



House of Commons  
The Public Accounts  
Commission

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# **Review of the National Audit Office's Corporate Governance**

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**Fourteenth Report**





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## Fourteenth Report

*Presented to the House of Commons in  
pursuance of section 2(3) of the National Audit  
Act 1983*

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## The Public Accounts Commission

The Public Accounts Commission is defined by the National Audit Act 1983. The Commission's principal duties under the Act are to examine the National Audit Office Estimate, to consider reports from the appointed auditor of the National Audit Office, and to report from time to time.

### Membership

Rt Hon Alan Williams MP (Labour, Swansea West) (Chairman)  
Mr Richard Bacon MP (Conservative, South Norfolk)  
Rt Hon Harriet Harman QC MP (Labour, Camberwell and Peckham) (*ex-officio* as Leader of the House of Commons)  
Mr Edward Leigh MP (Conservative, Gainsborough) (*ex-officio* as Chairman of the Committee of Public Accounts)  
Dr William McCrea MP (Democratic Unionist, South Antrim)  
Mr John McFall MP (Labour, West Dunbartonshire)  
Mr Austin Mitchell MP (Labour, Great Grimsby)  
Dr Nick Palmer MP (Labour, Broxtowe)  
Mr Andrew Tyrie MP (Conservative, Chichester)

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The Reports and evidence of the Commission are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at [www.parliament.uk/parliamentary\\_committees/public\\_accounts\\_commission.cfm](http://www.parliament.uk/parliamentary_committees/public_accounts_commission.cfm)

### Committee staff

The current staff of the Commission are Dorian Gerhold (Secretary of the Commission) and Ann Williams/Jill Herring (Secretaries).

### Contacts

All correspondence should be addressed to Mr Dorian Gerhold, Secretary of the Commission, House of Commons, 7 Millbank. London SW1P 3JA; [gerholddj@parliament.uk](mailto:gerholddj@parliament.uk). The telephone number for general enquiries is 020 7219 6257/1366.

## **PUBLIC ACCOUNTS COMMISSION**

### **14th REPORT (2008)**

In July 2007 we decided to review the corporate governance arrangements for the National Audit Office to ensure that these conform to best practice. In November we commissioned John Tiner to conduct the review. He has now submitted his review, which we are publishing as an Appendix to this report. In order to publish the review as soon as possible we are not commenting on it at this stage, but we will publish our observations on it shortly.



# Appendix: Review of the National Audit Office's Corporate Governance, by John Tiner (January 2008)

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# 1 Summary

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1. The National Audit Office is a unique and critically important organisation in the UK public sector. Its head, the Comptroller and Auditor General (C&AG) is an Officer of the House of Commons and enjoys complete discretion over the discharge of his functions. This combined with his appointment by Her Majesty the Queen on a motion from the House of Commons makes him completely independent of Government, a sine qua non for the position. The current C&AG has put in place a number of governance processes, but in their effectiveness these fall short of what is currently best practice, even when taking into account the unique role of the Office. In the exercise of his responsibilities the C&AG must, in my view, rely not only on the powers given to him by Parliament, but also on the moral authority which comes from the National Audit Office (NAO) maintaining the highest standards of governance.

2. I have established three objectives in framing my proposals for the future governance of the NAO:

- The C&AG must have the authority to form completely independent judgements about the audits and value for money and other studies conducted by the NAO and the presentation of these to Parliament.
- The NAO must maintain systems of governance and internal controls consistent with best practice, applied in ways which do not fetter its independence from Government, and to report publicly on these systems in its Annual Report.
- The NAO must conduct its work according to relevant auditing and professional standards and prevailing best practice.

3. I propose significant changes to the current governance structure. My main proposals are:

- The NAO should be formed as a body corporate with a governing board comprising a majority of independent non executive directors. Its main functions should be to set the strategy of the Office, support and oversee the work of the C&AG, ensure the Office (including the C&AG) conducts its business in an economic, efficient and effective way and satisfy itself that the systems of governance and internal controls operate effectively and to the highest standards. The Board should have a Remuneration Committee and an Audit Committee comprised entirely of non-executive directors.
- The Chief Executive (who would be styled the C&AG) should have complete personal discretion as to the audit judgements he reaches and the presentation of those judgements to the Public Accounts Committee and other committees of Parliament as may be necessary.
- Both the Chairman and Chief Executive of the NAO Board would be appointed by Her Majesty the Queen on a motion from the House of Commons. The Chairman and the other non-executives should be appointed for a term of 3 years renewable once. The

Chief Executive should be appointed for a fixed term of 8 years which cannot be renewed.

4. I recognise that to implement my proposals it will be necessary to introduce new primary legislation. I understand a possible mechanism to effect this exists in the Constitutional Renewal Bill foreshadowed in the most recent Queen's Speech.

5. While I have sought to understand the governance arrangements in the devolved administrations they do not fall within my terms of reference and I make no comment on whether my proposals for the NAO have any application in the devolved administrations.

