CHAPTER EIGHT

Accounting and Auditing for Local Government

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Accounting systems

Effective accounting systems are essential for local government, both to provide managers with the financial information they need to manage their services and to account to citizens and taxpayers for the use of public resources. There are two principal forms of accounting:

- Management accounting provides financial information to the executive (including service managers) before, during and after the financial year;
- Financial accounting provides information for those outside the executive (elected representatives, citizens and taxpayers), usually after the end of the financial year, and so is essential for public accountability.

Auditing is the mechanism which provides assurance to the public about the veracity of the accounts, and hence is essential for public accountability.

Conventional accounting is effective at identifying costs, but poor at identifying performance. Therefore, accounting as a tool needs to be combined with other approaches in order to assess the performance of a public body such as a local government.

Costs

Cost information is important in order to:

- Know the cost at which best value is obtained
- Determine the allocation of resources
- Set charges for services provided by the local government
- Monitor in-year spending
- Manage cash flow
- Review value for money as part of performance review or value-for-money audit
- Decide whether to continue to operate a particular service.

Different requirements and decisions need information about different types of cost. A number of types of cost are important:

- *Cash costs* (both direct costs and indirect costs) are generally relevant since the cash involved must be raised eventually;
- *Overhead costs:* These are the indirect part of cash costs and so are generally relevant, but there may be problems about allocating overhead costs (see below);
- *Opportunity costs:* Non-cash costs that represent income forgone by doing something (for example, the income that could have been earned in bank interest if the capital had not been invested in a particular project) – they too are relevant in many circumstances;
- *Unavoidable costs:* Those costs that would remain whatever decision is made; these should generally be ignored, but they may vary over time.

Overhead costs should be allocated between services or service units in order to establish the true costs of a service. If this is not done properly, charges for services will not reflect the true value of the resources used, and the good performance of one unit may be achieved on the back of another unit's costs. Overhead costs should be allocated in accordance with the factors that drive the underlying need for the costs to be incurred. Thus, the costs of a central building's maintenance unit might be allocated between service units according to the space occupied. As with all such allocations there is a degree of choice over the level of sophistication used. Space occupied might be adjusted for the type and condition of buildings, but this is only worth doing where there is good information about type and condition and where there is a clear understanding of how this relates to cost.

There are a number of problems with allocating overhead costs. Firstly, the calculation of the costs and the allocation formulae may be hard for service managers (and others) to understand. Secondly, there are some costs that it may not be possible to allocate to service units (for example, the costs of operating the decision-making processes of the council). Thirdly, allocating overheads to service units may blur the accountability for controlling support costs, for example where a support unit such as building maintenance can simply charge out its costs to other units in the local government without any accountability for efficiency. On the latter point, overhead allocation needs to be seen principally as a tool for managing performance; accountability for costs should rest primarily with those who are responsible for incurring the cost – in the case of buildings maintenance this would be the managers of the building maintenance operation.

Monitoring budgets

The monitoring of budgets is essential to effective financial management, not only to avoid overspending (which raises the question of where the additional cash will come from), but also to avoid underspending that might threaten performance in service delivery. However, budget monitoring provides only a limited insight into overall performance.

Budget monitoring requires a profiled budget, that is, a budget that is spread over 12 months (or possibly four quarters) to reflect expected spending patterns:

- Flat for some costs, e.g. office space;
- Seasonal for some costs, e.g. heating or air-conditioning;
- With a stepped increase where prices rise at a specific time of the year, e.g. wages;
- Specific – to reflect policy issues or specific constraints.

Budget responsibilities need to be clear: each budget should be the responsibility of one named budget officer. However, there also needs to be overall oversight to ensure that appropriate action is being taken and the overall position is understood. This is likely to be the primary responsibility of the finance department reporting to the equivalent of the chief executive.

In large councils, the volume of budget monitoring data can overwhelm the capacity to manage. In such cases, it is sensible to manage by exception – this means that the main focus of effort in the monitoring process is on those budget lines where there is a significant variation.

