FILE NUMBER

70-CH/NL/0704 PART A

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FILE BEGINS 9/11/1987

ENDS 26/07/1989

FILE TITLE

NATIONAL AUDIT OFFICE / AUDIT COMMISSION 5/11/87 - 9/12/88

PAC 16/9/88 - 24/4/90

1/2

LT4.22

cc PS/FST
PS/MST
Mr A Wilson
Mr Monck
Mr Moran
Mr Beighton-IR
PS/IR.

KHCES → TURNER MINUTES OF MEETING 14/5/86

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

14 May 1986

John Turner Esq
Private Secretary to the
Secretary of State for Employment
Caxton House
Tothill Street
LONDON SW1

Dear John

DEREGULATION WHITE PAPER

The Chancellor held a meeting this morning to discuss the outstanding unresolved issues for the White Paper. Your Secretary of State was present, with the Paymaster General; as was the Secretary of State for Trade and Industry, with Mr Howard; together with the Financial Secretary. Also present were Mr Wilson (head of the Government Accountancy Service), Mr Warry (No 10 Policy Unit) and Mr Brownlee (Deregulation Unit).

Accounting and Audit Requirements

It was agreed that the statutory audit requirement should remain for all companies, but to look at ways of reducing the administrative burden of the requirements on smaller companies. The White Paper should include a passage on these lines, and should go on to mention the discussions the Inland Revenue were already holding on disincorporation.

VAT Penalties

Ministers very briefly discussed the choice between options A, B and C for the form of words on VAT penalties. It was agreed that we should try for something between options B and C. Option B as it stood had the wrong flavour - it suggested that there was something wrong with the balanced package that had only been introduced after full consultation. All it should suggest is that of course the Government was willing to review the way the new rules worked out in practice.

Next Steps

Your Secretary of State undertook to circulate revised draft passages for the White Paper on both these subjects. The drafts should go to the Financial Secretary, Treasury and to Mr Howard, DTI. They would need to be cleared during the course of today.

I am copying this letter to David Norgrove (No 10) and to John Mogg (DTI).

Yours ever

Tony

A W KUCZYS
Private Secretary

CONFIDENTIAL
NOT FOR NAO EYES

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBERT ARMSTRONG

I have shown the Prime Minister your minute of 5 November in which you seek her authority to send to the Comptroller and Auditor General a letter about the National Audit Office (NAO) access to Cabinet papers, a draft of which was attached to your minute.

The Prime Minister has no hesitation in agreeing that you, and Sir Peter Middleton, should send the Comptroller and Auditor General the letters which are attached to your minute provided, of course, the other ministers concerned are similarly content. She believes it particularly important to have the Attorney General's assurance that the approach in the letters is soundly based in law.

I am sending a copy of this minute to Mr. Allan (H. M. Treasury), Mr. Wood (Lord Privy Seal's Office) and Mr. Saunders (Law Officers' Department).

N. L. W.

N. L. WICKS

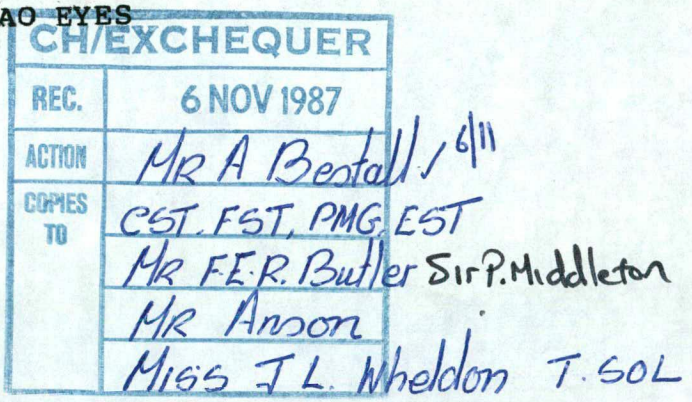
6 November 1987

CH/EXCHEQUER
REC. 6 NOV 1987 6/11
ACTION MR A BESTALL
COPIES TO CST FST PMGEST
SIR P. MIDDLETON
MR FERBUTLER
Mr Anson
Ms J. Whelan (T. Sol)

CONFIDENTIAL
NOT FOR NAO EYES

CONFIDENTIAL

NOT FOR NAO EYES



Ref. A087/3179

MR WICKS

The Comptroller and Auditor General has been trying for some months to assert a right of access to Cabinet papers (not minutes) and Treasury documents that he may reasonably require for the purpose of his examinations.

2. We are advised that we could not deny him the right of access to Cabinet documents or Treasury letters held on the files of the departments under examination (except in so far as they are addressed to "the merits of policy objectives", which the Comptroller and Auditor General is specifically excluded from examining), but that he has no right of access to any Cabinet documents or Treasury documents which are not in the custody or control of the departments under examination (ie are held in the Cabinet Office or the Treasury).

3. Sir Gordon Downey has now invited Sir Peter Middleton's and my comments on the draft of a note which he proposes to send to the Public Accounts Committee on this matter. I attach a copy of his draft note, and of the drafts of the letters of comment which Sir Peter Middleton and I propose to send in reply. These draft letters are being agreed with the Treasury Solicitor and are being shown to the Chancellor of the Exchequer.

4. I think that you, the Lord Privy Seal and the Attorney General should be aware of these drafts, since we are embarking upon a course which could lead to a clash with the Public Accounts Committee about the Comptroller and Auditor General's right of access to papers in the custody and control of the Cabinet Office and the Treasury.

NOT FOR NAO EYES

CONFIDENTIAL

RTAAES

5. Sir Gordon Downey is now pressing for our answers; I have promised that he shall have them on Monday 9 November.

6. I am sending copies of this minute and the attachments to the Private Secretaries to the Chancellor of the Exchequer and the Lord Privy Seal and to the Legal Secretary to the Law Officers.

RA

ROBERT ARMSTRONG

5 November 1987

RTAAES

DRAFT

ACCESS BY THE NATIONAL AUDIT OFFICE TO CABINET OFFICE AND TREASURY DOCUMENTS FOR THE PURPOSES OF ECONOMY, EFFICIENCY AND EFFECTIVENESS EXAMINATIONS

Note by the Comptroller and Auditor General

Background

1. Before taking evidence on the EH101, the Committee should, perhaps, be aware of a long-standing difference of view between the NAO and the Treasury (and more recently the Cabinet Office) over the rights of access to documents. The position has never been properly resolved although it has normally been possible to make adequate ad hoc arrangements to enable the NAO to complete its enquiries satisfactorily. This is not so in the case of the EH101 investigation and the Committee may wish to consider whether they are content with this situation.

Statutory provisions

2. Sections 6 and 7 of the National Audit Act 1983 empower me to carry out examinations into the economy, efficiency and effectiveness with which audited bodies have used their resources in discharging their functions. Section 8 gives me a right of access to such documents as I may reasonably require for carrying out these examinations, limiting this to documents in the custody, or under the control, of the body to which the examination relates.

3. The Treasury and the former MPO have accepted that I should have full access to their papers relating to the performance of their direct executive responsibilities as spending departments. They have also in the past allowed my staff access to papers concerned with executive co-ordinating functions, such as overall manpower control and the financial management initiative.

4. In carrying out investigations into other departments' activities, I would expect to see copies of correspondence with central departments, in particular the Treasury, on departmental files. I would not normally expect to examine the Treasury's internal papers concerning those activities, as my reports are generally focussed on departmental matters for which individual Accounting Officers are responsible. It could blur lines of accountability to make use of information not available to the Accounting Officer.

5. However there may be occasions when I do see a need to examine the direct executive responsibility exercised by the Treasury relating to the approval of major items of expenditure such as Defence or other capital projects; and also where the Treasury's role is to ensure that the financial consequences of expenditure proposals are fully brought out in departments' expenditure proposals put to Ministers for approval. It seems to me desirable that I should be in a position to examine the effectiveness with which the Treasury carries out its own approval function. And if examination of departmental papers leaves me in any doubt whether all relevant financial information has been fully disclosed to Minsiters, there is also a case for access to Treasury papers to establish whether the Treasury has exercised this function properly. These considerations apply in the case of the EH101.

Access to Cabinet Papers

6. In the past, I have not requested access to papers held by the Cabinet Office, since Departmental files have usually provided sufficient assurance that Ministers have been fully informed and that their approval has been obtained. I have taken the line that I do not need to have access to Cabinet Minutes since the NAO is not concerned with Ministerial differences of view and since I recognise the force of the arguments in favour of the confidentiality of Cabinet or Cabinet Committee discussions. In practice, my staff have often seen on departments' files copies of the departmental submissions to the Cabinet (or approved drafts) as well as the note recording the Cabinet's decision. But this was not the case with the EH101.

7. I still think it unnecessary to seek access to Cabinet Minutes. However, it seems to me that under the Act I do have a right of access to copies of departmental submissions to the Cabinet (or approved drafts) where these are retained on departmental files; and in those very rare circumstances when there is still doubt about the scope and accuracy of the information put before Ministers, as with the EH101, it would be reasonable for me to request access to those Cabinet papers, as such, containing Ministerial proposals even if they are not on departmental files. And I need, of course, to see satisfactory evidence of the terms of any Cabinet decision relating to the approval of substantial projects or programmes of expenditure.

EH101

8. Following our examination of MOD and DTI files, we concluded that there were certain relevant questions which could not be answered from those sources. In particular we could not be sure that Ministers were

fully informed in reaching their decisions. Any failure so to inform them would, of course, reflect on the efficiency and effectiveness with which Departments (including the Treasury) had used their resources in discharging their functions.

9. The information we required was as follows:

(i) Whether MOD's assessment of the number of aircraft needed to meet the Naval Staff requirement had been fully disclosed to Ministers;

(ii) Whether the Treasury, through their membership of an MOD Committee (and given their role of identifying the full financial consequences) had been aware of any doubts about the stated requirement;

(iii) Whether MOD had fully disclosed to Ministers their reservations about Westlands' viability and technical competence.

Some of this information would clearly be available from Treasury documents but for the rest, the most authoritative source would seem to be the Cabinet and Cabinet Committee papers which had been presented to Ministers. The NAO therefore sought access to the relevant Treasury and Cabinet Office papers. This was refused.

Treasury and Cabinet Office response

10. Both the Treasury and the Cabinet Office explained to me that their refusal of access had regard to a long-standing convention under which they did not give the predecessor of the NAO, the Exchequer and Audit Department, access to their papers. They understood that the 1983 Act was intended not to change existing

practice in this respect but to underwrite that practice with proper legislative provision. They believed this to have been accepted at the time both by those who sponsored the Bill on which the Act was based and by those who spoke for the Government. The two Departments considered that the provision of the Act restricting my access to those documents "reasonably required" for carrying out value for money examinations needed to be interpreted against the background of existing and long-standing custom and practice.

11. The Treasury also argued:

(i) that any access to their internal papers would tend to obscure the accountability of departments, who would not have access to the same information; and

(ii) that they did not believe there was, in respect of this project, a Treasury function which could appropriately be the subject of an examination under section 6(1) which restricts my value for money examinations to the way Departments have used resources in discharging their functions. Accordingly, they did not consider that access to Treasury papers could reasonably be required under section 8.

12. In addition, the Cabinet Office stated that:

(i) Cabinet and Cabinet Committee papers were concerned with formulating and deciding policy objectives and that it was important for discussions at this level to be protected so that the ability of Ministers to discuss policy issues freely was preserved.

(ii) in their view the NAO's proper concern would be confined to matters of propriety and value for money in the execution of policies adopted by Government and that the appropriate and authoritative sources of information about those objectives were the relevant documents held by the Department concerned.

(iii) also in their view NAO examination of information about how policy objectives had been formulated implied an examination of the merits of the objectives which, under section 6(2) of the Act, I was not entitled to question.

NAO's position

13. As I have acknowledged in paragraphs 4, 6 and 7, I accept the strength of the principles underlying these arguments. However, in my view, the arguments are not directly applicable in this case. My main objectives in asking to see the relevant Treasury documents and departmental submissions to the Cabinet (not the Minutes of Cabinet discussion) would be to ensure that Ministers have been fully informed and to examine the effectiveness with which the Treasury have exercised their function of approving major items of expenditure. (And the Treasury's argument that they do not have a direct executive responsibility in this area seems to conflict with their evidence of 22 June 1982 to the Select Committee on Procedure (Finance) - HC 24 of 1982-83.)

14. On the matter of the provisions of the National Audit Act, our legal advice is that the definition of "reasonable" access to documents must be determined according to the wording of the Statute (paragraph 2) and not by any restrictions based on past practice presumed to be in the minds of its original sponsors.

But even if this more restrictive interpretation were true, it would not be correct to say that the Exchequer and Audit Department or NAO staff had not previously sought or obtained access to Treasury or Cabinet documents.

Consequences

15. The response from Treasury and Cabinet Office seems to impose constraints not envisaged by legislation or established by past precedent. It does not enable me to provide Parliament with full assurances on the questions arising on the EH101. And the lack of clarity as to what constitutes a direct executive responsibility on the part of the Treasury may underline Government's recent rejection of PAC's proposal that the PESC System should be subject to my review. In that case, too, it seems to me that there is a legitimate distinction between the operation of the system so that it provides Ministers with clear and reliable information (which is an executive responsibility) and the consideration by Ministers of that information (which is not).

16. In the circumstances I have described I consider it reasonable for me to see Treasury and Cabinet papers in order that my Reports to Parliament may be fully informed. But the issues involved are not clear-cut, and I would be grateful for the Committee's views.

National Audit Office September 1987

DRAFT LETTER TO: Sir Gordon Downey KCB
National Audit Office

COPIES TO: Sir Robert Armstrong GCB CVO
Cabinet Office

P K Levene Esq
Chief of Defence Procurement
Ministry of Defence

NAO ACCESS TO TREASURY PAPERS

David Myland wrote to me on 16 September enclosing a draft note which you are proposing to put to the PAC.

It will not surprise you, following my letter of 3 April, to learn that I do not accept that the issues covered by your note arise out of the EH101 case. Nor do I think that the arguments are fairly presented. My comments below relate to the paragraphs in the draft note.

Paragraph 1

I do not agree that there has been a "long-standing difference of view" between the NAO and the Treasury. The long-established convention has been that the NAO has not had access to Treasury papers of the kind at issue. It is only recently that the NAO has sought to change this.

I definitely do not agree that in the EH101 case NAO were unable to complete satisfactorily any appropriate enquiries.

Paragraph 2

This paragraph should include a reference to the fact that Sections 6 and 7 specifically do not entitle the C&AG to question the merits of policy objectives.

Paragraph 5

I do not accept that the C&AG can, as part of an investigation into the activities of another department in relation to an individual project, consider the role of the Treasury in approving expenditure on that project. Viewed in this context, Treasury approval is part of the Government's procedure for coming to a decision on the policy represented by the expenditure proposal. I can see no justification whatsoever for confusing the investigation of the way in which the spending department has carried out its functions for the sake of obtaining further information about the formulation of policy objectives. The merits of these objectives are of course, as I have noted under paragraph 2, a matter which the C&AG cannot investigate.

As far as the presentation of all relevant financial information is concerned, this is the responsibility of the departmental Accounting Officer. Any contribution which the Treasury may make is not an appropriate subject for NAO audit in an individual case.

Paragraph 8

Here again I would not accept that what information the Treasury did or did not present to Ministers is a matter for NAO audit in the context of an investigation of an individual project within the responsibility of a departmental Accounting Officer.

Paragraph 9

As will be clear, I do not agree that the information described in (i), (ii) and (iii) is relevant to the NAO audit. In any event, it seems to me that all the relevant information has been made available to NAO on MOD files and the correspondence with NAO on the EH101 report. In particular, sub-paragraph (ii) seems to take no account of my letter of 10 April. (Incidentally, as I pointed out in that letter, the Treasury does not have "membership" of the MOD Committee).

Paragraph 10

This paragraph will need re-drafting if a note in anything like this form goes forward. For example, it is not appropriate to say merely that the Treasury (and Cabinet Office) "understood" that the 1983 Act was intended not to change things or that the departments "believed" this to have been accepted at the time. As you well know, this was the basis on which agreement was reached with the Bill's sponsors and the insertion of the word "reasonably" was intended to reflect this. Reference would need to be made to the Chief Secretary's statement in Standing Committee C on 30 March 1983 that the relevant new clause did not seek to embody any change in the present practice and that the sponsor of the Bill was so satisfied. I should also wish to see a quotation from your letter of 29 December 1983, where you said that you did not expect the Act to have any significant effect on working relationships between NAO staff and audited departments and that you did not envisage any change in the scope or nature of the NAO's VFM work.

Paragraph 13

I have already indicated that I do not agree that Treasury documents are relevant to an enquiry into whether Ministers were properly furnished with information in an individual case within a departmental Accounting Officer's responsibility; or that in such a case the process of Treasury approval is a proper subject for NAO audit. I hope I have also already made clear that there is no conflict in my view between what is properly subject to C&AG audit and the Treasury evidence of 22 June 1982 to the Select Committee on Procedure (Finance).

Paragraph 14

The point needs to be injected here that, since this is a Parliamentary issue, the intentions of Parliament in 1983 are highly relevant, notwithstanding any legal advice which the NAO may have received about the definition of "reasonable" access.

I am not aware of any cases relevant to the present debate in which E&AD or NAO staff have sought and obtained access to Treasury papers. Before I can comment on this assertion I need to have details of the cases which you have in mind.

Paragraph 15

As is clear from the above, it is factually incorrect to say that the Treasury response imposes constraints not envisaged by legislation or established by past precedent. Nor, as I have said, do I agree that NAO were inhibited in any way in carrying out their responsibilities to Parliament on the EH101. Nor is there any lack of clarity as to the Treasury's responsibilities. The explanation I have given you on this is wholly consistent with the rejection of the proposal that the PES system should be subject to NAO review. In both cases the Treasury's role is essentially concerned with the formulation of policy and not with its implementation.

