP.

You can find out about the FRAB – its membership, terms of reference, how it works, and how its remit has extended since 1996 – and the main issues it has considered during the year in its latest report (the seventh, for 2003-04), on the FRAB's website [www.frab.gov.uk](http://www.frab.gov.uk). You only have to read it – and the earlier reports – to appreciate that the FRAB is, indeed, independent.

I have selected four topics from the latest report that are likely to be of interest.

## Private Finance Initiative

Accounting for PFI is an issue that the Board has raised repeatedly in its reports and with the Treasury. Put simply, the FRAB is concerned how an asset can simply disappear from a balance sheet (or never reach one in the first place) under a PFI contract. Based on the presumption that FRS5 Application Note F and the Treasury's supplementary Technical Note No. 1 are being properly interpreted and applied, the Board assumes that risk transference will be such that an asset will be created on someone's balance sheet – perhaps, even, both parties' balance sheets.

Perhaps the FRAB's approach to accounting for PFI does justify using

the word 'policing' in the title of this article. The Board asked the Treasury for evidence to demonstrate, out of a sample of PFI contracts selected by Board members themselves, that assets are recognised on balance sheet. But out of a sample of 23, there were three cases where the assets were on neither party's balance sheet. Then the National Audit Office weighed in with an additional survey of 25 health and education PFI projects and found 20 cases where the assets were on neither the public sector nor the private sector balance sheet.

The next FRAB report will consider the issue of accounting for PFI assets again, in the light of work carried out by the Treasury and the Departments of Health and Education and Skills.

## International Accounting Standards

Listed companies within the European Union must prepare their consolidated accounts in accordance with EU-adopted international accounting standards from 1 January 2005. The Government will continue to follow UK GAAP in preparing accounts. Some Board members take the view that 'highest possible standards in financial reporting' should mean the Government following the standards it and other European governments require leading companies to follow. Others supported the Treasury's view that departments are going through enough change as it is, without piling more on in one fell swoop. The Board eventually accepted the Treasury's

arguments and so, as new accounting standards are issued by the ASB, the Government Financial Reporting Manual will be updated to bring in the new standards – adopting the UK Accounting Standards Board's (ASB) strategy for convergence with international accounting standards.

## Clearer guidance

'Government Financial Reporting Manual'? Some of you will recognise the title and might know the acronym – FReM. FRAB's 2003-04 report noted that it had decided that the separate sets of accounting guidance for departments, non-departmental public bodies and trading funds should be amalgamated and should comprise a high level, principles-based manual supported by worked examples where necessary. The idea is to have a manual that encourages (indeed forces) accounts preparers to turn to accounting standards as the main source of guidance. The FReM clearly identifies any adaptations (of which there are a limited number) or interpretations of GAAP for the public sector context. The intention is that the FReM will apply for financial years 2005-06 onwards, with the version for any one year being available in March as the financial year starts in April.

## Clearer financial reporting

The 2003-04 report also noted that the Board has commissioned a review of the format and content of resource accounts to ensure that they provide meaningful, readily understood information. Earlier this year the Treasury sent out a questionnaire seeking the views of interested parties. The results indicated a widespread view that resource accounts need to change. A new, improved format, will provide better accountability to Parliament and be easier to read.

## And finally....

So, do we have accounts that cannot be fiddled to present the Government as well as possible? Has the FRAB succeeded in its task?

Application of UK GAAP the norm; tough questioning about any proposals to adapt or depart from GAAP; Civil Service and other public sector employees' pension liabilities on the pension scheme balance sheets; pressure on accounting for PFI; emphasis on transparent reporting....

The answer has to be 'Yes'. ●

<sup>1</sup> Hansard, 29th February 2000, col 220

David Watkins,  
Secretary to the Board

# Roman soldiers and payment by results

Andrew Street & Sawsan AbdulHussain

In 301 AD, after several years of poor harvests, coupled with profiteering by 'evil' traders, inflation across the Roman Empire was such that soldiers of the Roman army could not afford clothing or enough to eat.