## 2 Introduction

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6. I have set out in this report the background to the review, the objectives of the corporate governance framework, a comparison of the current corporate governance of the NAO against best practice and arrangements in other countries, my proposal for the future governance of the NAO, the relationship between the NAO and the Audit Commission and other comments.

7. During my review I have interviewed all members of the NAO Senior Management Board other than its Chairman (the C&AG, with whom I have had a brief conversation) and all members of the Audit Committee, a number of senior officials in government, the Chairman and Chief Executive of the Audit Commission, the Auditor Generals in Northern Ireland, Scotland and Wales and the Auditor Generals of Sweden and Canada. I met with the Public Accounts Commission at the start of my review. I have invited input to my review from interested parties and have received 14 submissions. I am most grateful to all who have contributed to my review.

8. The position of the C&AG was established by the Exchequer and Audit Departments Act 1866. Three further Acts of Parliament have established the authority of the C&AG, most notably the National Audit Act 1983. This Act gives the C&AG complete discretion in the discharge of his functions. It also says there shall be a National Audit Office, whose staff shall be appointed by the C&AG. To support him, the C&AG has set up a Senior Management Board (which he chairs) and a Management Committee (chaired by the Deputy C&AG). There is also an Audit Committee.

9. The C&AG is accountable to the Public Accounts Commission (TPAC), an all party committee of MPs. The Commission examines the NAO's Supply Estimate (the annual budget), appoints the Accounting Officer (currently the C&AG) and appoints the external auditors.

## 3 Background to the review

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10. In its Thirteenth Report published on 11 July 2007, the Public Accounts Commission introduced a new system of independent oversight in respect of the expenses of the C&AG. It was emphasised in that report that as far as expenses are concerned the C&AG should

follow the rules and practices of Permanent Secretaries. The Chairman of the NAO's Audit Committee, assisted by the Office's Director of Internal Assurance, would oversee the planned expenses of the C&AG and have access to the Public Accounts Commission in the event that he or she has any concerns. In addition, the actual expenses of the C&AG would be reported to the Public Accounts Commission six-monthly and be subject to independent audit. These new procedures were designed so as not to fetter the discretion of the C&AG in the discharge of his functions.

11. The Thirteenth Report also stated that the Commission would be reviewing the corporate governance arrangements of the NAO to ensure they conform to best practice. I was appointed by the Public Accounts Commission to conduct this review on its behalf and this report sets out my findings and proposals for strengthening the governance of the Office. As agreed with the Commission, I have reviewed the governance arrangements in general and have neither specifically reviewed or assessed the expenses of the C&AG or the operation of the new oversight procedures referred to above.

12. The terms of reference for the review were set out in a press notice by the Commission on 11 October 2007, as follows:

“To identify the extent to which the NAO's corporate governance arrangements are consistent with best practice elsewhere (including the arrangements set out in the *Combined Code on Corporate Governance* and the *Treasury's Corporate Governance in Central Government Departments: Code of Practice*) and to propose any necessary improvements, taking account of the need to protect the Comptroller & Auditor General's statutory discretion in carrying out his duties.

“The review should focus on the role of the C & AG and his relationship with the NAO, and should cover the role of the NAO's Senior Management Board, whether a separate advisory board would be beneficial, the number of non-executives and the method of their appointment, the method of appointment and reporting arrangements of the Audit Committee, the method of appointment of senior NAO officials, arrangements for determining remuneration, and internal controls, together with any other matters the reviewer or the Commission consider appropriate.”

## 4 Objectives of the governance framework

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13. In my assessment of the extent to which the governance of the NAO complies with best practice and in framing my proposals for improvement, I have taken account of the unique characteristics of the NAO which make it central to the accountability of the public sector.

14. I set out below three objectives which I believe the future governance arrangements should satisfy (I recognise that to some extent these conflict with the current legislative requirements, but propose that new legislation be introduced to give effect to my proposals).

15. A cornerstone of a democratic and open society is the responsibility of government departments and other authorities to use public money in an economic, efficient and

effective way and to be accountable, through Parliament, to the public. The House of Commons Public Accounts Committee (PAC) is the parliamentary body through which this accountability is exercised in the United Kingdom. The PAC is informed in fulfilling this role by the work of the C&AG, as head of the NAO. It follows that the C&AG and the NAO which supports him should be completely independent of Government ministers and their departments.

**16. The first objective of the governance framework is:**

**The C&AG must have the authority to form completely independent judgements about the audits and value for money and other studies conducted by the NAO and the presentation of these to Parliament.**

17. The NAO is a critically important institution in Parliament's control and supervision of expenditure of public money. It derives its authority, currently via the C&AG, from Parliament and, consistent with its independence from government and its critically important role, it should buttress this formal authority with the moral authority which comes from leading by example in its systems of governance, internal and financial controls and principles of transparency. All management and staff of the NAO should be subject to such systems, including the head of the Office.