When variations emerge, there are a number of options for action where the variance is an overspend:

- Reduce future expenditure on the particular item;
- Transfer budgetary resources from another budget head which is (or can be) underspent (virement);
- Use a contingency fund or reserves;
- Raise extra income;
- Borrow (or borrow more);
- (Depending on local circumstances) seek additional help from central government – in some countries central governments do provide additional support, for example where extra spending is caused by catastrophic weather conditions.

A key issue will be whether the problem can be resolved within the sub-unit which holds the budget or whether (and under what circumstances) it is a corporate problem for the local government as a whole.

Auditing: regulation of government in the UK

The British tradition involves:

- A strong framework of internal control: rules, roles, methods, level of discretion and reporting;
- A strong post-event system of auditing, including both financial audit and performance audit;
- No pre-audit or similar pre-event authorisation;
- Separate inspection functions for certain services (increasingly the norm);
- Usually an ombudsman function (a relatively recent tradition).

Principles of public audit

The UK's Public Audit Forum (www.public-audit-forum.gov.uk) identifies three key principles of public audit:

- Independence of public sector auditors from the organisation being audited;
- Wide scope of public audit, covering financial statements, regularity (or legality), propriety (or probity) and value for money;
- The ability of public auditors to make the results of their audits available to the public and to democratically elected representatives.

Some observers would argue that the final point is too limited – that the public should have the right to access all audit reports except in very limited circumstances such as genuine cases of national security

In England, there are two principal external audit bodies. The National Audit Office (NAO) (www.nao.gov.uk) is responsible for auditing central government (ministries and most non-departmental bodies operating at the national level). It is headed by the Comptroller and Auditor General, who is an officer of Parliament, not a civil servant. The NAO is controlled and financed directly by Parliament and reports to the Public Accounts Committee. It conducts most audits directly, but contracts out around 15 per cent of its work to private firms.

The Audit Commission (AC) (www.audit-commission.gov.uk) audits local government and health authorities and trusts. It is headed by part-time commissioners and a full-time chief executive, all of whom are appointed by ministers. It is nominally independent of both the executive and legislature, but provides its reports to the relevant central government ministry. The AC supervises audits conducted by others: 70 per cent by the district audit service, which it controls, and 30 per cent by private firms. It is financed mainly by audit fees. It also produces national studies and comparative performance indicators. From April 2002, it took on part of the inspection role over local government, formerly carried out by central ministries.

Some public bodies, such as state-owned industries, some non-departmental public bodies and some local delivery organisations (e.g. colleges of higher education) are audited by private firms, which usually report to a central ministry or agency.

Audit and management roles

Table 8.1 shows the respective roles of management, internal audit and external audit within the UK system.

Table 8.1. Roles of management, internal audit and external audit

	Management	Internal audit	External audit
Policy and financial control	Prime responsibility	Safeguard	Reassure
Accuracy of accounts	Prime responsibility	Normally no direct role	Check and certify
Value for money	Prime responsibility	May carry out studies	Required to carry out studies
Able to prohibit expenditure?	n/a	No	Previously in local government and police, but this is no longer so; not in central government
Recover wrongful expenditure?	n/a	No	Previously in local government and police, but no longer. Not in central government

Historically, local government auditors had the power to 'surcharge' officers and politicians who were responsible for illegal spending or for 'causing a loss' to their local government. These powers were abolished and now local governments themselves must take action under common law to recover money where officers or politicians have acted improperly.

Traditional auditing

Traditional auditing focuses on probity and accuracy of accounts. It uses a regularity approach that examines whether transactions are within the law, within budget and have been carried out according to regulations, codes of practice, etc. It also checks whether funds were applied for the purposes for which they were provided.

The problem with regularity auditing is that it only looks backwards, discovering problems that have already happened, but not problems that could happen in the future. Regularity auditing is time-consuming, and it does not ask whether transactions were wise or effective (e.g. in terms of performance).