To rectify the situation, the Emperor Diocletian issued an edict establishing a maximum wage system and fixing a ceiling on prices for a wide range of commodities—it being decreed that these prices were to 'be observed in the whole of our empire in such fashion that every man may know that permission to exceed them has been forbidden him' (Frank, 1959). Traders had a strong incentive not to exceed the fixed price because selling at a higher amount was punishable by execution.

The edict, however, proved a disaster. Farmers and traders throughout the Roman Empire were unable to cover their costs and went out of business, creating shortages of food and commodities, and the edict soon fell into abeyance.

A policy meant to further the interests of soldiers by making goods affordable failed because it made goods unavailable.

Some 17 centuries after Diocletian's attempt, a new form of price fixing is being introduced to the English National Health Service (NHS), the so-called system of 'payment by results' (Department of Health, 2002). This system introduces a set of fixed prices—national tariffs—with commissioning based on the volume of casemix-adjusted activity.

Fixed prices are intended to be fair and transparent, rewarding efficiency and quality in the production of services (Department of Health, 2003). The belief that efficiency will be enhanced stems from the incentive for providers to reduce their costs and retain any savings that result. This arrangement differs from that introduced by Diocletian who instituted a system of maximum prices, dismissing fixed prices as unjust as this would entail foregoing the benefit of goods being offered at prices below the maximum (Frank, 1959). As such, under the Diocletian system, only high-cost providers had a clear incentive to reduce their costs. Under the NHS fixed price regime, low-cost providers have an

incentive to pursue further cost reductions, because they will be able to retain the savings.

Whether or not any of these benefits materialize depends crucially upon how prices are calculated and applied. Indications of potential financial instability can be gained from consideration of the summary statistics that the Department of Health produces annually to describe the reference cost data received from providers. Greater financial instability is likely to be associated with health care resource groups (HRGs) whose reference cost data display the following characteristics:

- A high degree of skewness, because this may be indicative of systematic differences among providers in their costs of provision.
- Large changes in the mean reference cost over time, because this might suggest general uncertainty about the true cost of provision.
- Substantial variation among providers in their reported reference costs at any point in time, because this might suggest the presence of influences on cost over and above differences in efficiency.

The policy also presumes that most costs can be controlled by providers. Diocletian failed to recognize that the costs to farmers and traders were influenced by the productivity of agricultural land or distance to market. Similarly, NHS organizations have limited control over costs associated with the size of the operation, the mix of services provided, and of financing capital improvements. Certainly in the short term, size is a fixed constraint, suggesting that prices might be adjusted accordingly. But even in the longer term, NHS hospitals are constrained in their ability to operate at an efficient scale because of political pressures. This implies that prices should be adjusted by more than just the market forces factor.

The system could generate negative consequences. Fixed prices may create incentives for providers to reduce quality or to shift costs on to general practitioners or other health and social care providers. One way to do this would be for hospitals to discharge patients at higher levels of dependency. Evidence suggests that earlier discharge occurred after the introduction of a similar payment system in the USA (Kosecoff et al., 1990). There is, perhaps, less of a danger that this will occur in the NHS, where PCTs will resist having to take on responsibilities that they believe should remain with hospitals. But the ability of hospitals to discharge patients to more appropriate settings depends on the availability of alternatives. Hospitals in areas with poor primary and community care support may report higher costs because they are required to keep patients in for longer periods than their peers in other locations. By setting a national tariff, there is an implicit assumption either that providers operate within similar environments or that they can be held responsible for the 'wider health care economy'.

Providers have been given three years to move to tariff prices and it is anticipated that some will face having to make 9% efficiency savings (Department of Health, 2003). The architects of the payment-by-results programme are forthright about the consequences to providers of failing to reduce costs to the tariff amount: 'If you are in deficit you will get paid by the tariff or not at all. There is no borrowing or handouts if you are in trouble' (Dredge, 2003). This assumes that the sole source of 'trouble' is inefficiency and, by implication, that there are no inaccuracies in how services are defined or in how prices are determined.