General

I would like to repeat two things. First, the accountability issue raised by the EH101 case, so far as the Treasury is concerned, is that MOD's Accounting Officer should be answerable to the PAC only on the basis of information available within his own department. It is only because you have sought to depart from that fundamental principle that the other matters raised in your note with which I take issue arise. Second, I am not of course seeking to deny the NAO access to the Treasury, simply to confine that access to long established practice. There are, as both you and the PAC know, numerous examples of NAO investigations into the discharge of our responsibilities and the use of our resources which do not infringe these conventions.

I am copying this letter to Robert Armstrong and Peter Levene.

[PEM]

Draft of 5 Nov. 1987

DRAFT LETTER FROM SIR ROBERT ARMSTRONG TO

Sir Gordon Downey KCB
Comptroller and Auditor General
National Audit Office
Buckingham Palace Road
SW1W 9SP

NAO Access to Cabinet Papers

David Myland wrote to me on 16 September, enclosing the draft of a note which you are proposing to put to the PAC.

2. I have seen Peter Middleton's reply to you, and I fully endorse all his general comments on the draft note. In particular, I do not accept that the issues covered by your note arise out of the EH101 case, or that that case is to be regarded in this context as in some sense exceptional. Nor do I accept that the refusal to grant access has made the NAO unable to complete successfully any appropriate inquiries.

RTAAEL

3. My specific comments are largely concerned with the arguments relating to Cabinet papers. Like Peter Middleton, I regret to say that I do not consider that my arguments are fairly presented. My particular concerns are with paragraphs 6, 7, 8, 9, 12, 14 and 15 of the draft note.

Paragraphs 6 and 7

4. These paragraphs state that "my staff have often seen on Departments' files copies of the departmental submissions to the Cabinet (or approved drafts)" and "under the Act I do have a right of access to copies of departmental submissions to the Cabinet (or approved drafts) where these are retained on departmental files".

5. Subject to my comments below on paragraph 14 of your draft, I would regard any access to documents on departmental files concerning advice to Ministers about particular policy proposals (eg near final drafts of Ministerial papers for Cabinet) as being at the discretion of the Departments concerned, in recognition of the fact that sight of these documents may well be helpful to NAO staff in their examination of the

implementation of the resultant policy. But access could not have been given on the basis that this information - part of the policy making process - is itself subject to examination. As I said in my letter to you of 18 February 1987, I do not accept that you have a right to obtain information about how policy objectives have been formulated.

6. I am glad that you do not seek access to Cabinet or Cabinet Committee minutes. I have to say that I do not think that you have any right of access, or can reasonably require access, to departmental memoranda to the Cabinet or Cabinet Committees held in the Cabinet Office or the Treasury, or indeed in any other department than that which is the subject of a particular examination.

7. Finally, your note refers to the need "to see satisfactory evidence of the terms of any Cabinet decision"; I think this should be recast to reflect your statements that you do not need to have access to Cabinet minutes.

Paragraph 8

8. The presentation of the relevant financial information is the responsibility of the Departmental Accounting Officer and can be checked from the Department's files. I do not accept that any other advice given to Ministers in reaching decisions is a proper matter for NAO audit. As I have said, again in my letter of 18 February, this implies an examination of the merits of policy objectives which are excluded from examination by Section 6.2 of the 1983 Act; and it is a matter of long-standing convention that advice to Ministers and interdepartmental exchanges are not disclosed to Parliament or its Select Committees, only the decisions themselves, for which Ministers are then accountable. And the Accounting Officer in a Department is accountable for what the Department has done in carrying out Ministers' policy decisions but not for explaining the considerations Ministers had in mind in reaching those decisions.

Paragraph 9

9. In addition to the points made by Peter Middleton on this paragraph, I should point out

that the content of any interdepartmental Ministerial consideration is not subject to NAO audit under the conventions designed to preserve the doctrine of collective responsibility. As I have made clear above, I also completely reject the leap you are making from access to documents in the custody and control of the Department under examination to access to documents of a wholly separate Department, in this case the Cabinet Office. This totally sidesteps the principle of audit of a Department on the basis of its own papers.

Paragraph 10

10. I entirely agree with Peter Middleton that, if a note anything like this goes forward, this paragraph will need to be redrafted as suggested by him.

Paragraph 12

11. As this paragraph is intended to state my views, I should like to offer the following redraft which sticks more closely to the texts of the various letters I have sent you:

"In addition, the Cabinet Office stated that:

i. The National Audit Office is concerned with questions of propriety and value for money in the expenditure of public money on the execution of policies agreed and adopted by Governments, but is not concerned with the merits of the policy objectives or the considerations which are taken into account in their formulation.

ii. Cabinet and Cabinet Committees are concerned with formulating and deciding policy objectives. It is important that the discussions which take place in Cabinet and Cabinet Committees should be protected, in order to preserve the ability of Ministers to discuss policy issues freely.

iii. The appropriate and authoritative source for the National Audit Office of information about the policy objectives formulated for Departments ... is the relevant documents held in the Department concerned to which I am entitled to have access.

iv. They do not accept that I have a right to obtain information about how policy objectives have been formulated; this implies examination of the merits of policy objectives which are excluded from NAO examination by Section 6(2) of the 1983 Act, and of confidential exchanges between Ministers during the formulation of policy."

Paragraph 14

12. I have already corresponded with you about the statement that NAO staff have previously sought and obtained access to Cabinet documents (my letters of 20 March and 2 April and yours of 3 April). I repeat my statement in the letter of 2 April that the provision of access to Cabinet documents would be contrary to the Ministry of Defence's internal guidance to their staff, and I would add that there are central standing instructions that Cabinet documents themselves may not be placed on departmental files where NAO staff might come across them. If NAO staff have in fact come across or been shown drafts of such papers on the

discretionary basis to which I have referred in comment above in paragraph 5, I do not consider that any precedent has been set.

Paragraph 15

13. My comments on the previous paragraphs demonstrate that I am not seeking to impose constraints not envisaged by legislation or established by past precedent.

14. I am sending copies of this letter to Peter Middleton and Peter Levene.

RTAAEL

psl/65A

CONFIDENTIAL

NOT FOR NAO EYES

pro

FROM: A C S ALLAN

DATE: 9 November 1987

SIR P MIDDLETON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr F E R Butler
Mr Anson
Mr Beastall
Ms J Wheldon (T.Sol)

NAO ACCESS TO TREASURY FILES

The Chancellor has seen Sir Robert Armstrong's minute to Nigel Wicks of 5 November, and Mr Wicks' response of 6 November.

2. The Chancellor is content with the proposed letters to the C&AG. Subject to any other points you have, I propose simply to phone Mr Wicks to say this.

3. There is one point on which the Chancellor would be grateful for clarificiation: could the C&AG seek to get round this by having as the subject of a new inquiry the Treasury scrutiny of MOD's procurement projects?

ACSA

A C S ALLAN

a

You may want to note for 2.30 meeting with PM — one point on her mind is whether our candidate would pursue this sort of line

AA

Mr A Wilson
85/2 P.M.P

Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Byatt
Mr Cassell
Mr Monck
Mr Burgner
Mr D Moore
Mrs Lomax
Mr Scholar
Mrs M Brown
Mr Houston
Mr Ilett
Mr Gray

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

The Rt Hon Lord Young of Graffham
Secretary of State for Trade
and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1H 0ET

9 November 1987

Mr Bradley
Mr Inglis
Mr Wynn Owen
Mr Flanagan

Mr D Walker - BE
Mr Beighton - IR
Mr Finlinson - C&E

ACCOUNTING DEVELOPMENTS

I know that your officials and mine have been talking about various shortcomings in the present legislative and working background against which accounting principles are developed and it might be helpful if I tell you how we see the problems from here. I am also taking this opportunity to reply to your letter of 29 September on small firms accounts and audit.

Attached to this letter is a draft list of specific issues which we feel need to be tackled, which I believe coincides to a large extent with issues which your own officials are already addressing. Some of these points relate to work underway in the Accounting Standards Committee, which could usefully be supported by the Government. Other aspects might require legislation which could be included in a Companies Bill if you are able to secure room for it in the timetable. I see advantage in bringing together the various issues in a single note which, if you agree, could then serve as an agenda for continuing discussions between our officials, identifying the issues to be covered and possible solutions, and about which they should consult informally both with other parts of Government as well as external interested parties.

I do not think that a formal inter-departmental working party should be established, for this would almost certainly extend the timescale for the exercise, but co-ordination of work on the several topics suggested will be necessary if real progress is to be achieved and our objectives met. Responsibility for such coordination could most sensibly be placed, I believe, in the hands of Mr Anthony Wilson, the Head of the Government Accountancy Services. The immediate aim would be to reach early conclusions on objectives for action by the accountancy profession

90/11

and to settle any provisions which might need to be included in legislation.

The amount of information which companies are expected to disclose in their accounts is a separate issue, and therefore it is not covered in the attached draft list of accounting matters. However, work on this, including the special concern of small firms mentioned in your letter of 29 September, could be carried forward by our officials as a separate exercise in parallel with what I have suggested above.

Turning to the other main point in your letter, I was interested to note that you now suggest removing the statutory audit requirement from companies with an annual turnover of less than £2 million, ie around 90 per cent of all businesses, rather than the £250,000 threshold you suggested when you were Employment Secretary. But I am not yet persuaded that conditions have significantly changed since we decided on 14 May last year to retain the statutory audit. Opinion among interested parties still seems divided. You mention that the Institute of Chartered Accountants are in favour of abolition, but I understand that the certified accountants, who audit the accounts of many small companies, have come out strongly in favour of retaining the statutory audit, as it introduces an element of financial rigour which many small companies would otherwise lack.

I remain concerned about fraud. You will recall that your White Paper "Building Businesses...Not Barriers" said of the statutory audit: "The Government are determined to clamp down on fraud and have decided that removal of this first defence against fraud would be inappropriate". To go back on that decision now would be to send out quite the wrong signals even though fraud in small companies obviously has a lower profile than in larger ones.

You asked what the implication to the Inland Revenue would be of abolishing the audit requirements. At present, the Revenue feel that the discipline of statutory audit makes company tax returns more reliable. They therefore investigate about half the percentage of accounts from companies which they do for unincorporated (and therefore unaudited) businesses. To provide the same coverage of company accounts as for unincorporated business accounts would require several hundred new inspectors, which is not a realistic prospect. So the consequence of the change would be to put Exchequer revenues at risk.

These considerations suggest to me that the decision we reached last year was probably correct, and that it would certainly be unwise to adopt the very much more far reaching exemption you now propose.

I am copying this letter to Douglas Hurd and John Cope.

NIGEL LAWSON

2911/3

DRAFT LIST OF CURRENT ACCOUNTING ISSUES WHICH REQUIRE CONSIDERATION

A number of issues to do with accounting requirements or practices are currently causing concern and need to be addressed. Accounting information provides an important influence on the way markets work, as well as the basis for sound economic decisions, and therefore attention must be paid to its quality

2. The main current issues are:

- the need for economic substance to prevail over legal form in the preparation of accounts and for unrestricted true and fair view requirements;

- off balance sheet financing;

- accounting for mergers and acquisitions;

- fair value and modified historical cost accounting;

- disclosure of R & D expenditure.

Substance over form and the true and fair view

3. The main purpose of accounts is to disclose corporate profitability and what may be distributed to shareholders, and the full state of affairs of the reporting group or company. Efficient markets require information about the true economic performance of companies at least as much as a statement of what may legally be distributed. Since the 4th EC Company Law Directive was reflected in UK legislation there has been a tendency for accounts to concentrate more on what is distributable than on economic performance. Furthermore the law now governs more aspects of accounts than it used to do and this seems to have led to an overlegalistic view of what is permissible in them and what is not. Some accounting shortcomings stem directly from the ability

of companies to hide behind restrictive legal interpretation of company law at the expense of showing a genuine "true and fair view".

4. The operation of the concept of a true and fair view has been restricted since the 1981 Companies Act and this has led to difficulties in developing accounting standards to cover such matters as what may be included in group balance sheets, and the related question of "off balance sheet finance", and what may be treated as a profit. The capacity of accounting to deal swiftly with new situations and abuses is gravely weakened if the requirement for accounts to show a true and fair view is restrained by the law.

Proposal

5. There is a case for considering change to legislation so that the requirement for accounts to show a true and fair view is reinforced (within the limitations of the 4th Directive) as overriding. The impact of the 7th Directive (group accounts) needs careful consideration to ensure that accounts are allowed to reflect the real composition of a group and the latter is not unduly restricted by statutory definition.

Off-balance sheet financing

6. Off-balance sheet financing takes a variety of forms designed to reduce disclosed gearing and to some extent, assets, thus improving the apparent rate of return on capital employed. It has arisen in part because of restrictive interpretation of company law by lawyers and merchant bankers. The technique of removing both assets and liabilities from company and group balance sheets conceals the true nature and extent of liabilities which the group may have underwritten, and improves the perceived rate of return on assets above its true level.

Proposal

7. The clarification of law on the supremacy of the true and fair view concept should prevent much of the abuse, but this needs to be bolstered by stonger accounting standards. The recent attempt by the accountancy profession to produce a solution was stopped in its tracks by legal quibbles. The objective must be to ensure that the true economic position of the group is reflected in accounts and that all the components of the group are included in them.

Mergers and acquisitions

8. More flexibility is given to the permissible accounting treatment of mergers and acquisitions in the UK than is the case in the US and some other developed countries. When the 7th EC Directive governing group accounts is translated into UK law, there will be an opportunity to revise the relevant provisions of the Companies Act.

9. The objectives of changes in this area are to improve disclosure of what has actually happened, (the price paid for acquisitions, their consequences and the accounting treatment adopted), and to reduce the number of accounting options available so as to improve the consistency and comparability of accounts, to make them easier to understand and to put a stop to some current abuses.

Proposal

10. The law should permit both merger and acquisition accounting as at present, but there is a case for considering prohibiting a currently popular hybrid of merger relief under the Companies Act and acquisition accounting. We should encourage the accounting profession to tighten up on the rules for disclosure, and narrow the range of circumstances when each form of accounting can be used, against a threat to legislate if the rules aren't strong enough. The Accounting Standards Committee review of the

composition and content of group accounts and the relevant Standards should be publicly encouraged and pressed forward.

Fair value accounting and regularity of revaluations

11. There has been a retreat from accounting for changing prices by the private sector and the Accounting Standards Committee is due to review the subject before the end of 1987. The decline in inflation and the cost of preparation of alternative forms of accounting information have been used to rationalise this retreat, (though many companies still use price level adjusted information in one form or another for management purposes). A more legitimate complaint is that the techniques tried have been oversophisticated and not appropriate for all types of business. Nevertheless, the main reason for retreat is undoubtedly still the fear of the effects of lower reported profits on share values as well as on profit related remuneration bases.

12. That said, the threat and practice of takeovers has led to increasing emphasis on modified historical cost accounts, incorporating updated valuations of significant assets, notably land and buildings. At present the UK law allows a choice of which, if any, assets to revalue and when, in contrast to other major countries such as the US and Germany, where revaluation is not an accepted accounting practice. This option distorts comparability of accounts. A requirement that there should be systematic, regular and consistent reassessment of fair values of all assets in company accounts, should achieve the benefit of price level adjustments without the complexities and dissent likely if more sophisticated methods of accounting were required.

Proposal

13. There may need to be a requirement in company legislation that revaluation of assets is comprehensive and regularly carried out using consistent principles or, as a minimum that this should be done where there is any departure from the historical cost

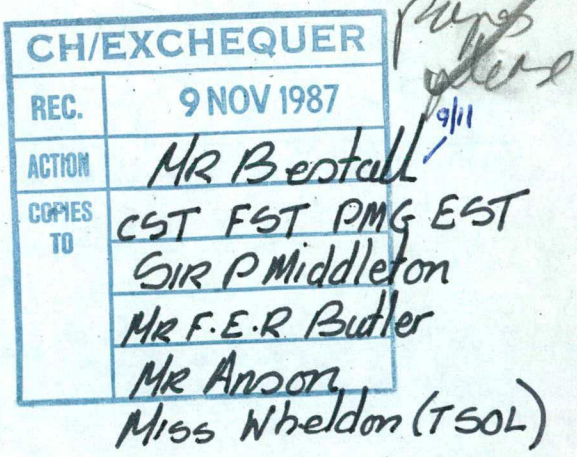
convention. The Accounting Standards Committee is already at work to develop a Standard in this area, but pressure is probably going to be needed to strengthen it.

Research and development

14. Considerable progress has been made with the accounting profession which is revisiting this subject. A new accounting standard is proposed in Exposure Draft 41, published in June 1987 which will require companies to disclose the level of research and development expenditure undertaken each year. This proposal should be publicly supported.

CONFIDENTIAL

NOT FOR NAO EYES



SIR ROBERT ARMSTRONG

NAO ACCESS TO TREASURY PAPERS

1. I have been asked to advise urgently on the soundness in law of the argument advanced to the Controller and Auditor General ("the CAG") in the draft letters from you and Sir Peter Middleton. These drafts refer to certain antecedent correspondence which I have not seen.

2. I regret to say that in one important respect I consider they are unsound. They seem to contend (see paragraph 5 of your draft for example) that in no circumstances and for no purpose is the CAG given by the National Audit Act 1983 ("the Act") a right to obtain information about how policy objectives have been formulated.

3. The Act will be construed by Parliament, where to do so will be in its own interest, as it would be construed by a court, that is to say by reference to what its language means. Previous conventions, and understandings conceived at the time of legislating, cannot safely be relied on.

4. Section 6(1) gives the CAG power to 'carry out examinations into the economy, efficiency and effectiveness with which any department ... has used its resources in discharging its functions'. Section 6(2) is in effect a provision inserted 'for the avoidance of doubt': it declares that subsection (1) 'shall not be construed as entitling the CAG to question the merits of the policy objectives of any department ... in respect of which an examination is being carried out'.