The following two approaches seek to address the weaknesses of traditional regularity auditing.

Systems-based auditing

Systems-based auditing examines the system of internal control to see whether controls are adequate and, if they are not, reports this to the relevant authority. It then checks whether the practice complies with the claimed system of internal control by examining any deviations. This is done on a sample basis, with the sample determined by risk factors. This means that audit capacity is used more effectively and there is more chance of preventing control breaches before they are abused. However system-based auditing requires more capable auditors than traditional auditing.

Performance auditing

Auditing needs to be concerned not just with probity, but also with performance in the use of public funds: whether resources were used effectively to achieve agreed objectives and efficiently (making the best use of resources).

The UK's Audit Commission has identified three key performance criteria, commonly known as the 'three Es', for its analyses:

- *Economy:* minimising the costs of inputs (for a given output)
- *Effectiveness:* maximising outcomes (for a given input)
- *Efficiency:* the appropriate mix of inputs and outputs (or outcomes).

In the UK, auditors play a number of roles in relation to performance audit:

- Conducting national studies on best practice
- Publishing papers on management performance
- Collating national data on best value performance indicators
- Verifying performance indicators at the local level
- Auditing the best value performance plans of local governments

- Checking the adequacy of local governments' management arrangements for delivery of economy, efficiency and effectiveness, and checking whether best practice recommendations are being followed.

A best practice approach

The best practice approach makes use of league tables and other information to identify a set of relevant and interesting cases. It then looks behind the numbers in respect of the selected cases to determine what explains the results: is it a better process or is it a different policy? From that, best practice recommendations are developed. This generally works best where it is done on a comparative basis. Developing best practice recommendations requires skills that go beyond traditional auditing; it takes expert analysis and often specialist understanding of the field that it is the object of the audit.

Audit and inspection

Audit and inspection offer complementary roles in improving service delivery by local government. Traditionally in the UK, inspectors of government services were concerned with professional standards (e.g. in prisons and schools). Auditors were concerned with costs and with financial regularity and probity. Increasingly, both are concerned with issues of performance and appropriate management structures. Thus there is a possibility of overlap. Some observers criticise this, pointing to duplication of effort and the burdens imposed on those who are being audited. Others argue that this creates healthy competition between the different scrutineers to be more effective, and allows for greater innovation in conducting and reporting on oversight. In local government in England, the potential for undesirable overlap is limited by the fact that the Audit Commission is also responsible for inspecting most services: important exceptions are schools and social services.

Some issues and caveats

In all this there are dangers of over-regulation. This is perhaps a natural consequence of increased devolution and local autonomy, and the lack of trust (much of which may be justified) on the part of central government towards local government. However, audit and inspection have heavy compliance costs (as well as direct costs), putting a strain on limited capacity and possibly encouraging rent-seeking behaviour by inspectors and auditors. Over-regulation and excessive inspection and audit can discourage local initiative and risk-taking.

Competition between audit and inspection agencies may be healthy, but it may also lead to turf wars. Scrutiny efforts need to be co-ordinated to ensure greatest benefit. Moreover, there are important issues about who scrutinises the scrutineers, and who guards the guardians.

Finally, the following are some caveats about adopting innovative financial management, accounting and performance approaches, adapted from Schick (1998: 31).

Before you …	You should …
Introduce performance or outcome budgeting	Foster an environment that supports and demands performance
Seek to control outputs	Control inputs
Account for accruals	Account for cash
Introduce internal controls	Establish external control
Install an integrated financial management system	Operate a reliable accounting system
Budget for results to be achieved	Budget for work to be done
Introduce performance contracts in the public sector	Enforce formal contracts in the private sector
Move to performance auditing	Have effective financial auditing
Insist managers efficiently use resources entrusted to them	Adopt and implement predictable budgets

Reference

Schick, A. (1998). *Contemporary Approach to Public Expenditure Management*. Washington, DC: World Bank Institute.