In other jurisdictions, refinements to the fixed pricing regime have involved more accurate specification of the service to which the price applies, more tailored reimbursement of costs associated with the care of atypical patients, and greater allowance for exogenous influences on costs (Duckett, 2000; Hanson, 2000; Zuckerman et al., 1990). For instance, in the Australian state of Victoria, where a similar financing reform was introduced in the 1990s, funding adjustments are made to allow for the costs of being located in rural or isolated areas, of serving communities that require support over and above that required to address their medical conditions, and to recognize the cost consequences of early adoption of new technologies (McNair and Duckett, 2002).

In the USA, it has been recognized that the cost of providing physician services 'varies not only from procedure to procedure, but also from area to area', and that 'failure to reflect relative geographic costs in reimbursement rates could create serious resource misallocation; namely, a physician oversupply in areas where fees are high relative to costs and an undersupply where fees are low relative to costs' (Zuckerman et al., 1990). More generally, it has been demonstrated that reimbursement systems which combine an element of prospectively determined fixed prices with a payment based on the actual cost incurred by providers are superior to those based on a fixed price alone (Laffont and Tirole, 1993; Ellis and McGuire, 1986).

The reduction in the supply of commodities that resulted as producers and traders went out of business meant that the intended beneficiaries of a fixed price regime, the Roman soldiers, were left worse off than before the Diocletian edict had been issued. It would be disappointing if, in the NHS, a policy designed to further patient choice had the reverse effect because of a 'definite threat that struggling providers will not be bailed out by government if they fail under the new financial regime' (Smith, 2003).

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# ALMOs – decent homes and beyond

Catherine Park & Neil Isaac

There has been plenty of debate around the government's three options for achieving decent homes, not the least of which is whether there is a fourth option. However once the arms length option has been chosen by a local authority and its tenants, what changes? On 1 April 2002 the first housing Arms Length Management Organisations (ALMOs) came into being. These ALMOs are now approaching their third birthdays. What benefits have been gained from their management of council housing and what difficulties and tensions have they faced, and do they face in the future? The Office of the Deputy Prime Minister (ODPM) is currently carrying out a review of ALMOs in order to inform decisions on their future beyond the decent homes initiative. When the ODPM looks at the story of ALMOs, will it be a story of success or failure?

There are many similarities between ALMOs and traditional local authority housing departments. After all, the majority of ALMO staff transfer from the parent local authority when the ALMO is set up. The same housing management activities are carried out, the houses are still owned by the council, the mechanism for setting rents remains the same, housing subsidy does not change and the Housing Revenue Account must still be maintained.

Nonetheless there are some important differences. The strategic and day to day management functions have been well and truly separated. Many ALMOs talk about the benefits of speedier decision making mechanisms, improved tenant participation and generally being closer to the customer. But how do ALMOs achieve these things? Perhaps the most important way is through their governance arrangements.

ALMOs are governed by a board of non-executive directors. The board is made up of tenants' representatives, leaseholder representatives, council nominees and independent members. The board is likely to meet around six times per year and will set up various decision making sub committees to deal with specific areas such as finance and personnel. In addition ALMOs may have working groups that are used for consultation on a variety of issues relating to housing management and capital investment decisions. These working groups report to the board and further inform decision making. These arrangements reduce the number of 'hoops' to jump through before strategic decisions are made. The standing orders and terms of reference clearly set out the decisions that require board approval and those that can be approved by a sub committee. A decision of strategic significance is therefore likely to pass straight from consideration by the senior management team, to either the board itself or one of its sub committees.

This is in stark contrast to the typical approval process of a local authority, which is likely to involve upwards of four separate stages.

Clearly part of the ALMO advantage is a direct result of being a single purpose organisation considerably smaller than the parent local authority. This means that operational managers can get ideas considered quickly and directly by the most senior officers and that operational managers as well as senior managers get the opportunity to present to Board and sub-committees. This offers important professional development opportunities for the officers involved as well as benefits for the organisation.

It is important to remember that an ALMO is a subsidiary of the parent local authority, although generally ALMOs and councils will avoid using that specific terminology. There are some decisions therefore that require approval from the council although this varies slightly from ALMO to ALMO or council to council. The housing capital programme may well require council approval. Other decisions which involve entering agreements of longer duration than the management contract itself may well fall into this category. The parent / subsidiary relationship is at its most stark and undeniable at the ALMO's annual general meeting. There is only one member and therefore one vote at the AGM and that of course is the vote of the council. This should not be viewed in a negative light however and is simply a manifestation of the company structure and public sector ownership of ALMOs. It also allows the council to control any changes to the Memorandum and Articles of Association.