5. It follows that the CAG is not excluded from access to a document by reason only of the fact that it bears upon the merits of a relevant policy, e.g. by comprising a discussion of points of policy before a final decision was arrived at. For, under the provisions of section 8(1), he 'shall have a right of access

to all such documents as he may reasonably require for carrying out any examination under section 6 ...'. Since your draft reply concedes that 'access to documents on departmental files concerning advice to Ministers about particular policy proposals (e.g. near final drafts of Ministerial papers for Cabinet) ... may well be helpful to NAO staff in their examination of the implementation of the resultant policy' (paragraph 5), it seems probable that any required access by the CAG to such a document would be reasonable. It is hard to see how requiring to see something that may be helpful to the CAG's lawful purpose could be unreasonable.

6. Accordingly if the concession in paragraph 5 stands, I do not think it would be possible to sustain the remainder of paragraph 8 of your draft, which argues that because such a document formed part of the policy making process the CAG had no right of access to it (your contention is that granting such access in the past has been within the discretion of Departments.) The key point is that the CAG can properly require access to the document for a purpose which is other than enabling him to 'question the merits of the policy objective of the department' - namely, the purpose (which he is here claiming) in respect of which he is empowered by section 6(1). It is only the questioning of the merits of a policy objective to which section 6(2) relates. The CAG will say he is not doing that.

7. The Government desires, for proper reasons, to maintain 'the longstanding convention that advice to Ministers and interdepartmental exchanges are not disclosed to Parliament or its Select Committees, only the decisions themselves, for which Ministers are then accountable': paragraph 8 of your draft reply. For my own part, however, I would think it far better for the Government to stand and fight on the contention that documents relating to the formulation of policy can never reasonably be required by the CAG for section 6(1) purposes, rather than to rely on paragraph 5 of the draft, which effectively gives away the pass.

8. I entirely agree that section 8(2) shuts out the CAG completely from access to any document not in the custody or control of the relevant department. It should however be noted that papers which are in the corporeal possession of a department (even though not on departmental files) can properly be required to be produced to the CAG provided that he reasonably requires to see them.

9. I am copying this minute to the Prime Minister, the Chancellor of the Exchequer and the Lord Privy Seal.

P. M.

9 November 1987

RA3.55

CONFIDENTIAL
NOT FOR NAO EYES

FROM: A C S ALLAN
DATE: 11 November 1987

MR BEASTALL

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Robson
Ms Seammen
Miss Wheldon - T.Sol.

NAO ACCESS TO TREASURY FILES

The Chancellor was grateful for your minute of 10 November. He was interested to see that the NAO could conduct an enquiry specifically into the Treasury's scrutiny of MOD procurement projects. He noted your point that a more respectable subject for investigation would be the Treasury's performance of its functions in relation to public expenditure as a whole; but he thought this would be much less digestible and therefore less likely to be chosen.

A C S ALLAN

FROM: J S BEASTALL
DATE: 10 November 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Anson
Mr Robson
Ms Seammen
Miss Wheldon - T.Sol.

NAO ACCESS TO TREASURY FILES

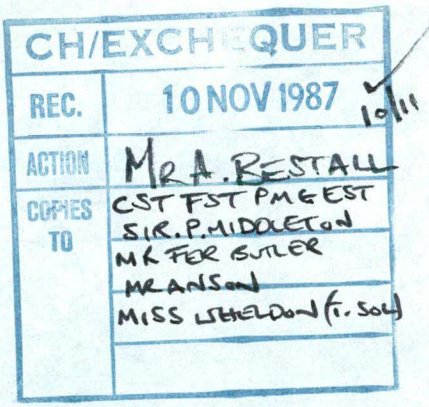
You asked whether the C & AG could get round our defences against his access to Treasury papers by conducting an enquiry specifically into the Treasury's scrutiny of MOD procurement projects.

2. The answer is "Yes". In the terms of the National Audit Act 1983, he could examine the economy, efficiency and effectiveness with which the Treasury had used its resources in discharging this particular function. However it would be absurd in practice for him to conduct an enquiry into the Treasury's work on a single procurement project. Even if the subject of the enquiry were the Treasury's scrutiny of MOD procurement projects generally, it would still be rather odd (although within his powers) to devote a whole investigation to part of the work of one expenditure division. A more respectable subject for him to investigate would be the Treasury's performance of its functions in relation to public expenditure as a whole.

3. Unwelcome as an enquiry on any of the above lines would be, it would of course be for the Treasury Accounting Officer to respond to it; the principle which we have been concerned to establish - that an Accounting Officer should not be called to account on the basis of papers he has not seen - would thus be preserved.

JSB

J S BEASTALL



PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

9 November 1987

Dear Trevor

NAO ACCESS TO CABINET PAPERS

The Lord Privy Seal has seen Sir Robert Armstrong's minute of 5 November to the Prime Minister, in which he sought her authority for the proposed response to the Comptroller and Auditor General approach about the National Audit Office's access to Cabinet papers. He has also seen Nigel Wicks' minute to Sir Robert of 6 November, reporting that the Prime Minister agreed, provided the other Ministers concerned were content.

The Lord Privy Seal has asked me to let you know that he, too, is content with the proposed response, subject to resolution of the objection raised on one point by the Attorney-General in his minute of today.

I am sending a copy of this letter to Nigel Wicks (10 Downing Street), Alex Allan (HM Treasury) and Michael Saunders (Law Officers' Department).

Yours sincerely,
Steve Wood.

S N WOOD
Private Secretary

T Woolley Esq
PS/Sir Robert Armstrong
Cabinet Office

Mr Mason
Mr Bradley
Mr Inglis

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

Secretary of State for Trade and Industry

26 November 1987

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1

MR Flanagan
PPS CST PMG EST
Sir P. Middleton
MR A. Wilson MR Monck
MR Scholar MR Burgner
MR Culpin MR Cropper
MR Tyrie MR Beighton IR
PS/IR MR Holloway C&E.

Dear Nigel,

ACCOUNTING DEVELOPMENTS

Thank you for your letter of 9 November on small companies accounts and audit, and other accounting issues.

I must say that I attach considerable importance to removing the statutory audit requirement from small companies, and this has assumed some additional significance since the question was considered in 1986, in the context of the new arrangements we shall have to set up for the regulation of auditors.

In many areas of company law our scope for removing burdens is limited by European directives; the audit for small companies is, however, optional under the fourth Directive and several member states including Germany have exercised the option not to require it.

Furthermore, I think we do need to give weight to the two major institutes of chartered accountants whose members actually carry out most of these audits (some 15,000 chartered accountants practise in small firms (6 partners or less) compared with a total of only 3,000 practising certified accountants) and who have made a point of repeating their views on the question of the statutory audit in the context of the Eighth Directive.

DW3CWS

Thirdly, we need to be realistic about what the audit of a small company actually entails. In most cases the auditor audits accounts which he has prepared himself, often from patchy records. He is also likely to act as an adviser to the company and its directors, particularly on tax questions. Many of the resulting audit certificates contain the qualification that the company's controls are dependent on the close involvement of the directors, and that where independent confirmation of the completeness of the accounting records has not been available the auditor has accepted assurances from the directors that all the company's transactions have been reflected in the records. A number of contributors to our consultative exercise, from within the profession as well as outside it, have questioned whether in these circumstances the audit can give a great deal of comfort.

The professional bodies are planning to set up machinery, to form part of the new regulatory set-up, to monitor the performance of auditors and their maintenance of professional standards of work and conduct. This will impose new costs, particularly at the small end (the big firms already have internal monitoring procedures), which will no doubt be reflected in fees charged to clients. It may therefore be that some of our earlier assumptions about the cost of audit to small firms will no longer hold good.

I do recognise the force of the points you make about fraud and about the concerns of the Inland Revenue, and of course we need to take account of the views of the Chartered Association as well as those of the other bodies. It may be that we need to look in the first instance at a smaller proportion of companies than I indicated in my letter, and it may be that there is more to be said than was previously thought for requiring accounts to be prepared by a qualified accountant in cases where audit is no longer obligatory. But I should like to see if colleagues generally believe that the balance of advantage remains as it was seen in 1986, and I propose to put a paper to MISC 133 on this subject. It would, I think, be interesting to know how far Inland Revenue practice differs between companies and unincorporated businesses within the relevant size ranges as well as across the board, and to what extent the value of the audit is borne out by the results of their examinations.

I am glad you can agree to further discussions between officials on the content of companies' accounts and I will ask officials here to contact yours. I propose that we should concentrate initially on small companies' accounts. I hope discussions on these accounts can proceed with the mutual objective of getting very much closer to the format of the modified accounts which certain companies are

DW3CWS

now permitted to file. The comments received on the existing package show that minor changes are not worth making on their own. Francis Maude has it in mind to make an announcement soon on deregulatory items which we propose to include in the next Companies Bill, and if something can be said on the content of accounts so much the better. In the longer term, we should also consider the reporting requirements imposed on larger companies but work on this subject is at a much earlier stage and I do not attach such a high priority to it.

You also raised in the attachment to your letter a number of other specific accounting issues. I agree that these are all important issues in which the Government has a key role to play; either directly or through stimulating the profession or the Accounting Standard Committee to deal effectively with them. Work on several of the issues is well under way and your note does not fully reflect the initiatives taken by my Department. In particular, we are already consulting external parties about a possible way of ensuring that the accounts of controlled non-subsidiaries are required to be consolidated, which is a particularly important aspect of off-balance sheet finance. Similarly we are about to consult on the legislative options for tightening up the requirements on accounting for mergers and acquisitions. Both these subjects are complex, and the issues must be thoroughly explored with the profession, as the implications of the various options are far reaching. It is, however, our firm intention to deal with both in the Companies Bill for which we are seeking a place in the 1988/89 legislative programme (for which I hope that we will have your support).

I strongly agree about the importance of the effective operation of the "true and fair" override. My officials are considering how best this can be re-inforced. If, on further consideration, it is concluded that an amendment to the law would be helpful, then this would be a strong candidate for inclusion in the Bill.

Work on fair value accounting and regularity of revaluations is at an earlier stage. I am sure that we shall need to keep pressure on the ASC to ensure that it tackles this subject effectively. It may be that in the longer term, we shall need to deal with the subject in legislation but we cannot decide this until work is further advanced. I doubt if it is a candidate for the forthcoming Bill. More generally, I think that the Government will have to give a lead (eg in relation to the basis for taxation) if any real progress is to be made in gaining public support for a move towards requiring information to be provided about the effects of changing prices.

DW3CWS

Finally, I welcome the progress that is being made in preparing an accounting standard requiring companies to disclose their expenditure on R&D. We shall, however, need to keep pressure on the ASC to ensure that the timetable does not slip.

A lot has therefore already been done. My officials are in close touch with yours on all these subjects and I understand that there are no major differences of view about what needs to be done. I agree therefore that a formal inter-departmental working party is not needed and I am certainly anxious to avoid creating any additional layer of bureaucracy which would delay progress. But if you think that it would be useful to have a meeting under Mr Wilson's chairmanship to agree on the next steps to be taken, then my officials would, of course, be ready to participate and to provide any secretarial support which may be necessary. Perhaps we could leave it to that meeting to decide how best thereafter to monitor and review progress and to keep us both informed.

I am copying this letter to Douglas Hurd and John Cope.

LORD YOUNG OF GRAFFHAM

DW3CWS

C5/49

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Mr Cassell
Mr Monck
Mr A Wilson
Mr Kemp

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

Mr Scholar
Mr Burgner
Mr Culpin
Mrs Lomax
Mr Gray
Mr Mason
Miss Sinclai
Mr Bradley
Mr Inglis
Mr Cropper
Mr Tyrie

18 December 1987

The Rt Hon Lord Young of Graffham
Secretary of State for Trade
and Industry
1-19 Victoria Street
LONDON SW1H 0ET

Mr Battishill - IR
Mr Beighton - IR
Mr Unwin - C&E
Mr Walker - B/England

ACCOUNTING DEVELOPMENTS

Thank you for your letter of 26 November.

The important new factor to be considered since we last discussed the possibility of removing the audit requirement for small companies eighteen months ago, is the attitude now expressed by the Chartered Accountants about their future ability to monitor the auditing standards of their members. Ineffective audit would be a dangerous smokescreen in our fight against fraud, but I do give considerable weight to the problems which the Inland Revenue, and to a lesser extent Customs and Excise, would face if small companies no longer had to have their accounts audited in any way whatsoever.

The Inland Revenue have to place great reliance on the existing universal audit requirements for a reasonable level of assurance about the accuracy and probity of company accounts and the tax computations based on them. It is not so much the form of the audit report itself, as the enforced incursion once a year of an independent professional accountant into the company's housekeeping, and the resulting presentation of the accounting information, which gives confidence.

If compulsory audit were to be removed without some public association by an independent professional accountant with the accounts put in its place, a dangerous vacuum would be created and credibility of the accounts of the small company business sector would undoubtedly suffer. The substitution of some sort of independent professional review for formal audit would only represent a small measure of relief from the

162/12

administrative burden small businesses have to face, but at least it would provide a brake on the development of heavier burdens as increased audit requirements for companies in general develop over the years.

Part of the problem lies in the wide spectrum of what an audit comprises. The comprehensive audit of major companies is very different in scope and standards from the audit of smaller businesses, where independent evidence is often difficult to obtain and the opinion which the auditors can express on the accounts is guarded and often qualified. We need to encourage the accounting profession to tighten up the audit standards applied to the larger businesses, but it would be difficult to do so if the same standards have to apply to the audits of small companies, so that progress here may be frustrated unless we can separate the two.

What I suggest, therefore, is that your officials should discuss with the professional accounting bodies ways in which the use of the word "audit" in relation to the accounts of small companies could be discontinued along with the legal need for it, but that some statutory requirement for the involvement of a professional independent accountant in the preparation of small company accounts should be developed instead. Such an involvement could be called a review, and instead of the word "auditors", it might be possible to refer to reporting accountants. The way would then be clear for audits of medium sized and larger companies to be developed through appropriate standards, and misconceptions about the application of full auditing standards to small companies could be removed. Such an approach would involve a major piece of work, but it would demonstrate that the Government is determined not to relax its determination to achieve better accountability and probity, while at the same time giving smaller businesses an option which might be better designed to serve their needs than universally applied requirements.

If you agree, it would be practical to suggest that our respective officials, under Mr Wilson's chairmanship, should discuss this, and coordinate progress on the various other matters referred to in our previous exchange of letters. Much work has already been done in relation to the Accounting Initiative, and you are right in saying that there are no major differences of view between our officials about what needs to be done.

Copies of this letter go to Douglas Hurd and John Cope.

NIGEL LAWSON

C5/49

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
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Mr Monck
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Mr Kemp

Treasury Chambers, Parliament Street, SW1P 3AG
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18 December 1987

The Rt Hon Lord Young of Graffham
Secretary of State for Trade
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1-19 Victoria Street
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Mr Battishill - IR
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162/12

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Copies of this letter go to Douglas Hurd and John Cope.

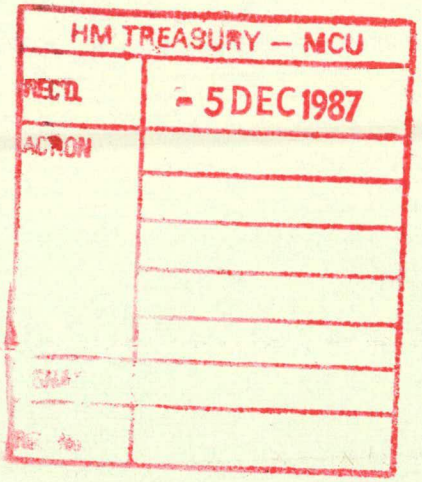
NIGEL LAWSON

Michael Stern, MP.

HOUSE OF COMMONS
LONDON SW1A 0AA

PRIVATE & CONFIDENTIAL

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3AG



REFERENCE:

02 Dec 87

Dear Nigel

RESTRICTIVE PRACTICES IN THE ACCOUNTANCY PROFESSION

Following your comments at prayers on Wednesday, 25 November, I hope you will find the comments below helpful.

What is undoubtedly the greatest restrictive practice in the profession is the audit requirement for proprietary companies where there is no significant outside shareholder The audit is expensive and highly formalised. Its original intention may well have been to protect, in addition to outside shareholders, outside creditors, proprietors and the Inland Revenue but, for the reasons given below, I believe that it is now failing to achieve any of these objectives.

1. Outside Creditors

Audited accounts filed at Companies House can rarely be less than 9 months out of date and the norm is closer to 2 years. Such out of date information cannot give more than a general guide to an outside creditor; if he is lending a large sum of money he will want additional verification anyway and smaller creditors do not have the time or resources to do anything other than operate credit control by the seat of their pants. I do not believe that there has been a significant decrease in the overall ratio of bad debts to GDP since the 1967 Companies Act required publication of audited accounts.

2. Proprietors

In my experience the services provided by accountants which are valued by proprietary shareholders are the agreement of tax liabilities and the provision of management and accounting services generally. The audit is regarded as irrelevant except to the extent that it assists with the above functions, and yet it is increasingly the most expensive service provided.

.../

3. The Inland Revenue

For many years auditing techniques were at least partially biased in favour of giving some reassurance to the Inland Revenue that tax computations submitted with accounts were broadly correct. Recent developments in audit techniques have moved sharply away from the provision of such reassurance. In particular, very few audit trails now look in detail at the makeup of individual items on the Profit and Loss Account and it is possible, particularly where the auditor is not also responsible for the tax computation, for the auditor simply to accept the assurance of the company secretary or outside accountant (or indeed his own tax department) of the acceptability of the estimated corporation tax liability shown on the accounts and pay no further heed to the potential interest of the Inland Revenue in any way. It is my belief that, as a result, there are significant areas of interest to the Inland Revenue which are untouched in a standard audit and I list below 4 examples:

a) disallowable expenses not being picked up. In all innocence, items such as disallowable entertaining, cash payments to so-called casual labour, substantial staff entertaining and disallowable subsistence expenses can all be lost in general headings on the Profit and Loss Account and therefore not picked up by the Inland Revenue. The auditor has no responsibility for the analysis of profit and loss account expenses.

b) The inclusion of disallowable capital expenditure in revenue has always been a problem especially on commercial building works. Now that the audit no longer looks at the analysis of, for example, repairs and renewals, the risk of such expenditure getting through is greatly increased.

c) In no audit programme that I have ever seen is verification of the forms P11D submitted on behalf of directors and executives ever dealt with.

d) If cash records are inadequate and there is a balance of unverifiable income, it is quite likely that an auditor would pick it up and make the necessary enquiries; were the balance, as is more common to be unverifiable or unrecorded expenditure, very few audit programmes would pick it up.