**18. The second objective of the governance framework is:**

**The NAO must maintain systems of governance and internal controls consistent with best practice, applied in ways which do not fetter its independence from Government, and report publicly on these systems in its Annual Report.**

19. The National Audit Act 1983 confers complete discretion on the C&AG in the discharge of his functions and, in particular, in determining whether to carry out any examination under Part II of the Act and the manner in which any such examination is carried out. As far as the manner in which audits are conducted, I consider that the NAO should be obliged to follow relevant auditing and other professional standards together with prevailing best practice and that any conscious departure from these should be referred to when issuing reports and further summarised in the NAO's Annual Report.

**20. The third objective of the governance framework is:**

**The NAO must conduct its work according to relevant auditing and professional standards and prevailing best practice.**

## **5 Benchmarking the NAO against best practice and practice elsewhere**

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21. The two most relevant sources of best practice guidance are the Combined Code on Corporate Governance applicable to all UK listed companies and HM Treasury's Corporate Governance in Central Government Departments: Code of Practice. I have also looked at the governance arrangements in the devolved administrations in Northern Ireland, Scotland and Wales and in a number of other countries.

## Combined Code

22. The code, which was last updated in June 2006, sets out the main principles and provisions applicable to listed companies under five headings (*italics refer to the provisions of the code*):

### **Directors**

23. *Every company should be headed by an effective board...with a clear division of responsibilities between the Chairman and the Chief Executive.* The NAO is, as stipulated in law, headed by the C&AG. There is no separate Chairman and Chief Executive and no formal board. The C&AG is supported by a Senior Management Board, comprising the C&AG as Chairman, the Deputy C&AG, the seven Assistant Auditor Generals (AAGs) and a non-executive who is also Chairman of the Audit Committee. The Senior Management Board meets quarterly. My discussions with the members of the board (excluding the C&AG) suggest that it does not operate in a fashion similar to a corporate board and makes limited contribution in a practical sense to effective corporate governance. Under the Senior Management Board is a Management Committee, chaired by the Deputy C&AG, which manages the day to day operations of the Office.

24. *There should be a formal, rigorous and transparent procedure for the appointment of new directors and there should be a balance of executive and independent non-executives on the board.* The C&AG is a Crown appointment on a motion of the House of Commons moved following agreement between the Prime Minister and the Chairman of the Public Accounts Committee. There is no limitation on the number of years the C&AG may serve in office. The C&AG can only be removed by a resolution of both Houses of Parliament.

25. There is no formal procedure for either executive or non-executive appointments to the Senior Management Board. Past appointments to the position of AAG have sometimes followed an open competitive process and at other times the individual has simply been appointed. The non-executive member of the Senior Management Board and the two additional non-executives who sit on the Audit Committee have all been appointed with no open competitive process. All appointments are made by the C&G. There is no utilisation of the Code set out by the Office of the Commissioner for Public Appointments. The balance of executives to non-executives on the Senior Management Board is 9:1.

26. *Non-executives should be appointed for specified terms and should be subject to re-election at the end of their appointed term.* The non-executive member of the Management Board and the two additional non-executives who sit on the Audit Committee have all been appointed for a period of three years. However, the terms of two of the three non-executives expired during 2007, yet they have continued in office and have received no communication about their reappointment or otherwise.

27. *The board should undertake a formal and rigorous annual evaluation of its own performance, its committees and individual members.* No such evaluation has been performed by the Senior Management Board. The Management Committee has sought to fill this void by reviewing its performance in 2006 and again in 2007 as part of its review of the performance of the NAO as a whole.

### **Remuneration**

28. *Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully.* In order to reinforce the independence of the C&AG, his salary is pegged to that of a High Court judge and paid out of the Consolidated Fund and so is not charged to the NAO budget.

29. *There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors.* There is no Remuneration Committee at the NAO. The remuneration of the Deputy C&AG and the AAGs is determined by the C&AG.

### **Accountability and audit**

30. *The board should present a balanced and understandable assessment of the company's position and prospects.* The NAO publishes an Annual Report which includes its audited financial statements, a report on the work and contribution of the NAO (including the financial impact of its work) and various statements about the internal operations and controls of the Office.

31. *The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.* The C&AG, as the Accounting Officer, makes a Statement on Internal Control in the NAO's Annual Report. The support for this statement is derived from a bottom up process involving budget holders, the finance function and the Audit Committee.

32. *The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.* The NAO has an Audit Committee chaired by an individual with recent and relevant financial experience. In addition to the non-executives, the Deputy C&AG and an NAO director are also members of the Audit Committee, which, as executives, is contrary to the code.

33. The external and internal auditors routinely attend Audit Committee meetings, although there are no formal meetings with these auditors without the presence of the executive Audit Committee members. The Annual Report sets out a list of Audit Committee responsibilities and activities but does not offer any qualitative assessment or evaluation of the financial reporting or internal controls which may be informed by those activities. The Audit Committee reports through its Chairman to the C&AG and, following concerns over the C&AG's expenses, has a direct line to the Public Accounts Commission.

34. In accordance with the National Audit Act 1983, the external auditors are appointed by the Public Accounts Commission on the advice of a selection panel which included a non-executive member of the Audit Committee. In addition to the financial audit, the external auditors also perform Value for Money (VfM) studies whose scope is agreed by the Chairman of the Audit Committee.