An interesting question posed about the ALMO / council relationship is, 'how long is the arm?' The answer is that it depends. And it depends on many things, including the political situation of the council, the performance of the ALMO in

achieving its key objectives, the amount of trust between officers and members on both sides and perhaps less obviously, the approach of the council's external auditor.

Interestingly when the idea of ALMOs was born, conceptually it was envisaged as a partnership relationship between the ALMO and the council. Not a partnership in the strict legal or accounting sense, but allowing the ALMO genuine management freedom to deliver the objectives set out in the management agreement. However some council members, officers and even auditors have not always taken the same view and there can be pressure to adopt a more 'client' style role in relation to the ALMO. While this may provide some reassurance, it inevitably leads to duplication of roles and if care is not taken the result is an ALMO with a performance management and monitoring function and a council with exactly the same function! In this context the degree of regulation should also be considered. In addition to the council audit and the company's own audit, the Housing Inspectorate must award an ALMO 'good' or 'excellent' rating to allow access to the additional funding, and will visit again within three years to re-inspect.

There are many other issues to consider in the story of ALMOs and many other benefits to proclaim, not least the progress towards decent homes, but also the benefits of private sector expertise on the board, the 'challenge' of tenant representation on the board, the increased financial discipline resulting from greater control over the organisation, to name but a few. The fundamental question to ask though is 'do they do it better?' Our answer clearly is 'yes' given the measured and published service improvements highlighted by inspection. Nevertheless the ODPM may find it hard to define a role for ALMOs beyond the achievement of decent homes. ●

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# Is the modern UK/US approach to internal audit appropriate in all circumstances?

Noel Hepworth

## Introduction

'Internal audit is an assurance function that primarily provides an independent and objective opinion to the organisation on the degree to which the internal control environment supports and promotes the achievement of the organisation's objectives. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources.'

This definition is taken from the CIPFA Code of Practice for Internal Auditors in Local Government and is similar to that developed by the United States based Institute of Internal Auditors. However, is this definition of internal audit and its supporting rationale appropriate in all circumstances?

This article argues that an approach to internal audit focussed on internal control and risk is not necessarily an appropriate model for public sectors in countries with vastly different circumstances from those applying in countries with developed economies and highly sophisticated public services. Indeed in some circumstances such an approach can be inappropriate and positively damaging.

Lying behind this definition are several assumptions, because the definition has been developed for application in a sophisticated public sector. These assumptions include:

- That underlying internal control systems (financial and non-financial) exist and are generally sound;
- The extent of fraud and corruption is limited;
- Standards of ethical behaviour and governance are high;
- An adequate reporting system exists;
- Action is taken on internal audit reports;
- Management is reasonable in terms of quality and training;
- A clear distinction exists between official and political levels of management. ►

► Current conventional wisdom is that internal audit resources should be directed to those systems and activities that present the greatest risk to the operational integrity of the organisation. The internal auditor, along with management identify the areas of potential greatest risk. The internal auditor then draws up an audit plan agreed with management. Organisations need assurance that their risk management processes support their capacity to achieve their objectives. Therefore in the strategic business planning process, risks need to be identified, assessed and then addressed. 'Internal audit occupies a unique position ...with a remit to review the whole of risk control and governance, with the added value of independence.' (H.M. Treasury)

**An alternative scenario**

However, does the definition of internal audit set out above remain relevant and is it appropriate for the internal auditor to focus attention on internal control and the risks to and within the internal control system where the above assumptions do not apply?

In such circumstances, which prevail in many developing countries and in some transition economies, pursuit of the prevailing developed country approach (ideology?) to internal audit leaves a vacuum. What is more, the inevitability (at least in general) is that the capacity of the internal audit function will be limited to the capacity of public sector management in general. Therefore, a high quality and expert internal audit capacity is unlikely to be available to react to the deficiencies in the internal control system and the operational public sector environment.