.../

In the light of the above, it must be questioned whether the interests of the Inland Revenue are best protected by a change in audit techniques, or by the abolition of the audit requirement for small proprietary companies and the substitution of an alternative form of reassurance to the Inland Revenue. My own view is very strongly towards the latter; the divide between audit techniques and the work required to ensure the collection of both Corporation Tax and personal Income Tax for which the company is responsible is now unbridgeable.

What is needed is an alternative form of reassurance specifically designed for, and directed to, the Inland Revenue; I cannot be sure that the audit techniques that have developed since the 1967 Companies Act have led to increased fraud on the Inland Revenue, but what I am convinced of is that there is much greater scope for companies to underdeclare; and this cannot be corrected by any change in audit techniques which are no longer adaptable to the purposes of the Inland Revenue.

I should be happy to amplyify or discuss the above comments as appropriate.

Yours ever

Michael

RM2.44

CONFIDENTIAL

FROM: MOIRA WALLACE
DATE: 7 January 1988

SIR P MIDDLETON

cc Sir A Wilson
Mr Cropper
Mr Tyrie

RESTRICTIVE PRACTICES IN THE ACCOUNTANCY PROFESSION

The Chancellor thought you and copy recipients would be interested to see the attached extract from a letter from Michael Stern MP. He would be interested in your comments.

MPW.

MOIRA WALLACE

What is undoubtedly the greatest restrictive practice in the profession is the audit requirement for proprietary companies where there is no significant outside shareholder The audit is expensive and highly formalised. Its original intention may well have been to protect, in addition to outside shareholders, outside creditors, proprietors and the Inland Revenue but, for the reasons given below, I believe that it is now failing to achieve any of these objectives.

1. Outside Creditors

Audited accounts filed at Companies House can rarely be less than 9 months out of date and the norm is closer to 2 years. Such out of date information cannot give more than a general guide to an outside creditor; if he is lending a large sum of money he will want additional verification anyway and smaller creditors do not have the time or resources to do anything other than operate credit control by the seat of their pants. I do not believe that there has been a significant decrease in the overall ratio of bad debts to GDP since the 1967 Companies Act required publication of audited accounts.

2. Proprietors

In my experience the services provided by accountants which are valued by proprietary shareholders are the agreement of tax liabilities and the provision of management and accounting services generally. The audit is regarded as irrelevant except to the extent that it assists with the above functions, and yet it is increasingly the most expensive service provided.

.../

3. The Inland Revenue

For many years auditing techniques were at least partially biased in favour of giving some reassurance to the Inland Revenue that tax computations submitted with accounts were broadly correct. Recent developments in audit techniques have moved sharply away from the provision of such reassurance. In particular, very few audit trails now look in detail at the makeup of individual items on the Profit and Loss Account and it is possible, particularly where the auditor is not also responsible for the tax computation, for the auditor simply to accept the assurance of the company secretary or outside accountant (or indeed his own tax department) of the acceptability of the estimated corporation tax liability shown on the accounts and pay no further heed to the potential interest of the Inland Revenue in any way. It is my belief that, as a result, there are significant areas of interest to the Inland Revenue which are untouched in a standard audit and I list below 4 examples:

a) disallowable expenses not being picked up. In all innocence, items such as disallowable entertaining, cash payments to so-called casual labour, substantial staff entertaining and disallowable subsistence expenses can all be lost in general headings on the Profit and Loss Account and therefore not picked up by the Inland Revenue. The auditor has no responsibility for the analysis of profit and loss account expenses.

b) The inclusion of disallowable capital expenditure in revenue has always been a problem especially on commercial building works. Now that the audit no longer looks at the analysis of, for example, repairs and renewals, the risk of such expenditure getting through is greatly increased.

c) In no audit programme that I have ever seen is verification of the forms P11D submitted on behalf of directors and executives ever dealt with.

d) If cash records are inadequate and there is a balance of unverifiable income, it is quite likely that an auditor would pick it up and make the necessary enquiries; were the balance, as is more common to be unverifiable or unrecorded expenditure, very few audit programmes would pick it up.

.../

In the light of the above, it must be questioned whether the interests of the Inland Revenue are best protected by a change in audit techniques, or by the abolition of the audit requirement for small proprietary companies and the substitution of an alternative form of reassurance to the Inland Revenue. My own view is very strongly towards the latter; the divide between audit techniques and the work required to ensure the collection of both Corporation Tax and personal Income Tax for which the company is responsible is now unbridgeable.

What is needed is an alternative form of reassurance specifically designed for, and directed to, the Inland Revenue; I cannot be sure that the audit techniques that have developed since the 1967 Companies Act have led to increased fraud on the Inland Revenue, but what I am convinced of is that there is much greater scope for companies to underdeclare; and this cannot be corrected by any change in audit techniques which are no longer adaptable to the purposes of the Inland Revenue.

22/2917

FROM: SIR ANTHONY WILSON
DATE: 8 January 1988

SIR PETER MIDDLETON

cc PS/Chancellor
Mr Bradley
Mr Inglis
Mr Cropper
Mr Tyrie

RESTRICTIVE PRACTICES IN THE ACCOUNTANCY PROFESSION

I read the extract from a letter from Mr Michael Stern, attached to Miss Wallace's minute of 7 January, with interest. Mr Stern's remarks are to some extent confirmation of the views expressed in our discussions before Christmas about continuation of the audit requirement for small companies.

2. I am not sure that I go along with Mr Stern in his description of universal audit requirement as the greatest restrictive practice in the accounting profession. There are two aspects to this. I would accept that compulsory universal audit is an imposition on companies which are totally owned and managed by the shareholders, but I would defend strongly the position that if an audit is necessary, then it should be done by people who know what they are doing technically. Therefore wherever an audit is required it is hardly a restrictive practice to expect that it should be done by suitably qualified and experienced people.

3. I believe Mr Stern is right in saying that accounts filed at Companies House are too out of date to be reliable, and no sensible bank or trading partner will rely on the filed accounts without other evidence of the credit status of the company in extending a loan to it. It follows from this that the ratio of bad debts to turnover is hardly dependent on the filing of the annual accounts for public inspection.

4. Mr Stern identifies the valuable services provided by accountants to smaller companies as the agreement of tax liabilities and the provision of management and accounting

services generally. I agree with that, but would go further and say that the real value of the compulsory intervention of a qualified auditor each year in the housekeeping of a company is in the encouragement it gives to proprietor management to keep proper records of transactions, and it may also be something of a deterrent to those who would otherwise put their fingers in the till.

5. The section of Mr Stern's letter dealing with the Inland Revenue supports, in many ways, my own views which I expressed to you in our meetings before Christmas. I think the Inland Revenue maintains an unjustified reliance on the traditional identification of allowable and disallowable expenses made during the course of an audit. It is an unfortuante fact that with the complexity of accounts content and format developed through the Companies Act 1985 (based on EC requirements) and a proliferation of accounting standards, which really should not be addressed to the smaller proprietor managed companies, the auditor spends too much of his time on the disclosure aspects of the accounts, and probably not enough on the underlying propriety aspects of the affairs of the company. We can hardly turn back the clock and institute an expensive and time consuming regime for the better identification of disallowable expenses in small company business, so I go along with Mr Stern in his views that we try to substitute something for audit which will give to the Inland Revenue more justification for relying on small company accounts as a basis for tax assessments and stop the confusion over the use of the term "audit" in relation to such an exercise.

6. This is exactly in line with the recommendations you put to the Chancellor and which have gone forward to Lord Young. I wait with interest to see what his response will be.

A WILSON

Ch/ Shall we circulate to those who have seen previous papers - FST, PEM, Sir AW, Advisers (+ IR "anonymously")

Yes pls -

MPW 19/1

3977/55

PMP -

Papers please

CONFIDENTIAL

FROM: P J CROPPER
DATE: 11 January 1988

CHANCELLOR

cc Sir P Middleton
Sir A Wilson
Mr Tyrie

RESTRICTIVE PRACTICES IN THE ACCOUNTANCY PROFESSION

You invited comments on Michael Stern's note.

2. I have to say that this whole thing appals me. Here we have the accountancy profession which, since the middle of the c19 century, has grown fat on audit fees. "Audit is absolutely essential" they would say. "Reassurance to the minority shareholders - guarantee against monkey business - vital to the revenue".

3. Now, hey presto, the accountants have found more lucrative lines of business - consultancies, tax avoidance, VAT, international tax planning. They no longer see audit as a profitable business. Overnight we are told the annual £2,500 audit certificate is not worth the paper it is printed on. As Michael Stern puts it: "Recent developments in audit techniques have moved sharply away from the provision of such assurance." So now the accountants are saying: "What you want, my fellow, is not a £2,500 audit certificate: what you want is an annual dollop of £25,000 worth of sophisticated financial advice. Surely you realise that the audit is merely a perfunctory formality - it doesn't really tell you anything. You need much more than that."

4. So what do the accountants do? They toddle along to Lord Young and tell him the audit is a costly and dangerous burden on small businesses and that it should cease to be a statutory obligation. Lord Young swallows it. Gullible people like Tyrie take up the chorus. "The statutory audit is a waste of money: let us abolish it."

5. What will happen? The audit for small businesses will be quietly dropped. A priceless guarantee of probity and respectability will have gone - the Price Waterhouse audit certificate, costing £2,500 a year. What will the small companies get in place? A dubious flow of financial services for which the bill will be £25,000 a year. And it will be dubious, because even at £25,000 a year you can only buy the time of a third year graduate trainee. The average small business is not going to get top class service, any more than the private client does on the Stock Exchange.

6. In my view we should go back to the accountants and say this to them. "Here you are, for the last 150 years you have been covering the fixed charges of your business with a base load of statutory audit business. Suddenly you come and tell us it is all a load of old crap. Kindly go away and start doing the job properly." And the next time I found a Price Waterhouse audit that failed to expose monkey business at the expense of the Inland Revenue I would publicise the fact that it was a Price Waterhouse client.

7. The small business world will rue the day that statutory audit is abolished. As for the Inland Revenue, Michael Stern says it all: "I cannot be sure that the audit techniques that have developed since the 1967 Companies Act have led to increased fraud on the Inland Revenue, but what I am convinced of is that there is much greater scope for companies to underdeclare."

8. Apologies to HOTGAS.

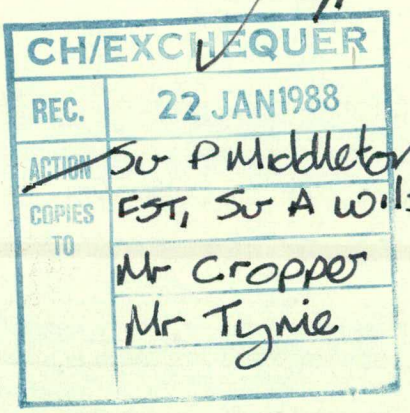
P J CROPPER

Michael Stern, MP.

HOUSE OF COMMONS
LONDON SW1A 0AA

Br to m. 28/1

22/1



PRIVATE & CONFIDENTIAL

Rt Hon Nigel Lawson, MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

18 Jan 88

RESTRICTIVE PRACTICES IN THE ACCOUNTANCY PROFESSION

I am grateful for the opportunity of a sight of Peter Cropper's memorandum of 11 January in response to mine of 2nd December. In passing, I am not sure that it is true that accountants now no longer see audit as a profitable business. Certainly new areas of activity have been developed and in some cases have become exceedingly profitable, eg. the oligopoly created by the DTI in the field of public sector efficiency audit, but in general most small and medium sized practices regard audit as their bread and butter.

The question we are addressing is surely not whether the audit can be done properly, in which case it should of course be done by experts, but rather, whether it is worth doing at all! Barely a day passes without a fresh negligence action, frequently against one of the largest firms, being announced and the continuing rise in professional indemnity insurance premiums is proof that a substantial number of such actions are successful.

Is the real value of the audit, to companies without outside shareholders, the encouragement to keep proper records and a deterrent to fraud or, as Peter Cropper puts it 'a priceless guarantee of probity and respectability'? So far as fraud is concerned, I would accept that audits can uncover very basic frauds which would have been found out sooner or later anyway like obvious thefts by staff, but the existence of the black economy and the fact that no audit technique yet exists to guarantee the recording of sales in a retail business indicate that the value of the audit in detecting fraud is somewhat limited. So far as

.../

keeping proper records is concerned, my experience has been that the irreversible change in business habits in this area came about, not as a result of the 1967 Companies Act, but more from the imposition of VAT in 1973 - and auditors have no obligation to comment on the correctness of the VAT liability, just as they have no obligation to comment on the correctness of the corporation tax liability.

I admire the faith of those who believe that the audit still has a value to the small proprietor-controlled company; I just do not think that that faith should stand in the way either of making the company more efficient, or of ensuring that the company pays something closer to the correct amounts of income tax, corporation tax and VAT.

Yours ever

Richard

Ch/

We will send to PEM, and copy to Sir AW + also Messrs Tyrie and Cropper if you approve (AT knows of the letter and asked me if he could see it – some time ago).

Ok.

MPW 6/1

Ch

(not seen in draft). Presumably way forward is to ask Tony Wilson for his comments?

What I had in mind was PBM, pursuant to the discussion last week before Xmas.

AA

Xerox section of letter sent. red lines.

By all means [illegible] doubtful, tho. M.

mjd 3/90m

CONFIDENTIAL

mp.

FROM: MISS M P WALLACE
DATE: 29 January 1988

MR CROPPER

cc Financial Secretary
Sir P Middleton
Sir A Wilson
Mr Tyrie
Mr M Stern MP

RESTRICTIVE PRACTICES IN THE ACCOUNTANCY PROFESSION

The Chancellor was grateful for your minute of 25 January. He agrees with your observation that the present audit system is not an effective instrument for protecting the revenue. More generally, he has commented that this has been a good correspondence, in which Mr Stern has made his point.

MPW.

MOIRA WALLACE

3978/5

CONFIDENTIAL

FROM: P J CROPPER
DATE: 25 January 1988

CHANCELLOR

cc Financial Secretary
Sir P Middleton
Sir A Wilson
Mr Tyrie
Mr Michael Stern MP

RESTRICTIVE PRACTICES IN THE ACCOUNTANCY PROFESSION

Mr Stern's note of 18 January provided a useful corrective to my pyrotechnical minute of 11 January. The interesting thing that comes out of it is where Mr Stern says:

> "I admire the faith of those who believe that the audit still has a value to the small proprietor-controlled company; I just do not think that that faith should stand in the way either of making the company more efficient, or of ensuring that the company pays something closer to the correct amounts of income tax, corporation tax and VAT."

2. He is supporting the point I have been trying to make all along, that a lot of revenue is slipping through our hands. It is quite clear that, as things stand, the audit system is not an effective instrument for protecting the revenue and the Inland Revenue are being a bit naive if they think it is.

3. But what to do about it? Remove the audit requirement altogether for small companies and tell the Inland Revenue they are out on their own? Turn the clock back and attempt to restore the audit's former glory? Or replace the audit by some more rigorous certification process, expressly designed to ensure that, in Mr Stern's words, "the company pays something closer to the correct amounts of income tax, corporation tax and VAT"?

4. I doubt very much whether the certification route is what the DTI had in mind when they opened up this question. To introduce a rigorous auditor's certificate of tax compliance would hardly be classed as removing Burdens on Business. I fear that what they had in mind was likely to weaken the position of the Revenue, not strengthen it.

P J CROPPER

3978/22

FROM: P J CROPPER
DATE: 5 February 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Anson
Mr Kemp
Miss Peirson
Mr Saunders
Mr Tyrie
Mr Call

AUDIT COMMISSION

Howard Davies invited the special advisers round to the Audit Commission today, and gave a very impressive survey of what they are doing.

2. Recipients might like to glance quickly at the attached paper. I was particularly interested in Exhibit 2, where the Audit Commission has compared the financial ratios for a particular authority's school meal service with the average ratios for a group (family) of comparable authorities.

3. Hospital service please copy!

P J CROPPER

THE STRENGTHS OF THE AUDIT COMMISSION

The Audit Commission is uniquely placed to audit, advise and stimulate local bodies - of any size - in receipt of public funds. The experience of the last four years has shown that to promote economy, efficiency and effectiveness a new co-ordination of skills and procedures is required, which are unavailable elsewhere in either the public or private sectors.

The key success factor is the integration of up to date management consultancy skills with a wholly reliable local audit function founded in the public service ethic.

The Commission has now built the structure required to achieve and sustain this success - a structure flexible enough to cope with the audit of £40 billion annual expenditure on services as diverse as education and the police. Its principal features are:

- a mix of public and private-sector audit - 70% of work is currently carried out by the Commission's District Audit Service and 30% by the major accountancy firms - the Commission's central services are integral to the work of both

- a strengthened District Audit Service, with improved terms and conditions to attract and retain higher quality staff - the Commission now annually recruit around 30 graduates of at least civil service Administration Trainee standard who then take a professional accountancy qualification

- a management practice 'firm' staffed by high quality people drawn from the public sector and from leading private sector consultants (especially Mckinsey)

- a special studies unit with an OR flavour which has developed recognised expertise and methodology in specific areas of public sector provision from care of the elderly to education administration, using a mix of in-house staff, seconded auditors and bought-in expert practitioners (Exhibit 1 shows the study areas covered so far and projected)

- a quality control function with close links to the accountancy bodies, and a focus on improving audit standards in the District Audit Service and in private firms

- coherent and disciplined mechanisms for bringing the central work into the audit process - and vice versa. These involve

    . the development of unit cost profiles for all relevant bodies in all services (see Exhibit 2)

- the preparation of VFM-focused audit guides
- intensive annual training sessions and workshops to bring local auditors up-to-date
- tracking systems to monitor efficiency gains achieved

Working Methods

The shape of the resulting integrated audit is shown on Exhibit 3 attached. From a value for money perspective the three most important elements are:

- statistical support
- audit guides
- training in the analysis of management structures

The first is critical if auditors are to have a chance of assessing the efficiency of any individual body. Without access to comparability data an auditor does not know where to start.