### ***Relations with shareholders and the role of institutional shareholders***

35. There is no parallel for the NAO in respect of these final two headings in the code. The NAO audit and VfM reports on government departments are addressed to Parliament and then discussed with the Public Accounts Committee. The NAO is also increasingly providing support to other Select Committees.

36. The Public Accounts Commission appoints the Accounting Officer (the C&AG) and the external auditors and also examines the NAO's annual Corporate Plan and Supply Estimate.

### **Corporate governance in Central Government Departments: Code of Practice**

37. The Corporate Governance in Central Government Departments: Code of Practice was published in July 2005 and sets a number of principles which it expects Government Departments to apply flexibly in the context of their own circumstances. The code covers three main headings (*italics refer to the provisions of the code*):

#### ***Parliamentary accountability***

38. *Under the Minister, the head of the department, as its Accounting Officer, is personally responsible and accountable to Parliament for the management and organisation of the department, including the use of public money and the stewardship of assets.* Since the NAO is independent of government there is no minister responsible for it. The C&AG is the Accounting Officer accountable to Parliament through the Public Accounts Commission.

#### ***The Board***

39. *Each department should be managed by an effective board which supports the head of the department by advising ministers and taking ownership of the department's performance. The board's membership should have a balance of skills and experience appropriate to directing the business of the department and should include independent non-executive members to ensure that executive members are supported and constructively challenged in their role.* The NAO's Senior Management Board meets quarterly, but its members feel that it is of limited value in supporting the C&AG or maintaining good standards of governance. There are concerns that there is no substantive discussion of major issues, with decisions in effect being taken outside the Management Board meetings. The Senior Management Board only has one non-executive, making it very difficult to effectively challenge the executive and the C&AG in particular.

#### ***Internal control***

40. *The board should ensure that effective arrangements are in place to provide assurance on risk management, governance and internal control. In this respect, the board should be independently advised by: an audit committee chaired by an independent non-executive member and an internal audit service operating in accordance with Government Internal Audit Standards.* There are processes in place through the Director of Internal Assurance, the external auditor and the oversight of the Audit Committee to put the C&AG, as the

Accounting Officer, in a position to make the statements about the NAO's internal controls as set out in its Annual Report. However, the C&AG himself, as a corporation sole and not an employee of the NAO, has not been required to sign the employee Code of Conduct.

## **The devolved administrations**

41. Following devolution of administration different arrangements have emerged in Northern Ireland, Scotland and Wales, as summarised below:

### ***Northern Ireland***

42. The Northern Ireland Audit Office (NIAO) is modelled on the NAO, although there are a number of changes currently being contemplated. In particular, there are likely to be significant changes to the process of how the NI C&AG is appointed.

43. The NI C&AG is appointed by Her Majesty The Queen on the nomination of the NI Assembly. The NI C&AG will be a permanent post with a statutory retirement age of 65. When the NI C&AG position becomes vacant a selection panel will be formed comprising the Speaker (Chairman) of the Assembly, the Chairman and Vice Chairman of the Public Accounts Committee, the Chairman and Vice Chairman of the Audit Committee and the C&AG of the NAO. An open competitive process will be followed and candidates will be assessed against pre-determined criteria established by the selection panel.

44. The NI C&AG is supported by a board, which is in the process of being restructured. The new Senior Management Board will be chaired by him and comprise his deputy and two non-executive members. All members of the board are appointed by the NI C&AG and the selection process is subject to the Code set out by the Office of the Commissioner for Public Appointments. It meets quarterly. There is an Audit Committee comprising the non-executives (one of whom is the Chairman) and two members of the executive. I understand the composition is currently under review with the intention that the non-executives will be in the majority.

### ***Scotland***

45. The Auditor General in Scotland (AGS) is appointed under the Scotland Act 1988 by Her Majesty The Queen on the nomination of the Scottish Parliament. He is appointed for an unspecified period. He can be removed by a vote of two-thirds majority of serving Members of Parliament following a petition. His remuneration is determined by the Scottish Parliament. The AGS has complete discretion in the performance of his function. He employs a small number of direct staff but has access to Audit Scotland and professional audit firms to support him in the performance of his work.

46. Audit Scotland is a corporate body, set up under the Public Finance and Accountability Act, which provides services to both the AGS and the Accounts Commission, which is responsible for appointing auditors of local government. The board of Audit Scotland is chaired by the Chairman of the Accounts Commission and comprises the Auditor General, Deputy Auditor General, one further member of the Accounts Commission and an independent non-executive. The AGS has been appointed the Accounting Officer of Audit

Scotland. The board of Audit Scotland has two sub-committees – a Remuneration Committee and an Audit Committee.

47. The Remuneration Committee, is chaired by a non executive and consists of members of the board who are not employees of Audit Scotland, including the AGS. The Remuneration Committee recommends to the board the compensation of all senior employees of Audit Scotland.