**Trends in internal audit**

Internal audit used to operate within narrow terms of reference. It would focus on financial records, financial systems and controls. It would examine whether established procedures and policies were being complied with, were assets being properly safeguarded, perhaps were employees functioning efficiently, whether the financial records were being accurately maintained. An important emphasis was on fraud detection. In summary the internal audit principal concern was with financial probity and regularity.

The pressure for change in this role came partly from the internal audit profession and partly from management. Both were looking for ways to add value to the internal audit function, and at the same time reduce the cost. Internal audit has now moved on to embrace risk (with

risk being the determining factor in the decision about where to allocate internal audit resources) with integrity of the internal control system regularly reaching beyond the financial control element.

Where these assumptions do not exist, or exist only with significant weaknesses, as is the situation in many developing countries, then the question that has to be addressed is, whether a risk based internal audit approach, with risk being determined within the organisation, is appropriate? And the answer to this question has to be, 'no'.

However, as a general rule the conventional attitude of the internal audit professional and internal audit consultancies (often non-nationals trained in modern internal audit approaches) seems to neglect the fact that the current risk based approach is a development of the original approach to internal audit and is only applicable where certain pre-conditions apply, for example:

- Management fully understands and participates in the risk assessment process;
- There is a significant variability in the level of risk between systems and activities that allows judgements to be made about where the greatest risks exist;
- Management and internal audit have the technical capacity to identify and assess comparative risk;
- Internal audit has the technical capacity and the resources to undertake risk based audits.

Such pre-conditions exist in very few developing countries, where aid agencies have particular concerns that aid might leak into inappropriate spending or that there is actual diversion of funds for private purposes. How can it be argued that the modern, risk based approach to internal audit is appropriate in these circumstances? The question becomes more significant as aid agencies seek to switch from programme support to direct budgetary support. With the latter there is a much greater risk of funds being siphoned off compared with programme support.

**Modifications to a modern internal audit approach**

What is the alternative to a modern risk based approach to internal audit? To provide real benefit, the internal audit approach must be adjusted, as must the approach of the aid agencies.

That alternative approach is arguably to return the internal audit role to that of financial checker, but in the case of developing countries with an important difference. This difference would be to allow a role for external influence. There is a precedent for such an approach. Developed countries and transition economies seeking to join the European Union have been subject to intensive pressure to improve their public sector management arrangements including public financial control (viz. the Chapter 28 requirements). Progress has been subject to annual verification, with failure in meeting requirements resulting in delay in the accession timetable. Aid agencies should arguably become the equivalent of the external regulator or the European Commission, identifying those areas of activity over which they have a particular concern. In addition, the agencies should set programmes of reform activity and systematically review progress on a regular basis.

On what should the programmes of reform activity focus? In particular there has to be local ownership of reform and a real desire at the highest political level to achieve progress (the role referred to above of the 'interested owner') in ensuring that resources are directed to those areas where policy decisions indicate that they should go. An essential financial environmental condition is, therefore, a robust budgetary system with clear policy objectives, which for developing countries receiving international aid, would be policy objectives in line with an agreed poverty reduction strategy.

A second financial environmental condition concerns the accounting system. This is equivalent to the traditional role of ensuring that adequate financial records exist are properly kept. An effective accounting system should exist which records, on a timely basis, spending in a similar format to the budget.

These two financial environmental conditions then provide the internal auditor with the basic raw material on which to work. The internal auditor should also, with the support of management (which is essential), ensure as far as possible that fraud and corruption and other misuse of funds is minimised. If the role of internal audit in these circumstances requires extensive transaction testing because of the scale of error, then this needs to be accepted. Sampling may be employed but above small percentages of error, complete audits may be required.

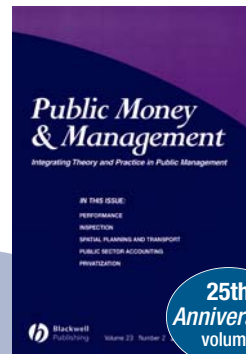
The key role of the internal auditor in these circumstances should therefore be that of 'financial checker'. Neither the aid agencies nor consultancies advising the aid agencies should expect more than this. ●

*Noel Hepworth  
Director, CIPFA  
International*

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