The audit guides are the practical output of the special studies directorate. The central work on a particular service area, which results first in a published report, is the Commission's Research and Development. That R and D is then 'rolled out' into a detailed guide which allows auditors previously unfamiliar with the subject to analyse the service in their area. They are trained centrally each autumn in the use of the following year's guides.

Training in management is the third element, which is assuming increased importance. Management structures and competence are critical to efficient service provision. The central management practice staff have recently developed a methodology of analysing central management and administration in local authorities. Auditors will be trained in the use of this methodology shortly. The combination of a close knowledge of local circumstances and an understanding of the principles of good management will be particularly helpful to bodies which now lack strong corporate management.

Results

The Commission's central studies have pointed to national value improvement opportunities - it is by no means always a question of straightforward cost savings - amounting to well over £1 billion. At local level specific opportunities totalling £500 million annually have been identified. £80 million (annually) of this has so far been achieved.

Exhibit 4 shows how these sums are made up by individual service area. And it illustrates another important point. Decision making in public bodies is slow. But the longer a report has been in the system the more results are identified. The Audit Commission's rolling audit process keeps earlier reports 'live' at local level. Unfulfilled opportunities are brought back to the attention of decision-makers in future years, or whenever the environment appears more conducive to action.

These figures do not, of course, describe the full impact of value per money audit. Regular reporting on economy, efficiency and effectiveness creates an environment in which resource management generally assumes - higher profile in the minds of officials and elected or appointed representatives with benefits well beyond the specific areas covered by auditors each year.

Scope

The Audit Commission's structure and methodology is readily adaptable to areas of public provision outside the traditional local authority functions or to new bodies providing services currently controlled by local authorities. In many cases quasi-public provision does not operate within the constraints imposed by a free marketplace. Where this is so, structured value for money audit is an important guarantor of efficient resource utilisation.

Two other factors are also important:

- the Audit Commission's political independence is now acknowledged this adds to its value as a guarantor of efficiency and regularity

- the Commission's services themselves represent outstanding value for money; wholly private sector provision of a similar package - if it were available - would be considerably more expensive

Exhibit 1

PROGRAMME OF AUDITS

Type of Authority	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9	1989/90
CCs LBs** Met Ds	**Further Education** School Meals Police Civilian-isation	**Non-Teaching Costs** **Care of the Elderly** Children in Care Fire* Service		**Secondary School Teaching Costs**	Services for the Mentally Handi-capped	Education Admin Phase I Police* Phase I	Education Admin Phase II Police* Phase II
LBs Met Ds Shire Ds	**Refuse Collection** Leisure Centres Develop-ment Control	**Housing Supervision and Management Phase I**	**Housing Supervision and Management Phase II**	**Housing Maintenance**		Building DLOs	Parks and Leisure
All	**Purchasing Phase I**	**Vehicle Fleet Management**	**Purchasing Phase II** **Energy Management** **Cash Flow Management**	Highway Maintenance Phase I	Highway Maintenance Phase II Property Management		

(National reports have been published on those services in bold type and boxed)

* There are also independent police and fire authorities covering the metropolitan areas

** In Inner London education is managed by ILEA

Exhibit 2

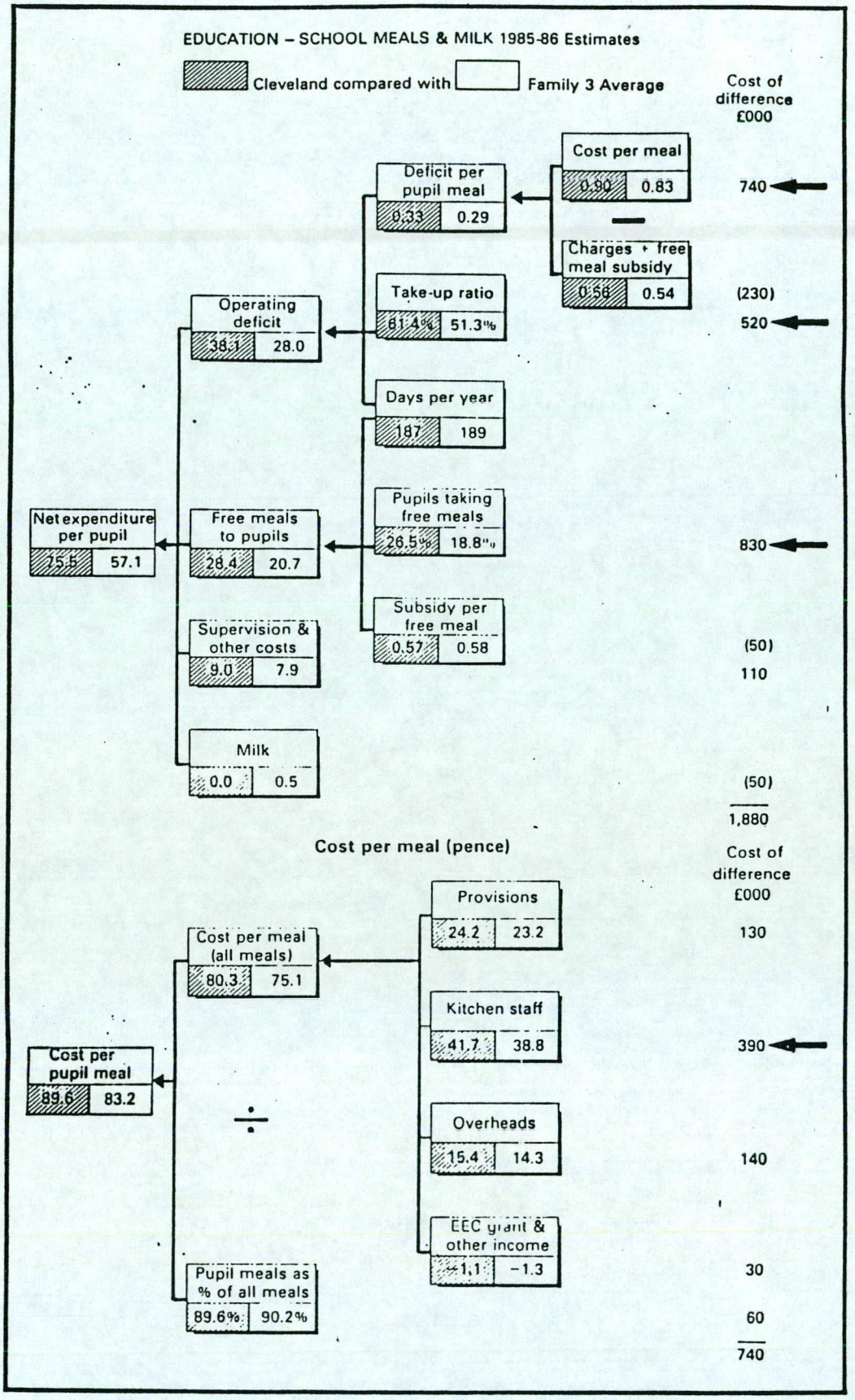

EDUCATION – SCHOOL MEALS & MILK 1985-86 Estimates
Cleveland compared with
Family 3 Average
Cost of difference £000
Cost per meal
0.90
0.83
740
Deficit per pupil meal
0.33
0.29
Charges + free meal subsidy
0.56
0.54
(230)
Take-up ratio
61.4%
51.3%
520
Operating deficit
38.1
28.0
Days per year
187
189
Pupils taking free meals
26.5%
18.8%
830
Net expenditure per pupil
55.5
57.1
Free meals to pupils
28.4
20.7
Subsidy per free meal
0.57
0.58
Supervision & other costs
9.0
7.9
(50)
110
Milk
0.0
0.5
(50)
1,880
Cost per meal (pence)
Cost of difference £000
Provisions
24.2
23.2
130
Cost per meal (all meals)
80.3
75.1
Kitchen staff
41.7
38.8
390
Cost per pupil meal
89.6
83.2
÷
Overheads
15.4
14.3
140
EEC grant & other income
−1.1
−1.3
30
Pupil meals as % of all meals
89.6%
90.2%
60
740

Exhibit 3

THE INTEGRATED AUDIT

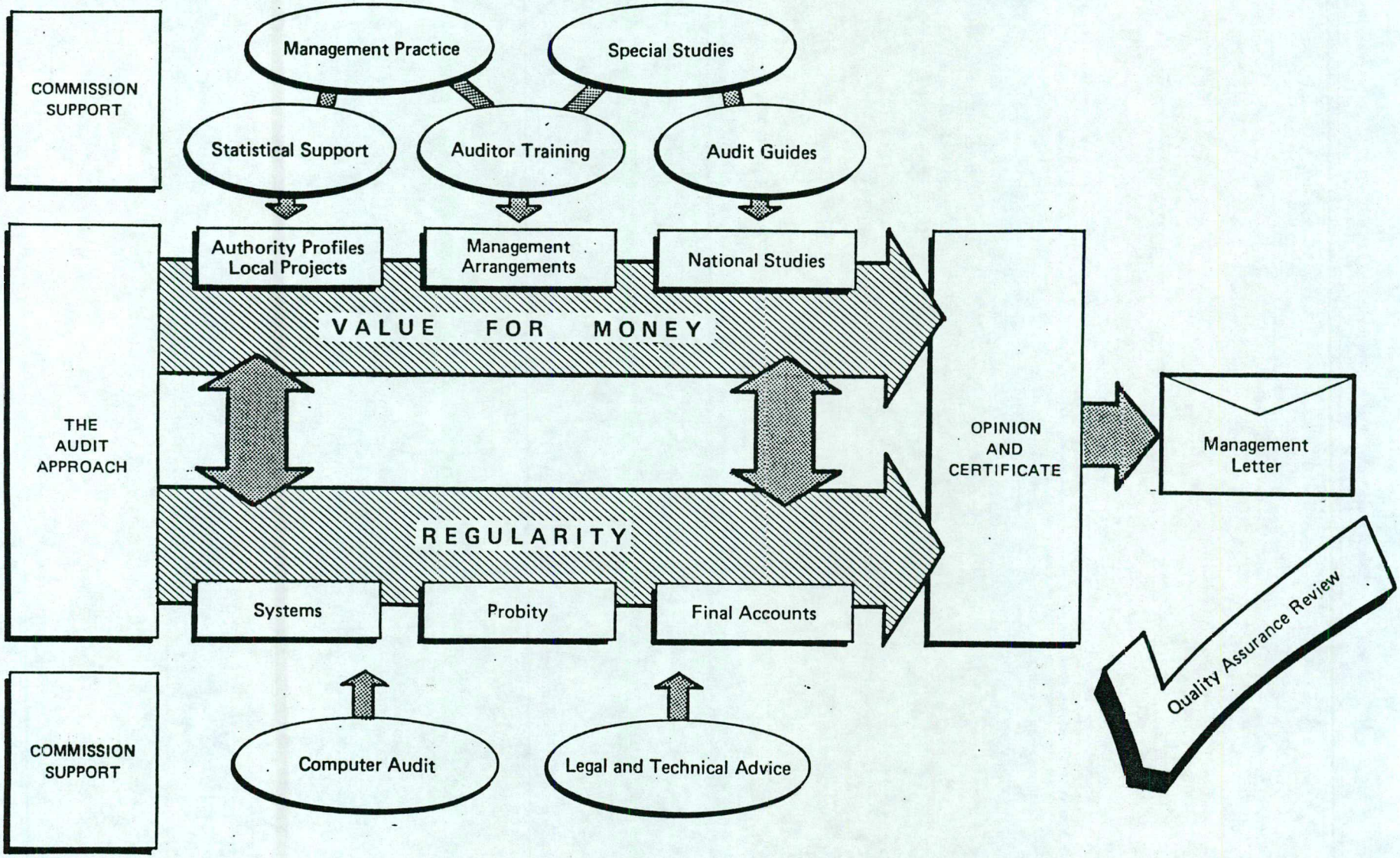
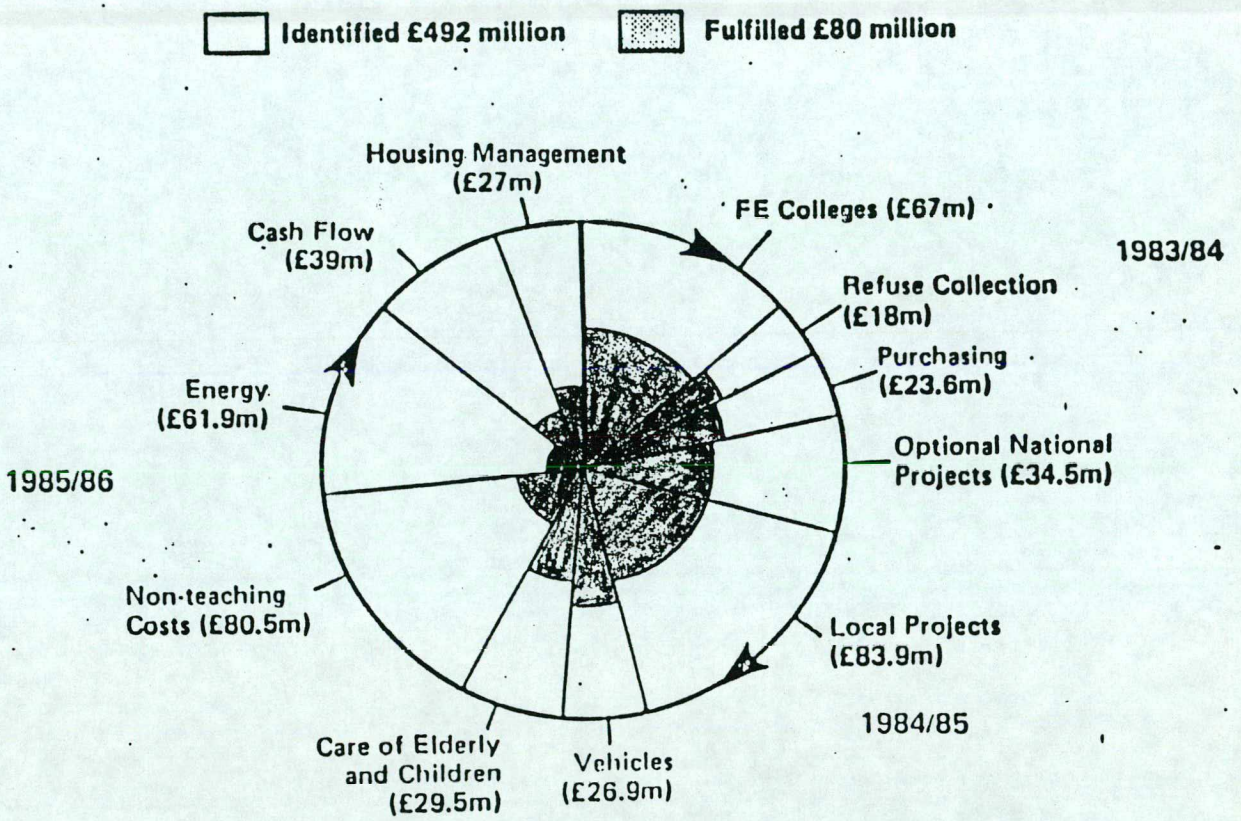


Exhibit 4

VFM PROJECTS 1983 TO 1986
VALUE IMPROVEMENTS



MC58

SECRET

FROM: MARK CALL
DATE: 8 FEBRUARY 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Sir P Middleton
Mr Anson
Mr Kemp
Miss Peirson
Mr Turnbull
Mr Saunders
Mr Parsonage
Mr Satchwell
Mr Cropper
Mr Tyrie

AN "AUDIT COMMISSION" FOR THE NHS

As you will have seen from Mr Cropper's note the Audit Commission entertained all Special Advisers to lunch last Friday, at which Howard Davies gave a very interesting resume of the work of the Commission. Andrew Turner, Special Adviser at the DHSS, and I took the opportunity to stay on and discuss with Howard how audit in the NHS might be made more effective. Earlier that week, Sir Robin Butler had met with the Audit Commission to discuss this, and the attached paper was the basis for their discussion.

2. AUDIT COMMISSION APPROACH

If the Audit Commission's responsibilities were extended to cover the NHS, they would approach it in the same way they had Local Authority expenditure. While they had initially been regarded with suspicion as a kind of Spanish Inquisition, the balance had now shifted and many councils were now seeking their help. Thus they would start on the NHS by identifying discrete areas where there was a greater chance of a successful outcome, such as property management, maintenance, cleaning, or vehicle fleet management.

3. From this work in a number of geographic areas, yardsticks would be developed and the lessons apllied throughout the UK.

In this way, specific and specialised Management Information Systems would be developed step by step. He reacted with horror to the suggestion that somebody would sit down and try to design from scratch an information system to cover the whole of the NHS. Essential to the successful rolling out of the local studies to national implementation would be the establishment of mechanisms whereby it was in the interest of other hospitals/districts to adopt the changes. This again points to the internal market.

4. After several years, and having notched up some successes, they would then have earned the "right" or credibility to look at such sacred cows as consultants.

5. ASSESSMENT

There is obviously an element of salesmanship in this, Nevertheless, overall the approach sounds plausible, and they certainly have an impressive track record regarding Local Authority expenditure, and a reputation for effectiveness and objectivity. The latter will be essential to achieving implementation of the conclusions of their work.

6. Howard Davies points out that the Government should recognise that an independent audit of the effectiveness of NHS spending may, from time to time, come to conclusions which would cause the Government some discomfort and point to higher spending. Thus from the public expenditure perspective, we would really have to believe that there are opportunities to improve productivity before embarking on this route. I don't think that should be a stumbling block.

MARK CALL

THE AUDIT COMMISSION AND NHS AUDIT

Advantages

1. Tighter control over the quality of regularity audit.

2. The management of competition and co-operation between 'own brand' and commercial firms' auditors maximises the use of the expertise of both sides. Commercial firms with experience of working with the Commission support wider application of its systems.