48. The Audit Committee, under Audit Scotland's standing orders, consists of members of the Board who are not employees of Audit Scotland. It currently comprises three members, all of whom are non-executives. The AGS attends the Audit Committee.

## **Wales**

49. The legal framework for the audit of Central Government Departments is similar to that in England in that the Auditor General (AGW) has complete discretion in the discharge of his functions. The one significant difference is that the Welsh National Assembly can fix the period of office at the time the AGW is appointed. The current AGW is appointed for a renewable term of 5 years. The AGW is appointed by the National Assembly and its Audit Committee (equivalent to the Public Accounts Commission) which is required to write to the AGW, on appointment, setting out his duties as Accounting Officer.

50. In addition to auditing Central Government Departments, the Welsh Audit Office (WAO) also has responsibility for appointing auditors of local government, a role carried out in England by the Audit Commission.

51. The AGW has set up an Audit and Risk Management Committee comprising three members external to the WAO. It is empowered to have direct relationships with both internal and external auditors and the Chairman of the Committee has access to the Chairman of the Audit Committee of the Assembly. The Audit and Risk Management Committee members are each appointed by the AGW but selected through open competition and I understand each was previously unknown to the AGW. The Chairman of the Committee is consulted on the pay of senior staff.

52. There is no unitary board comprising both executive and non-executive members. The AGW is supported in the running of the Office by a Management Committee, which he chairs. The AGW has also appointed a Compliance Partner (who is also the Head of Internal Audit) whose activities include regulating WAO staff and the external contracting firms appointed by the AGW. The AGW himself is subject to the internal and financial controls of the Office and the work of the Compliance Partner.

## **Other countries**

53. I have met with the Auditor Generals of Canada and Sweden and reviewed the arrangements in a number of other countries. Broadly, there seem to be two distinct approaches to the audit of public money.

54. The first is similar to the arrangements in the UK, with wide discretions conferred on the Auditor General who is personally and directly responsible to the legislature, but with many different approaches in the detail of how the Auditor General chooses to organise the governance, leadership and management of their Office. In Sweden there are three Auditor Generals with each having equal powers. Most major economies have a fixed term of appointment which generally is not renewable, although those which have shorter durations (such as 5 or 6 years) may be renewed.

55. The second approach, which is more prevalent in mainland Europe, places the authority to inspect the proper use of public money on a specific division of the Judiciary. The responsibility is for the Courts to be satisfied that the annual budget of public expenditure has been incurred in accordance with the budget law passed by the legislature.

## 6 Proposed future governance framework

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56. There is in my view an overwhelming case for strengthening the governance of the NAO. I have considered three approaches to resolving the shortcomings in the present arrangements.

57. First, maintaining the powers and authorities set out in the National Audit Act 1983 whereby the C&AG has complete discretion over all matters related to the work, operation and governance of the National Audit Office, but with the Public Accounts Commission setting out clear expectations about standards of governance in making the appointment of the next and subsequent C&AGs. This could be in the form of a transcript of Commission meetings or a letter from the Chairman of TPAC to the C&AG at the time of his/her appointment. Much of what I believe needs to change could be accomplished by a C&AG who without the force of law wishes to maintain governance in practice of the highest standards. While this approach would not require primary legislation, I believe it has a number of shortcomings. TPAC may feel concerned that they do not have the necessary expertise in governance matters to clearly establish such expectations. Also, subject to refinements for emerging best practice, there should be institutional continuity in the governance arrangements and not major changes coinciding with a change in C&AG. In addition, preserving the present arrangements would continue to place the responsibility for appointments of non-executives solely with the C&AG and runs the risk that the C&AG may over time pay less attention to the governance framework given the complete authority vested in him as an individual.

58. Second, transferring the complete authorities from an individual (the C&AG) to a corporate body. This body would be represented at Parliamentary Committees by its Chairman and/or Chief Executive. This would provide a robust framework for the shortcomings in the governance of the NAO to be addressed. However, I consider it has one fatal flaw; that the responsibility for making audit judgements would be determined by the board (perhaps by delegation to individuals or sub-committees) and ultimately the accountability for those judgements would rest with the board, rather than the responsibility for audit judgements and the accountability for them being conferred on an individual by statute as is presently the case. It is a long established practice that audit opinions are best formed by individuals (for example individual partners in professional

accounting firms) using their professional experience and judgement, often following consultation with senior colleagues. In the context of the NAO, I believe it would be a dilution of the Auditor General's responsibility for him to derive his powers from the board rather than directly from Parliament.

59. The third and my proposed governance framework is to combine the best of the above two approaches. The essence of my proposal is to preserve the discretion of the C&AG in forming audit judgements and communicating these to Parliament, while putting in place formal and institutionalised processes for the governance, leadership and management of the office, including the C&AG.

60. I recommend the following:

61. A new corporate body should be formed (The National Audit Office) to carry out financial audits, Value for Money studies and such other work as its board may decide is consistent with its objectives and responsibilities. The Chief Executive of the Office, who would be styled the Comptroller and Auditor General, would continue to have sole discretion over all judgements about financial audits and Value for Money and other studies and also the form and tone of presentation of all reports to Parliament. I am not aware of the background to the C&AG being an Officer of the House of Commons and feel it is a matter for Members of Parliament to consider whether this should continue in the event that my proposals for changing the governance of the NAO are taken forward. It would be consistent with past practice and, in my view appropriate, for the Chief Executive to be appointed by the Public Accounts Commission as the Accounting Officer of the NAO.

## **The Chief Executive**

### ***Period of appointment***

62. The Chief Executive would be appointed for a single, non-renewable, term of 8 years. It is clear to me that the position should have a fixed term and that the length of this term should on the one hand give the incumbent time to settle into the role and to become a strong and effective leader of the Office, while on the other hand mitigating the risk that the Office becomes too closely associated with the personality of the Chief Executive over the longer term. I also believe that refreshing the leadership of an organisation such as the NAO from time to time enables it to continually improve its performance and contribution. Many other countries have fixed, non-renewable terms for their Auditor Generals, ranging from 5 years in Norway to 15 in the United States. It seems to me that the term for the Chief Executive of the NAO should be at the shorter end of this spectrum, although I think, given the complexity of the role and the reliance Parliament places on the judgements of the C&AG, that 5 years is too short a period. It is also clear to me that there should be no question of the Chief Executive seeking reappointment, which either in reality or perception may compromise his judgements as the possible renewal of his term approaches.

### ***Appointment process***

63. Like the C&AG in the present arrangements, the Chief Executive of the NAO would hold a unique position in assisting Parliament to hold Government Departments accountable for the efficient and effective use of public money. It therefore remains essential in my view that the appointment of the Chief Executive is made by the Crown following approval by the House of Commons, where the motion is moved by the Prime Minister with the agreement of the Chairman of the Public Accounts Committee (who according to convention is a member of the Opposition). To give credibility to the independence of the position of Chief Executive, the nomination must receive cross-party support. However, improvements do need to be made in the way the candidate presented to Parliament for approval and Her Majesty for appointment is selected. In particular the principles set out in the Code of Practice published by the Office of the Commissioner for Public Appointments should be followed.

64. I would advocate a Nominations Committee being formed whose membership would include the NAO Chairman and an Independent Assessor. Identifying candidates should be an open and transparent process including public advertising and specific searches for potentially suitable candidates. The criteria for the Chief Executive should be determined by the Nominations Committee. While it is not in my terms of reference to advise what the criteria should be, based on my observations during this review and my professional experience, it seems to me that the criteria should include (a) experience of auditing large complex organisations; (b) experience in successfully leading large organisations through change; (c) knowledge and experience of the public sector; (d) evidence of a strong independent mind and an ability to take decisions; and (e) strong influencing and communication skills.

### ***Responsibilities***

65. The Chief Executive would be responsible to Parliament for the audit opinions and other reports he issues and would be responsible to the Board of the NAO for the proper running of the Office. He would be subject to the professional standards and systems of internal and financial controls determined by the Board.

### ***Remuneration***

66. To reinforce the independence of the C&AG from Government, the current C&AG's level of remuneration follows that of a High Court judge and is paid out of the Consolidated Fund. While I can see that this achieves the objective of independence, I do not believe it benchmarks the position of Auditor General against the appropriate peer group in seeking to attract high quality candidates to the position. I would favour the Chief Executive's remuneration being set by the Public Accounts Commission based on advice by the non-executive members of the NAO Board, which itself would take advice from its Remuneration Committee. The Remuneration Committee would provide an evaluation of the performance of the Chief Executive in the management and leadership of the office and should seek expert external advice on relevant benchmarks in both the public and private sectors.

## **Restrictions**

67. The Chief Executive should not be allowed to take up any external paid employment without the explicit agreement of the Public Accounts Commission.

## **The Chairman**

68. I propose that the Chairman be a Crown appointment following approval by the House of Commons, where the motion is moved by the Chairman of the Public Accounts Commission with the agreement of the Chairman of the Committee of Public Accounts.

69. The Chairman, which would be a non-executive position, would be remunerated for working the equivalent of two days per week. I suggest the Chairman be appointed for a period of three years, subject to one term renewal.

70. He would be responsible for leading the board and its effectiveness in discharging its responsibilities. I would expect the Chairman to maintain relationships with key stakeholders and to provide evidence to the Public Accounts Commission in its oversight of the NAO. The Chairman should be sufficiently informed to be able to provide advice, if requested, to the Chief Executive in the exercise of his personal responsibility to form audit judgements.

## **The NAO Board**

### **Status**

71. The board should not be part of the Crown. It should employ its own staff who should not be Civil Servants or officers or employees of the House of Commons.

### **Composition**

72. The board would be a unitary board comprising both executive and non-executive members, but with a majority of non-executives, one of whom would be the Chairman. There would be fewer executives on the board than are currently on the Senior Management Board. I propose that the board be composed of eleven people, as follows:

- Chairman
- Chief Executive
- Chief Operating Officer (responsible for finance, human resources, technology, operations)
- 2 further executive directors (who could be styled Deputy Auditor Generals or Managing Partners with perhaps one being responsible for financial audits and one for Value for Money studies, depending on how the Chief Executive decides, with the board's support, to organise the Office)
- 5 non-executive directors
- Chairman of the Audit Commission

73. A non-executive director would not be an employee of the board, but would be subject to the internal standards and code of conduct.