3. Major increase in the effectiveness of value for money work through

   - Development of usable comparative statistics.
   - Central studies on individual topics and national published reports.
   - Training and 'audit guides' for in-house and commercial auditors to use locally.
   - Analysis of the results of local VFM work.

4. Direct learning from investigations of similar functions in local government (eg. property management, maintenance, cleaning, vehicle fleet management) which gives the Commission's auditors a head start in many areas.

5. Increased morale of internal staff through exposure to a more dynamic organisation with a commitment to progress, 'the rate for the job', training and collaboration with the private sector.

6. Enhanced private sector input up to Audit Commission current level of 30% or (probably) above.

7. Strong commitment to, and outstanding expertise in, computer audit.

8. Audits paid for by individual authorities, creating increased pressure on auditors and enhanced interest in the product of auditors work at local level.

THE AUDIT COMMISSION AND NHS AUDIT

DIFFICULTIES	HOW TO RESOLVE
1. Additional cost of £2-3m pa.	1. Additional efficiency savings will more than compensate.
2. Relationship with NAO and PAC.	2. (Need to consult PAC). Audit Commission work open to NAO inspection. Joint efficiency studies between Audit Commission and NAO. ? power of direction for C+ AG.
3. Relationship with DHSS/Secretary of State	3. Annual report to Secretary of State.
4. Future of FP4 Division of DHSS (existing external auditors).	4. As with District Audit Service, suitable staff offered transfer terms to Audit Commission. (Maybe no net reduction in staff numbers if VFM work is increased).
5. Role of the Commission itself.	5. Need for statutory clarity on locus vis-a-vis NHS. Strengthen Commission with health-focused members.
6. Little NHS expertise among Commission staff.	6. Have already examined health-related areas. Hire in small team for central work on quality control and value for money studies.

mjd 3/11lm

CONFIDENTIAL

PMP

FROM: MISS M P WALLACE
DATE: 8 February 1988

MR CROPPER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Anson
Mr Kemp
Miss Peirson
Mr Saunders
Mr Tyrie
Mr Call

AUDIT COMMISSION

The Chancellor was grateful for your minute of 5 February. He has commented: "The sooner these people are let loose on the NHS, the better".

MPW.

MOIRA WALLACE

mjd 3/114m

SECRET

FROM: MISS M P WALLACE
DATE: 9 February 1988

MISS PEIRSON

cc Chief Secretary
Paymaster General
Sir P Middleton
Mr Anson
Mr Kemp
Mr Turnbull
Mr Parsonage
Mr Saunders
Mr Satchwell
Mr Cropper
Mr Tyrie
Mr Call

AN "AUDIT COMMISSION" FOR THE NHS

The Chancellor was most grateful for your minute of 8 February and Mr Call's of the same date. He broadly agrees with the points you make. But he still has a deep suspicion of the Korner exercise, on the grounds that it is too elaborate, although the RMI is clearly something to build on. He agrees that it will be important to feed into the drafting of any audit paper our view that we need an independent audit commission to publicise cost differences between health authorities.

MOIRA WALLACE

8.2.1

SECRET

FROM: MISS M E PEIRSON

DATE: 8 FEBRUARY 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Sir P Middleton
Mr Anson
Mr Kemp
Mr Turnbull
Mr Parsonage
Mr Saunders
Mr Satchwell
Mr Cropper
Mr Tyrie
Mr Call

AN "AUDIT COMMISSION" FOR THE NHS

1. Perhaps I could add one gloss to Mr Call's note of today.

2. Mr Call says that Mr Davies reacted with horror to the suggestion that an NHS information system should be designed from scratch. His reaction was the more justified in view of the fact that the Korner management information system has only recently been designed and is in process of being implemented. Mr Davies may not have been aware of that. It would be a great pity if the efforts now being made by DHSS and throughout the NHS to get managers, doctors and nurses to use the Korner system were to be undermined by any suggestion that another new information system should be designed.

3. Secondly, although I can well understand Mr Davies' desire to start slowly in easy areas, it would in fact be a pity in the case of the NHS to start with the support areas he mentioned. These areas (cleaning, etc) have been intensively looked at for several years by the health authorities, in their effort to pursue cost improvement programmes, and DHSS have been telling us for a year now that the scope for efficiency savings in these areas is running out. (Separate work is proceeding on property management, and there is a considerable incentive here for health authorities to pursue greater efficiency, in the freedom they have to keep the proceeds of asset sales to spend on new building.)

4. What we need now is greater efficiency in the clinical area, which is, as Mr Davies rightly implies, the most difficult. And DHSS have begun here, with the Resource Management Initiative. It is true that we do not know an awful lot about that initiative, and exactly how the pilot schemes are working, but it is clearly an attempt to persuade health authorities, and especially the consultants working in them, to ascertain the costs of treating different types of patient, and to manage their budgets accordingly. Since DHSS have got as far as persuading 5 or 6 health authorities to attempt these schemes, and have got the support of the Joint Consultants Committee, we should build on that Initiative, and push it through. The DHSS do not wish to antagonise the doctors, and are therefore at present planning a very lengthy evaluation of the pilot schemes, as I mentioned at your meeting this morning, and we need to try to shorten that process drastically; but we do need to recognise that it would be counterproductive to force the pace to such an extent that the Joint Consultants Committee came out against the idea. However, I think a management consultants' report by July, and a significant extension of the Initiative (say to 20-30 more health authorities initially) in the autumn should be acceptable.

Conclusion

5. I conclude that Mr Davies' suggested approach would be starting much too far behind the game. But there certainly is a role for an independent Audit Commission, especially (initially) to publicise the differences in costs between different health authorities, as Mr Davies has done for education authorities. We shall make sure such thoughts get into the paper that is written about audit in response to 7h of the Cabinet Office paper.

MEP

MISS M E PEIRSON

2.10.2

NOT FOR NAO EYES
CONFIDENTIAL

FROM: MISS M E PEIRSON

DATE: 10 FEBRUARY 1988

CHIEF SECRETARY

cc Chancellor
Paymaster General
Sir P Middleton
Mr Anson
Mr Kemp
Mr Beastall
Mr Turnbull
Mr Parsonage
Mr Saunders
Mr Satchwell
Mr Cropper
Mr Tyrie
Mr Call

THE AUDIT COMMISSION AND THE NHS: VISIT BY MR DAVIES

You are seeing Mr Davies tomorrow, and you asked for a brief. Mr Davies will of course wish to go further into the possibility of the Audit Commission taking over the external audit of the NHS, on which he has already supplied the notes attached to Mr Call's minute of 8 February (further copies attached). Points that are likely to come up, or that you might wish to raise with Mr Davies, are as follows.

The Audit Commission?

2. You may wish at this stage to be a little cautious about whether the new independent auditors for the NHS should be the Audit Commission. That certainly seems the best idea, but there are some hurdles, within Government and beyond, to surmount before it can be agreed:-

(i) the DHSS have to be persuaded: not only do they at present provide the external audit (probably not a serious difficulty), but they are resistant to the idea of publicising the differences in costs between the various health authorities, and know that is why we want a new independent audit;

(ii) the NAO have to be persuaded (see below).

Proposed role

3. You may also wish to discuss with Mr Davies how, if the Audit Commission did take on the job, they should set about it. As I said in my earlier note to the Chancellor, I think we want to persuade Mr Davies that it is the clinical area (ie the actual treatment of patients) that now needs looking at, not the support areas. See below for further details.

Relationship with NAO and PAC

4. Mr Davies is clearly aware, from his notes, that there is a problem here. The NAO have a statutory right of access to health authority accounts, and indeed last year I was informed by the NAO that they had begun or were planning a large number of studies of the NHS. The NAO people are extremely unimpressive, and ignorant, so we certainly do not want to propose them as an alternative to the Audit Commission, but they must be squared, particularly since they are expanding very considerably into the value for money area (generally, not just in the health service).

5. Mr Beastall advises that the Government is entitled to bring in the Audit Commission if it wants, but clearly it would be better to try to reach agreement with the NAO, not only because of the NAO's feelings but because life could get very rough for the health authorities if the NAO were stimulated by jealousy to accelerate their programme of studies so that two very eager beavers were investigating the same sorts of things. Mr Beastall suggests that the best approach would be to consult the NAO, and to try to do a deal, which would then simply be reported to the PAC. The offer of joint studies, which Mr Davies suggests, might be a way of getting NAO to agree. Mr Beastall adds that the approach to the NAO should probably in the first instance be by a letter to Mr Bourn, the C and AG, which could go from either the Treasury or the DHSS: provided that we can persuade the DHSS, it would look better if the letter came from them. Finally, Mr Beastall says that there would be no power of direction for the C and AG (as queried by Mr Davies).

Avoidance of support areas

6. Mr Davies has a good point in suggesting that, in order to obtain the confidence of the health authorities, it is desirable to start with areas where it is easy for an efficiency audit to show scope for significant savings. However, in the case of the health authorities that is not what we urgently require, and the scope is much more limited than Mr Davies probably supposes.

7. On the first point, what we urgently need is publicisation of the statistics for different health authorities, showing the differences in costs of treatment, lengths of waiting lists, waiting times, and the factors that go to make up those differences (eg lengths of stay in bed). That would help to support, among other things, the one effort that DHSS are making to improve efficiency in this area, namely the resource management initiative (see below).

8. On the second point, Mr Davies mentions property management, maintenance, cleaning, and vehicle fleet management. For some years now, the health authorities have been obliged to produce cost improvement programmes, and these have concentrated largely on these very support services (excluding property management, which I discuss below). As a result, savings of £150m per annum cumulative have been secured, partly through contracting out but mainly through greater efficiency in the inhouse services. DHSS (Mr Ian Mills) have been assuring us for a year now that the scope for further savings of this sort is running out, and that the only hope of maintaining such a rate of savings is to begin to investigate the clinical area. Therefore it is unlikely that Mr Davies' people could impress the health authorities by discovering easy new savings in the support services.

9. As for property management, it is true that the health authorities at present do not manage their property at all well, having little or no information about the assets they hold, or any rational estate or investment plans; but work has begun in this

area. A working party recommended in 1985 various steps to be taken, and options are being tested in some pilot regions. (The work was prompted in part by CIPFA.) Again, it is probably not a good area for Mr Davies' people to achieve the good press he wants.

Information systems

10. In this context, you might mention to Mr Davies the existence of the Korner information system. It is now fully operational, as regards data being fed into the computers, though there is still a problem about getting some of the managers, doctors and nurses to use the information. The Chancellor has suggested that the system may be too elaborate, and that may well be one of the problems, but it would do no good to try to overturn it and replace it with another system, only months after the enormous efforts that have been made to put it in place. Any new value-for-money efforts should work with the Korner system.

Resource Management Initiative

11. In case Mr Davies asks about this, you might like to explain that, as we understand it, the Initiative represents a big effort by DHSS (again, Mr I Mills) to persuade health authorities, and especially the consultants working in them, to ascertain the costs of treating different kinds of patient, and to manage their budgets accordingly. Pilot schemes began first with the community health services in a couple of district authorities, and are now extending for those services to a dozen or more districts. In addition, and perhaps more importantly, pilot schemes are running at six districts for the acute services. Since DHSS have managed to persuade these districts to attempt these schemes , and have got the support of the Joint Consultants Committee, we should build on that Initiative, and push it through.

MEP

MISS M E PEIRSON

THE AUDIT COMMISSION AND NHS AUDIT

Advantages

1. Tighter control over the quality of regularity audit.

2. The management of competition and co-operation between 'own brand' and commercial firms' auditors maximises the use of the expertise of both sides. Commercial firms with experience of working with the Commission support wider application of its systems.

3. Major increase in the effectiveness of value for money work through

   - Development of usable comparative statistics.
   - Central studies on individual topics and national published reports.
   - Training and 'audit guides' for in-house and commercial auditors to use locally.
   - Analysis of the results of local VFM work.

4. Direct learning from investigations of similar functions in local government (eg. property management, maintenance, cleaning, vehicle fleet management) which gives the Commission's auditors a head start in many areas.

5. Increased morale of internal staff through exposure to a more dynamic organisation with a commitment to progress, 'the rate for the job', training and collaboration with the private sector.

6. Enhanced private sector input up to Audit Commission current level of 30% or (probably) above.

7. Strong commitment to, and outstanding expertise in, computer audit.

8. Audits paid for by individual authorities, creating increased pressure on auditors and enhanced interest in the product of auditors work at local level.

THE AUDIT COMMISSION AND NHS AUDIT

DIFFICULTIES	HOW TO RESOLVE
1. Additional cost of £2-3m pa.	1. Additional efficiency savings will more than compensate.
2. Relationship with NAO and PAC.	2. (Need to consult PAC). Audit Commission work open to NAO inspection. Joint efficiency studies between Audit Commission and NAO. ? power of direction for C+ AG.
3. Relationship with DHSS/Secretary of State	3. Annual report to Secretary of State.
4. Future of FP4 Division of DHSS (existing external auditors).	4. As with District Audit Service, suitable staff offered transfer terms to Audit Commission. (Maybe no net reduction in staff numbers if VFM work is increased).
5. Role of the Commission itself.	5. Need for statutory clarity on locus vis-a-vis NHS. Strengthen Commission with health-focused members.
6. Little NHS expertise among Commission staff.	6. Have already examined health-related areas. Hire in small team for central work on quality control and value for money studies.

007/3651

RESTRICTED

CY

You have already seen notes from Messrs Cropper & Call. NOPW 9/2

? Just arrived

FROM: A G TYRIE

DATE: 5 FEBRUARY 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Potter
Mr Cropper
Mr Call

We can discuss post-Budget.

THE AUDIT COMMISSION

Howard Davies asked the advisers round to lunch at his HQ today.

He seems to be running a pretty efficient ship. I asked him how we could convert more of the £1 billion 'value improvement opportunities', already identified by the Commission, into savings. (So far only £80 million have been 'achieved'.) One point he made in reply struck me as important. He said that the consequence of Government reform in other areas, for example education, would eventually force us to review the whole structure of local authority administration, the relationship between councillors and local government employees, the numbers required to perform each function etc. As he pointed out, what on earth is the point of heavily staffed committees on educational matters in areas where a high percentage of the schools may have opted out? Howard felt that this structural reform of local government would be unavoidable in a fourth term. Is anyone doing any thinking in this highly sensitive area?

I gather that Peter Cropper is minuting you separately on Audit Commission type work for the health service and that he has also attached the 'sales promotion' note we were handed.

Agt.

A G TYRIE

AUDIT COMMISSION

ps2/9M

RESTRICTED

25/3

FROM: MISS M P WALLACE
DATE: 10 February 1988

MR TYRIE

pl put on prayers agenda for ~~Friday~~ MONDAY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Potter
Mr Cropper
Mr Call

THE AUDIT COMMISSION

The Chancellor has seen your minute of 5 February. He thinks Mr Davies' ideas would be worth discussing after the Budget.

MONDAY PRAYERS

MOIRA WALLACE

RM2.77

CONFIDENTIAL

FROM: MOIRA WALLACE
DATE: 8 February 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Anson
Mr Monck
Mr Mason
Mr Ilett
Mr MacAuslan
Mr Inglis
Mr Wynn Owen
Mr Flanagan
Mr Call
Mr Cropper
Mr Tyrie
Mr Beighton - IR
Mr Shaw - IR
Mr Fryett - C&E

AUDIT OF SMALL COMPANIES

The Chancellor has seen Sir A Wilson's minute of 2 February, providing briefing for the Financial Secretary's meeting with Mr Maude tomorrow. The Chancellor agrees that we could readily move from a £100,000 ceiling to one of - say - £500,000 in order to reach agreement. The Chancellor has also noted that Sir A Wilson refers to the accountants' endorsement which we seek in place of audit as something that would be necessary on a "transitional" basis.

MOIRA WALLACE

3/2919

FROM: SIR ANTHONY WILSON
DATE: 2 February 1988

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Anson
Mr Monck
Mr Mason
Mr Ilett
Mr MacAuslan
Mr Inglis
Mr Wynn Owen
Mr Flanagan
Mr Call
Mr Cropper
Mr Tyrie
Mr Beighton - IR
Mr Shaw - IR
Mr Fryett - C&E

Ch/ you may like to see briefing for FST's meeting with Mr Maude. Also IR/C&E views on Touche Ross submission behind

AUDIT OF SMALL COMPANIES

You are holding a meeting on Tuesday 9 February with Mr Maude, Mr Cope and others to discuss possible changes in the audit requirement for small companies, and asked for an aide-memoire on the subject. This is attached, together with a copy of the exchange of correspondence between the Chancellor and Lord Young on the subject, for easy reference.

2. You also asked for a commentary on the Touche Ross submission on this subject, and this will be sent to you in a day or two.

3. The suggested line to take at your meeting is set out on the last page of the aide-memoire. Those members of the accountancy institutes whom I have consulted in confidence about the possibility of developing a form of endorsement of unaudited accounts by their members, associating themselves in some sort of "properly prepared" way, have expressed concern about the form in which such endorsement could be given. Nevertheless, I believe that the need for such endorsement

is important during the transitional period in which mandatory audit for small companies is abandoned for the first time. If Mr Maude and Mr Cope appear unable to accept a threshold of £100,000 turnover as a dividing line between the companies which need no longer have an audit, and those which must continue to do so, I believe it would be reasonable to raise this threshold, but only on condition that they agreed to have a continuing endorsement of unaudited accounts by a professional accountant in some way falling short of an audit report.

pp A WILSON

2928/10

AUDIT OF SMALL COMPANIES

CURRENT POSITION

- All UK limited companies are required by law to have an annual audit. This contrasts with the position in the USA and many European countries where the audit is not mandatory for many privately owned companies.

DTI PROPOSALS

- DTI has proposed that mandatory audit be removed for companies with turnover of less than £2 million (the EC 4th Directive permissive threshold), except for companies engaged in financial services business and members of groups with combined turnover of more than £2 million for which universal audit requirements will continue.

TREASURY POSITION (as set out in the Chancellor's letter to Lord Young of 18 December 1987 - attached for easy reference)

- The universal audit requirement should not be removed without the substitution of some form of public association of an independent professional accountant with the accounts.

- DTI officials and the professional accountancy bodies should discuss ways in which the "audit" of accounts of small companies could be discontinued and replaced with some form of review by an independent professional.

- Removal of the mandatory audit requirement is difficult to reconcile with the Statement made in 1986 in the White Paper "Building Business .... not Barriers" that the Government was determined to maintain the audit as a first defence against fraud.

The only changes since that date have been the representations of the English and Scottish Chartered Institutes to the DTI that the mandatory audit requirement be removed; the Chartered Association of Certified Accountants wishes to maintain mandatory audit.

- Replacement of the mandatory audit by an independent accountant's review will allow proper development of "auditing" standards for larger companies while ensuring that a reasonable element of independent expertise is brought to bear on the accounts of smaller companies.

COMMENTS ON DTI ARGUMENTS

1. The limitations of small companies' audits are such that any deterrent effect they may have does not outweigh their costs.

   - The involvement of an independent professional in a company's housekeeping at least once a year is more important than the intrinsic value of the audit report.

   - The additional cost of audit over and above the other services, such as accountancy and taxation which most commentators expect to continue, is, for many companies, a relatively small proportion of the whole (perhaps 10% of total cost).

   - The Inland Revenue and Customs & Excise argue that significant amounts of revenue will be put at risk by abolition. In practice a far greater source of loss of revenue is error rather than fraud and the involvement of an independent professional accountant should ensure that potential losses to the Exchequer from this source are minimised.

2. The English and Scottish Chartered Institutes have expressed the view that the mandatory audit requirement for small companies should be removed.

- This represents a recent change of heart caused by concern that the monitoring standards required on implementation of the EC 8th Directive are likely to be difficult and expensive to enforce if they have to be applied to all the members of these Institutes including the large number of small firms engaged in small company audits.

- The Certified Accountants on the other hand, whose members audit a significant number of small companies, favour retention of the mandatory audit.

3. The USA and most other European countries do not have a mandatory audit requirement for all limited companies.

- Most of these countries have never had a business culture in which audit of all companies is compulsory. There is a considerable difference between a climate in which a mandatory audit becomes optional and one in which an audit has never been expected. Something of value needs to be put in place to fill the vacuum.

4. The introduction of performance monitoring standards under the EC 8th Directive is likely to increase audit costs.

- The recommended route of the independent accountant's report amounting to less than an audit would avoid the extra costs created by the new regulatory regime. (As indicated under the "Treasury Position" section above, the scope of the independent accountant's role has yet to be defined).

5. Where a company employs its own qualified accountant, the requirement for an independent accountant's involvement will add unnecessary cost.

- If the reporting accountant's role is to be of any value, it is vital that he is independent of the management or ownerships of the company. Most people, faced with a conflict of loyalties between an employer and a remote professional body, will find it extremely difficult to maintain an independent stance.

LINE TO TAKE

The Inland Revenue and possibly Customs and Excise will make separate submissions regarding their special interests and will attend your meeting on 9 February.

You should repeat the points made by the Chancellor in his letter to Lord Young of 18 December 1987 (attached for easy reference):

a. Removal of compulsory audit without substituting some form of association of an independent professional accountant with the accounts would damage their credibility in the small company business sector

b. It is not so much the form of the audit report itself as the annual incursion of an independent professional into every company's housekeeping and the resulting presentation of the accounting information which is of value

c. Inland Revenue, Customs and Excise, banks and smaller traders all have important interests in the credibility of small company accounts; these must be reasonably safeguarded

d. DTI officials should discuss with the accountancy institutes how best to provide an effective substitute for audit of small companies which is less burdensome for them.

You should suggest that mandatory "audit" is relaxed for companies with an annual turnover of £100,000 with a power to increase this by Statutory Instrument once experience of the new regime has been evaluated. There will be pressure from DTI to increase this threshold to say £500,000 but this should only be conceded if DTI Ministers are prepared to accept the continuation of a mandatory review in place of audit.

Reference may also be made to the need for further work to identify

accounting disclosures which can be relaxed for smaller companies. The Inland Revenue oppose this, but you should be prepared to authorise an interdepartmental review of accounting disclosures, in which DTI, Inland Revenue and the Treasury would be concerned as soon as the Budget is out of the way.

A WILSON

42/2/CG/74/4367

NOTE OF A MEETING HELD IN THE FINANCIAL SECRETARY'S ROOM, HM TREASURY ON 9 FEBRUARY 1988 AT 3.15 PM

Those present: Financial Secretary

Mr Cope - Department of Employment
Mr Maude - Department of Trade and Industry

Sir A Wilson - HMT
Mr Inglis - HMT
Mr Cropper - HMT
Mr Tyrie - HMT
Mr Beighton - IR
Mr Shaw - IR
Mr Fryett - Customs & Excise
Mr Worman - DTI
Ms Hall - DE

SMALL COMPANIES: ACCOUNTING DISCLOSURES AND STATUTORY AUDIT

Mr Maude opened by saying that he wanted to discuss two issues:

(i) The content of small company accounts

(ii) The statutory audit requirement for small companies.

2. As regards (i), Mr Maude said that the 1986 inter-departmental study had proposed only minor relaxations to the disclosure requirements. In his view it would put businesses to more trouble to implement this small change than to leave matters as they stood. He therefore hoped that it would be possible for officials to look again at the scope for making substantial changes in this area.

3. Mr Beighton pointed out that the reason why the 1986 proposals had not been implemented was not because they were in themselves insignificant, but because it had been established at a late stage that primary legislation would be required. A suitable legislative vehicle was still awaited.

4. The Financial Secretary said that he was happy for Treasury and Inland Revenue officials to take part in a further review of accounting disclosures. Mr Cope asked that DE officials also be involved.

5. As regards (ii), Mr Maude said that for companies with turnover between £100,000 and £2 million per annum the statutory audit requirement represented a considerable burden. The audit was of negligible use to DTI, shareholders or creditors.

6. Mr Cope said that he thought the removal of the audit requirement for small firms would be an important change, although he doubted whether in practice it would save them a great deal of money. He thought that the Revenue would want something in its place.

7. The Financial Secretary said that the Chancellor had suggested (his letter to Lord Young of 18 December 1987) that if the compulsory audit were removed for small companies there ought to be put in its place a requirement for some form of public association by an independent professional accountant with the accounts. The Financial Secretary said that this would do something to remove the burden on small businesses whilst maintaining the credibility of small company accounts. What was important was the annual incursion of an independent professional into every company's housekeeping. The Financial Secretary asked for Mr Maude's views on this proposal.

8. Mr Maude said that the outline proposal needed to be spelt out in more detail. He thought there was a danger that the proposed "association with the accounts" might turn out to be close to an audit. On the other hand, the association might be fairly unconsequential, in which case he doubted whether it would be acceptable to the Financial Secretary.

9. Sir Anthony Wilson said that the kind of approach proposed by the Chancellor was used both in Australia (which previously had had a statutory audit requirement) and in the US. In Australia the accountant or tax agent filled in a form for taxation compliance purposes and signed it, sending in the accounts as supporting information.

10. Mr Maude thought it was certainly worth exploring the Chancellor's proposal but he was sceptical about whether it would produce an acceptable compromise.

11. As to the appropriate threshold, Mr Maude said that he thought £2 million turnover was a sensible level. Mr Beighton said that this would cover 95% of all companies. The Financial Secretary added that a threshold of £2 million was very much higher than that envisaged by the Treasury.

12. Mr Cope said that if the purpose of the "professional association" was to satisfy the Revenue (as was the case in Australia), there was no logic in not placing a similar requirement upon unincorporated businesses.

13. Mr Beighton said that the conclusion reached by Ministers in 1986 after the original consultation exercise was that a case had not been made for removing the statutory audit requirement for small companies. This conclusion had not rested on tax considerations, but on the view that the audit was the first defence against fraud. He thought therefore that the Government would need, in its presentation of the change of policy on the audit, to emphasise that the latter would be replaced by some other requirement which continued to provide a defence against fraud.

14. The Financial Secretary said that the objective was to find a way of lessening the burden on businesses, a burden which would otherwise be likely to rise, without opening up the possibility of widespread fraud. He asked how Mr Maude wanted to take things forward.

15. Mr Maude said that he wanted officials to work on a form of association which would represent a substantial reduction in the compliance burden. He also thought officials should explore whether the form of association would be a Revenue requirement or a company law requirement.

16. The Financial Secretary agreed that this was an acceptable remit and suggested that Sir Anthony Wilson's group take it forward.

q.h.

JEREMY HEYWOOD
Private Secretary
10.2.1988

cc Those present
PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Mr Kemp
Mr Monck
Mr Burgner
Mr MacAuslan
PS/IR
PS/Customs & Excise

NOT FOR NAO EYES
CONFIDENTIAL

From: S D H SARGENT

Date: 11 February 1988

MISS PEIRSON

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
Mr Anson
Mr Kemp
Mr Beastall
Mr Turnbull
Mr Parsonage
Mr Saunders
Mr Satchwell
Mr Cropper
Mr Tyrie
Mr Call

THE AUDIT COMMISSION AND THE NHS: VISIT BY MR DAVIES

Sir Peter Middleton has seen your minute to the Chief Secretary of 10 February. He wonders whether we can really deal with the NAO in this way. He is not at all keen for the Treasury to play a leading role in promoting the possibility of the Audit Commission taking over the external audit of the NHS, given our other problems with the PAC at present.

S D H SARGENT
Private Secretary

ps2/11A

NOT FOR NAO EYES

CONFIDENTIAL

FROM: MISS M P WALLACE
DATE: 11 February 1988

PS/CHIEF SECRETARY

cc PS/Paymaster General
Sir P Middleton
Mr Anson
Mr Kemp
Mr Beastall
Mr Turnbull
Miss Peirson
Mr Parsonage
Mr Saunders
Mr Satchwell
Mr Cropper
Mr Tyrie
Mr Call

THE AUDIT COMMISSION AND THE NHS: VISIT BY MR DAVIES

The Chancellor has seen Miss Peirson's minute of 10 February, providing briefing for the Chief Secretary's meeting with Mr Davies today. The Chancellor has commented that, while he agrees that the clinical area is the key, he does not believe the DHSS claims that scope for further savings in the support areas is running out.

MOIRA WALLACE

HK/Q/42

Department of Employment
Caxton House Tothill Street London SW1H 9NF
Telephone Direct Line 01-213 5805
Switchboard 01-213 3000

Minister of State

The Rt Hon Norman Lamont MP
Financial Secretary
Treasury
Parliament Street
LONDON
SW1P 3AG

19 February 1988

Sir. A. Wilson.
PPS, CST, PMG, EST
Sir. P. Middleton.
Mr. Anson Mr. Kemp
Mr. Monck Mr. Inglis
Mr. Burgner Mr MacAusian

Further to our meeting with Francis Maude about Statutory Audit for small companies I thought I should make clear that I see a clear distinction between a requirement for statutory public audit to check fraud against creditors, shareholders etc and Revenue requirements for the information necessary to check tax liability and tax fraud.

The need for statutory public audit arises from limited liability towards creditors and the shared liability of shareholders. These days general creditors, standing behind the Revenue, Customs and preferential creditors, find statutorily audited historic accounts of very limited value in the case of small companies and I think shareholders should be able to dispense with an audit if they wish, and if the company can borrow what they need without the bank or other major creditor insisting on it. The Revenue requirements as far as small companies are concerned are no different from those involving unincorporated businesses of similar size. Clearly in both cases independently verified figures will require less vetting. I am not clear from our meeting whether the Revenue really rely much on audit certificates in the case of small companies, or what extra they do in the case of unincorporated businesses.

I would also like to suggest two slight amendments to the minutes of the meeting which were circulated by your Private Secretary on 10 February.

cc: Mr. Cropper
Mr. Tyrie
Mr Beighton IR
PS/IR
PS/C + E

Para 12 "Mr Cope asked if the Revenue proposed that the "professional association" should also be placed on unincorporated businesses as a distinction would be logical".

Para 13 "Mr Beighton said the Revenue had no proposal to extend further requirements to unincorporated businesses. The conclusion reached by Ministers ...".

I am copying this letter to Francis Maude.

JOHN COPE

ph61

CONFIDENTIAL

BF 29/2

FROM: MISS M P WALLACE
DATE: 22 FEBRUARY 1988

PS/CHIEF SECRETARY

cc PS/Paymaster General
Sir P Middleton
Mr Anson
Mr Phillips
Mr Beastall
Mr Turnbull
Miss Peirson
Mr Parsonage
Mr Saunders
Mr Potter
Mr Call

AUDIT COMMISSION AND THE NHS

The Chancellor has seen Mr Sargent's minute of 11 February, and your note of the Chief Secretary's meeting with Mr Davies and Dr Tristem. He would be grateful for the Chief Secretary's views on whether the Audit Commission can be used for the NHS, and if so, how.

MOIRA WALLACE

001/4202

CONFIDENTIAL

briefing & minute from PEM pse.

NOTE OF A MEETING WITH MR DAVIES AND DR TRISTEM OF THE AUDIT COMMISSION (11 Feb)

Present: Chief Secretary
Mr Kemp
Miss Peirson
Mr Potter
Mr Call

Mr Davies)
Dr Tristem) Audit Commission

Ch/ see also PEM's reservation in minute of 11/2 behind

MPW 17/2

AUDIT COMMISSION

Mr Davies gave the Chief Secretary a presentation on the work of the Audit Commission following the lines of the attached handout.

2 Mr Davies said that the key to the theme of the Audit Commission's approach was the integrated audit which differed from a pure regularity audit. The basic tool was the comparability study where a statistical profile of the local authority comparing it with similar authorities in its cluster was produced. This work was based on CIPFA data and Sub-contracted by the Audit Commission. Exhibit 1. showed the sort of profile that this produced. Miss Peirson asked about the publicity given to these profiles. Mr Davies said that business ratepayers were encouraged to make use of them in statutory consultation. They were not press released but they were made available within the Council. The second area of work was in depth special studies. The Audit Commission employed permanent staff and secondees to undertake these investigations. They found it useful to engage people with particular expertises. Each year about £1½ to £2 billion of expenditure was covered. Three fully researched projects

were produced every year. The study was completed and then provided an input into the audit of individual authorities. The public national study raised interest and illustrated best practice based on a sample of authorities.

3 The Chief Secretary asked about the study that had been produced on care in the community. Mr Davies said that they had been discussing with Sir Roy Griffiths his report on 'Care in the Community'. They believed he was working towards a solution which would encourage financial neutrality between local authority health authority and private residential care from the point of view of the "care co-ordinator". The present system failed on that count. Mr Davies said that the Audit Commission would not resist ring-fencing of this item of expenditure and paying a specific grant based on monitorable and auditable plans.

4 Mr Davies said that Section 27 studies interacted to some extent with the responsibilities of the NAO. There had been a deliberate decision to set up a joint study on the probation service.

5 The local audits were carried out by the District Audit Service and big eight chartered accountants. They were structured around the audit guide. That encouraged linkage between the regularity audit and the value for money audit. There were points where to the two blurred the one into the other e.g. on housing maintenance in many cases fraud was a major factor in failing to achieve decent cost efficiency. The Chief Secretary asked about the duties of local authority pension fund trustees in the News on Sunday case - would that fall foul of a regulatory audit. Mr Davies said that this was the subject of a current audit investigation. On first sight it looked as though the Council had protected itself because it was reasonable to devote a small part of a pension fund to high risk investment. Mr Potter noted

that some of the big eight accountants did not regard Audit Commission work as profitable work. He believed that Councils felt they didn't get the same value for money from a private accountancy firm as from the Audit Commission. Mr Davies noted this point and said there were advantages and disadvantages to using the private firms and District Audit Service.

6 The management letter sent to the local authorities translated the audit guide into specific savings at local level. While some proposals were initially rejected as policy changes it was notable that policy did evolve over time and increasing amounts of saving were being achieved from the earlier studies. However it would have been possible to move towards full achievement of these savings without the boost from the legislation to ensure competition. The Chief Secretary asked about quality of service, post contracting out. Dr Tristem noted that there had been teething problems because local authorities were unskilled in drawing up contracts providing for specific standards of service. Mr Kemp asked whether price and quality tended to rise over time. Mr Davies noted that inefficient Councils with expensive DLOs tended to invite high-prices from outside competition.

7 Summing up this part of this presentation Mr Davies said that he believed that the independence of the Audit Commission and the integration of its approach were both important. They then needed a way of leverage back at local level to ensure that the results of studies were implemented. The aim was not to duplicate management but to provide constant prodding towards acceptance.

National Health Service

8 Mr Davies raised the issue of the way in which the Audit Commission approach might be applied to the National

Health Service. His preliminary thoughts were based on looking at the way in which the NHS carried out external audit at the moment. He believed that value for money auditing in the NHS could be improved if it were done in a more systematic way. At the moment the auditing of the health service very much resembled the way in which the districit audit service operated before the Audit Commission was established - it was under resourced and had very few qualified people and a small number of qualified accountants. It was backward in accounting terms compared to local government. Value for money work consitituted only 10 per cent of the workload. Auditing of 50 health authorities had been put out to private competition last year but that had been taken on on terms which were not very beneficial. The buttressing that was necessary to get value for money for private audit work had not been done - there were no audit guides, no profiles and no joint training. He believed that the opportunity for efficiency audit in the NHS was being missed. He did not believe that efficiency audit could be the solution to management problems but it was an important ingredient in strengthening management. He believed that efficiency auditing leading to enhanced internal efficiency was an important supplement to increased competition. The Secretary of State for Social Services had asked him about the scope for the Audit Commission doing work in the NHS. At present the Audit Commission would be debarred by statute from doing such work but he had replied that he believed that the Audit Commission could do such work in principle if the legislation were changed - e.g. producing audit guides for a fee. But that sort of marginal approach he believed would miss a greater opportunity.