74. In Section 7 I have discussed the relationship between the NAO and the Audit Commission. It is in the public interest that there should be closer and more formal contact, collaboration and cooperation between these two bodies. I propose that the Chairman of the NAO should sit *ex-officio* on the Audit Commission and that the Chairman of the Audit Commission should sit *ex-officio* on the board of the NAO.

### ***Role of the NAO Board***

75. The role of the board would be to oversee the activities of the NAO, but not to form judgements on individual engagements, which would be reserved to the sole discretion of the Chief Executive in a personal capacity. I anticipate the functions of the Board would include:

76. **Setting the strategy of the Office.** For example the board would consider the overall balance of work between its core responsibility for financial audits and Value for Money studies of central government departments and other assignments where it may be required to enter competitive tenders, such as overseas work and, from April 2008, audits of UK companies in which the Government has an interest. The strategy would also include setting the criteria and parameters for the balance of work between that performed in-house and that contracted out to third parties.

77. **Establishing the priorities of the Office** on an annual basis and publishing a work plan on which it would invite comment from interested parties. Of course it might be necessary to reprioritise work during the year as events require and as the Public Accounts Committee may propose. The Chief Executive would select and perform engagements which are consistent with the board strategy and would discuss with the board other work he considers important in the light of circumstances. I believe that for the board to be effective and to take the appropriate responsibility for the governance of the NAO it should determine the overall strategy and allocation of resources to general areas of activity.

78. **Supporting the Chief Executive** by providing appropriate resources for him to carry out his responsibilities.

79. **Overseeing the proper implementation** of domestic and international standards of auditing in the conduct of financial audits and Value for Money studies.

80. **Approving the systems of internal and financial controls** to be applied throughout the Office and the oversight for the monitoring of the proper implementation of such controls by the Director of Internal Assurance and the Audit Committee of the board.

81. **Approving the annual budget submitted to the Public Accounts Commission** for their consideration. As a public body, the NAO should be under a legal obligation to conduct their affairs in an economic and efficient manner.

82. **Evaluating the risks faced by the NAO** and the mitigating steps taken, including risks to its reputation.

83. **Approving policies related to human resources** such as personal objective setting, code of conduct and reward. Specifically the board should establish transparent processes over the appointment and remuneration of senior staff. The board should delegate responsibility for making recommendations about the remuneration of executive directors and the framework for rewarding other senior staff to a Remuneration Committee.

84. The board should report on its work in the NAO's Annual Report in accordance with the Combined Code.

### ***Appointment of board members***

85. Non-executive board members should be appointed by the Chairman and perhaps be confirmed by the Public Accounts Commission. The Chief Executive should be the major influence over the selection of executive board members with the appointments being made jointly by the Chief Executive and the Chairman. There should be a selection process in accordance with the principles set out in the code of practice by the Office of the Commissioner for Public Appointments. A nominations committee should be formed, chaired by the NAO Chairman (in the case of non-executives) or the Chief Executive (in the case of executives) and include a suitably experienced individual appointed to the committee by the Public Accounts Commission and an independent assessor.

86. Non-executive and executive directors should be appointed to the board for a period of 3 years. Non-executive members could be reappointed to serve a second and final term. Executive directors could be reappointed for a number of terms without limitation, subject to meeting appropriate performance standards.

### ***Audit Committee***

87. The audit committee should be formed of only non-executive directors. Executive directors and other senior staff may be invited by the committee chairman to attend and the committee should, from time to time, hold meetings with the internal auditor and external auditor without the presence of management. As is presently the case, the audit committee should have responsibility, following consultation with management and other relevant parties, for the scoping of Value for Money studies conducted by the external auditors.

### ***Remuneration Committee***

88. A remuneration committee of the board should be formed comprising only non-executive members. It should approve the objectives of the executive directors and evaluate their performance annually against those objectives based on the input of the Chief Executive. It should commission research on the remuneration of peer positions in other organisations in order to determine benchmark levels and advise the board on the remuneration of the executive directors.

### ***Appointment of external auditors***

89. Presently, the external auditors are appointed by the Public Accounts Commission following a process managed by the NAO procurement function. I propose that with a

more robust and legally enforceable governance structure in place, the selection of the external auditors should be led by the audit committee. The audit committee would recommend a firm to the board who, if they agreed, would appoint the firm. Consideration should be given to the Public Accounts Commission approving the auditor's appointment in the same way as shareholders approve the appointment of their company's auditors at an Annual Meeting.

## 7 Relationship between the NAO and the Audit Commission

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90. The NAO and the Audit Commission have distinct mandates. The NAO is responsible for supporting the C&AG in his audit of central government departments, whereas the Audit Commission appoints auditors to audit local government with the appointed auditors having powers independent from the Commission.

91. However, as national and local government bodies work more closely on the delivery of public services it is evident that these mandates will become less distinct and the NAO and the Audit Commission will need a greater degree of collaboration and partnership. There are an increasing number of examples where this is happening:

- NAO participation on the Audit Commission's Comprehensive Area Assessment Strategy Board.
- Joint audit reports on areas such as the finances of the NHS and the delivery chains for Public Service Agreements.
- The coverage of the recent report "Staying Afloat" which dealt with local authority costs related to the floods last summer, but also addressed the value for money of different government grant schemes.

92. In addition, as the government accounts move to International Financial Reporting Standards (IFRS), it is essential that the responsible audit bodies are able to reach common views on the interpretation of IFRS.

93. It has been suggested that consideration should be given to merging the two audit bodies. The arguments I have heard for and against include:

### **For**

- Cost savings secured through the benefits of scale and synergies.
- A single identity for the organisation responsible for the audit of public money in the UK (I am told there is much confusion between the NAO and the Audit Commission, even among the better informed).
- A single, unambiguous approach to policy development.
- Improved consistency and quality through better sharing of knowledge and intellectual capital.

## Against

- There is no empirical evidence which suggests the current divide in responsibilities is operating against the public interest.
- The constitutional background and the lines of accountability for the audit of central government and local government are, properly, quite different and could become unclear if one body was responsible for both.
- There will be a substantial challenge for the leaders of a merged organisation in bringing together the different cultures and professional backgrounds of the people in the two organisations, which might divert focus from its formal responsibilities.

94. The question of whether a merger of the two bodies should be pursued is beyond my Terms of Reference. I support the need for closer collaboration both at a working level and board level and I have proposed an exchange of Board/Commission membership. It seems to me that pursuing a merger now would slow down the governance reforms necessary at the NAO while the public policy case for a merger is formulated and what would most likely be complex legislation passes through the parliamentary process. My personal view is that it would be better to put the structure of the NAO on a firmer footing, continue to strengthen relationships between the two organisations and then evaluate in (say) 6 years the cost effectiveness of maintaining the divided structure against moving to a single body.

## 8 Other comments

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### Role of TPAC

95. My proposals suggest a slightly more onerous workload for the Public Accounts Commission. It will be important to ensure that the Commission has the necessary support to be able to discharge adequately its wider responsibilities.

### Transitional issues

96. I have proposed a set of governance arrangements in steady state. There will be many issues to consider in the transition from the present position to the new arrangements, if they are approved by Parliament. A particular issue concerns the appointment of the first Chief Executive, since Parliament may wish to move to appoint a longer-term successor to the current C&AG before the legislative process is complete and the NAO Chairman has been appointed.

### Mexico declaration

97. The International Standards of Supreme Audit Institutions (ISSAI) has set out eight principles for the independence of national auditors (the “Mexico Declaration”). I have compared my proposals against these principles and consider that they would be in compliance.

## List of Interviewees

Sir Brian Bender – Permanent Secretary (Department for Business, Enterprise and Regulatory Reform)  
Bob Black – Auditor General - Scotland  
Steve Bundred – Chief Executive (Audit Commission)  
Tim Burr – Deputy Comptroller & Auditor General (NAO)  
Chris Cairns – Tenon (NAO external auditor)  
Gaby Cohen – Assistant Auditor General (NAO)  
Jeremy Colman – Auditor General – Wales  
Sir Michael Davies – non-executive – NAO Audit Committee  
Paula Diggle – HM Treasury  
John Dowdall – Auditor General - Northern Ireland  
Sheila Fraser – Auditor General – Canada  
Steve Freer – non-executive – NAO Audit Committee  
Christine Freshwater – non-executive – NAO Audit Committee  
Ed Humpherson – Assistant Auditor General (NAO)  
Mary Keegan – HM Treasury  
Wendy Kenway-Smith – Assistant Auditor General (NAO)  
Edward Leigh MP – Chairman (Public Accounts Committee)  
Karin Lindell – Auditor General – Sweden  
Nick Macpherson - Permanent Secretary (HM Treasury)  
Caroline Mawhood – Assistant Auditor General (NAO)  
Sir Gus O’Donnell – Cabinet Secretary and Head of the Home Civil Service  
Michael O’Higgins – Chairman (Audit Commission)  
Jim Rickleton – Assistant Auditor General (NAO)  
Sir Michael Scholar –Chair of the Statistics Board  
Martin Sinclair – Assistant Auditor General (NAO)  
Michael Whitehouse – Assistant Auditor General (NAO)  
Rt Hon Alan Williams MP– Chairman (Public Accounts Commission)

## List of Written Submissions<sup>1</sup>

Gurmaj Dhillon  
Dr Nigel Dudley  
Prof David Heald  
K P Joseph  
Dudley Lashmar BA(Econ) FCA  
Rt Hon Theresa May MP (Audit Committee, House of Commons)  
New Local Government Network

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<sup>1</sup> Multiple submissions were sent in by some of the individuals listed.