9 The Chief Secretary asked whether the present auditing of the NHS was as shambolic as Mr Davies' presentation implied. Dr Tristem said that the NHS auditors did regularity audits quite effectively. It was the value for money dimension which was lacking. Miss Peirson asked whether the information

was available to do profiles for health authorities along the lines of those produced for local authorities. Dr Tristem had mentioned that for local authorities they used existing CIPFA data; would the Korner statistics produce similar information? Mr Davies said he could not answer the specific question but his views were based on looking at the audit function within the NHS. It was noted that the information being produced for the resource management initiative would provide some useful inputs - though it was noted that this was only getting under way very slowly.

10 Miss Peirson noted that the Audit Commission had expressed the view that the support services would be an easy way into the NHS. But Ian Mills had concluded that the scope for such efficiency savings had largely run out. Dr Tristem did not accept that. He cited the example of local authorities energy bill of £1 billion. The bill for health authorities must be similar. He believed that without much effort savings amounting to 15 per cent of that bill could be made - half of those savings without additional capital investment.

11 Mr Davies added that it was important that the Audit Commission were not simply seen as cutters. Their rubric implied an interest in getting more out of given level of spending as well as identifying scope for economy. He contrasted the approach adopted by an Audit Commission auditor and a health authority auditor. A health authority treasurer was in a position where he could clear a backlog of relatively straightforward operations by doing a local deal on overtime. But his auditor had complained that he was disobeying a DHSS circular on the way overtime should be paid. In such circumstances an Audit Commission auditor would have backed-up more flexible use of overtime to achieve the health authority's objective. That did have a risk for central government in that it partly undermined control through DHSS circulars.

12 On a separate issue Dr Tristem mentioned that there was at present a cliff edge between caring work in the NHS

and in local authorities. At present an auditor advising a local authority would recommend that putting people into NHS care was cost efficient from the local authorities point of view. There would be advantage in bringing those two sides together.

13 Miss Peirson raised questions relating to the National Audit Office and the accountability of an independent audit body for the NHS. Mr Davies said that he believed there was a strong case for an independent audit of the NHS but he thought the arguments were more finely balanced as to whether there should be a new separate Commission or the Audit Commission given an extended role. He believed that the risk of damaging the Audit Commission credibility with local authorities was relatively limited. There would obviously be a need to reconstitute the Commission itself which was local authority orientated. The advantages of using the Audit Commission was that it was already established, it could recruit staff at existing terms and conditions it already had a relationship with the private sector accounting firms - many of whom used the same people to do local authority and health authority work. Its credibility was already established. On reporting he would expect to make an annual report to the Secretary of State and to make reports on value for money issues public. At the moment the NHS auditor simply sent a letter to the General Manager of the hospital, not to the District Health Authority. He believed that practice was based on a false analogy with the private sector.

14 Mr Davies handed the Chief Secretary a list of possible areas of study in the NHS.* He thought there was advantages in building on existing Audit Commission expertise in various areas e.g. work they had already done on energy management and purchasing for local authorities; he believed they were many lessons that could be derived from that for health authorities. Looking at purchasing would carry them into

* attached (flagged)

the area of GP prescribing. Mr Davies believed that the FPCs would also have to be within the auditor's remit.

15 The Chief Secretary thanked Mr Davies and Dr Tristem for coming and giving him the presentation.

Jill Rutter

JILL RUTTER
Private Secretary

Distribution

Those present
PS/Chancellor, Sir Pete Middleton
Mr Anson

THE AUDIT COMMISSION

How it works; what it has achieved

Presentation to the Chief Secretary to the Treasury

February 11, 1988

The Commission's first priority has been to maintain its independence; in this, it has been successful

- local authorities now do not view the Commission as a tool of central government

- even critical reports are often welcomed

- local authorities now suggest new topics for review

There are three, important, linked elements in the Audit Commission's 'package'

- statistics on comparative performance
- central 'value-for-money' studies
- an integrated audit at local level

The basic statistical took is the authority profile which

- is issued each year for each council on the basis of the previous year's spending

- compares an authority with a 'family' average of areas with similar characteristics

- identifies over-and under-spends and provides the auditor (and the authority) with a vfm 'map' of the council (Exhibit 1)

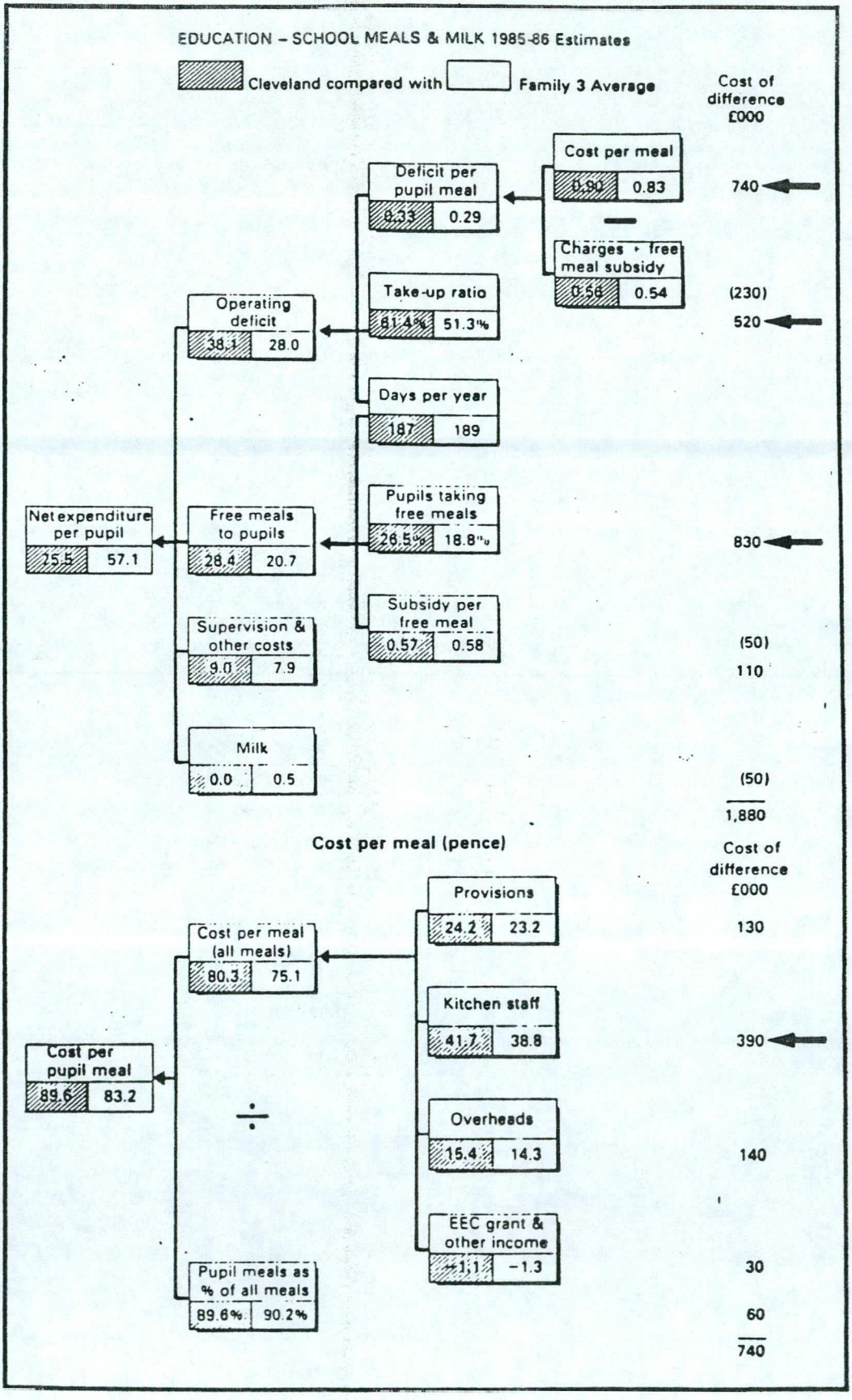

EDUCATION – SCHOOL MEALS & MILK 1985-86 Estimates
Cleveland compared with
Family 3 Average
Cost of difference £000
Cost per meal
0.90
0.83
740
Deficit per pupil meal
0.33
0.29
Charges + free meal subsidy
0.56
0.54
(230)
Take-up ratio
61.4%
51.3%
520
Operating deficit
38.1
28.0
Days per year
187
189
Pupils taking free meals
26.5%
18.8%
830
Net expenditure per pupil
25.5
57.1
Free meals to pupils
28.4
20.7
Subsidy per free meal
0.57
0.58
Supervision & other costs
9.0
7.9
(50)
110
Milk
0.0
0.5
(50)
1,880
Cost per meal (pence)
Cost of difference £000
Provisions
24.2
23.2
130
Cost per meal (all meals)
80.3
75.1
Kitchen staff
41.7
38.8
390
Cost per pupil meal
89.6
83.2
÷
Overheads
15.4
14.3
140
EEC grant & other income
−1.1
−1.3
30
Pupil meals as % of all meals
89.6%
90.2%
60
740

EXHIBIT 1

At the centre, the Commission carries cut a number of in-depth special studies each year into particular areas of local government activity

- the work is carried out by mixed teams of auditors, secondees and consultants under in-house management

- the focus is on performance measurement and identification of good practice

- the results are published, and form the basis of the following year's vfm audits (Exhibit 2)

Exhibit 2

SPECIAL STUDIES CURRENT WORK PROGRAMME

1987-8	1988-9	1989-90	Section 27
Audit Flavours	Audit Flavours	Audit Flavours	Studies
Care of Mentally Handicapped*	Police . fingerprinting . admin support . vehicles . purchasing	Police . budgetting . policing by objectives . prisoner handling	Urban Regeneration (LA role)
Property Management*			Homelessness
Highways Maintenance	Building DLOs	Parks & Leisure	Probation Services (with NAO)
	Education Administration (phase 1)	Education Administration (phase 2)	

* published

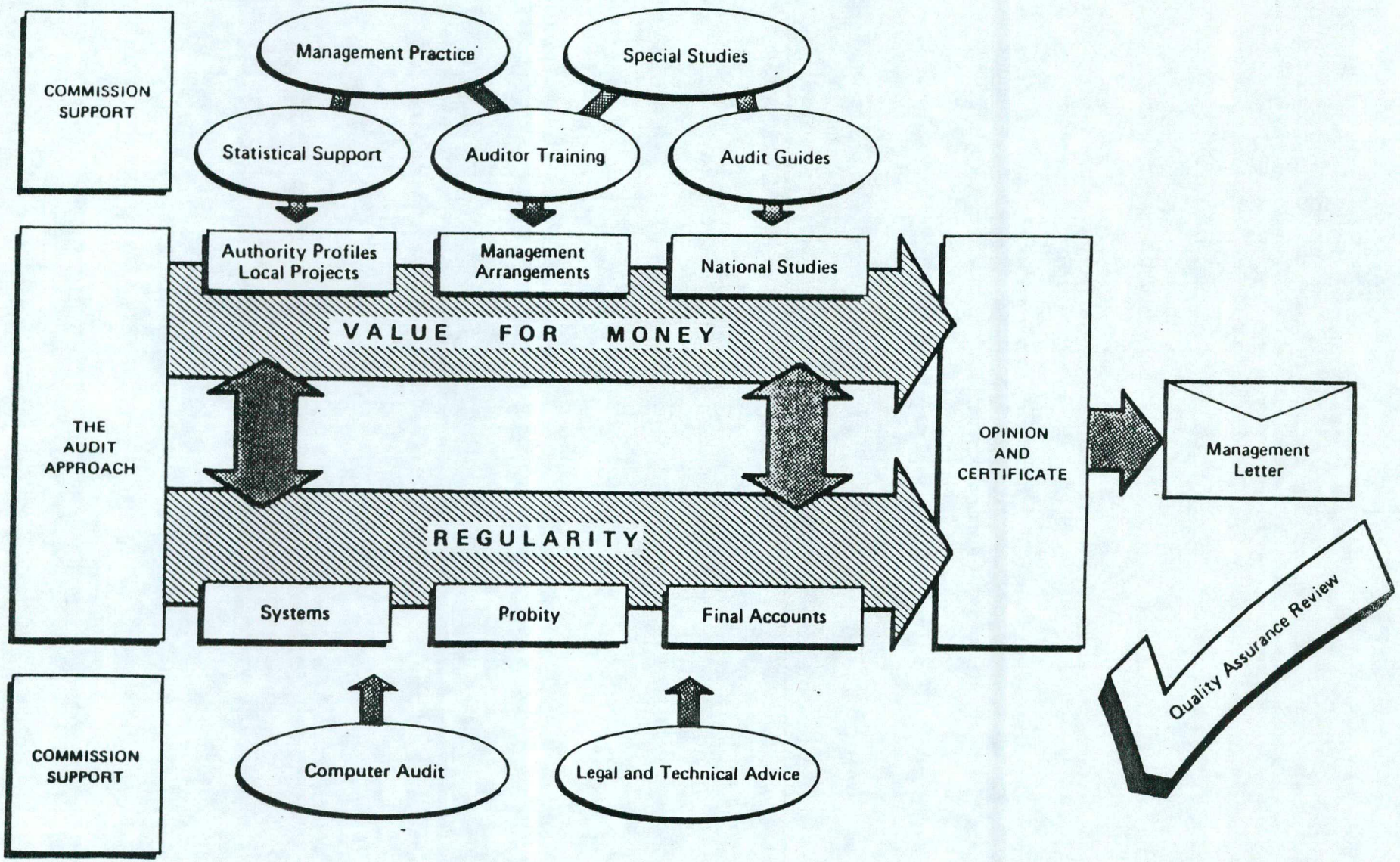
Local audits - of which around a third are carried out by private firms

- are carefully structured by the Commission to achieve

- a good quality, cost-effective regularity audit
- 50% value for money content
- focus on centrally-directed 'flavours' across all authorities
- local projects tailored to local circumstances
- a management letter targetted at council members and senior management review that year's - and previous year's audits (Exhibit 3)

Exhibit 3

...E INTEGRATED AUDIT



The Commission monitors results in a variety of ways

- through feedback from clients

- through quality control reviews (of District Audit Service work by private firms and vice versa)

- through direct monitoring of value improvements achieved by authorities

Encouraging authorities to make changes is a lengthy process; decision-making in councils is slow (painfully). But monitoring shows

- the central studies - based on the implications of top quartile performance - shows total opportunities of more than £2 billion

- auditors had substantiated around £500 million at local level by March 1987

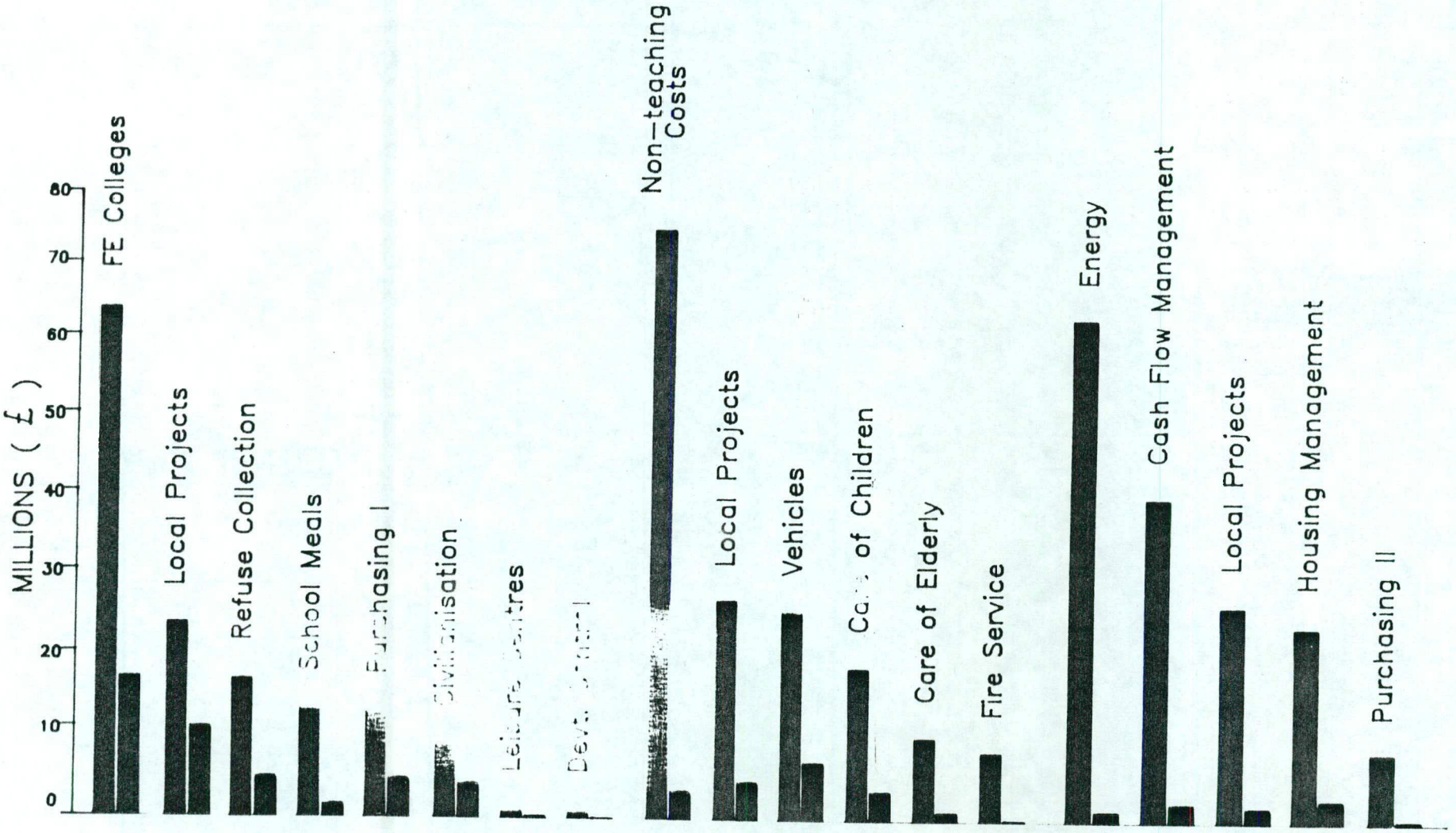
- of that £80 m (per annum) had already been achieved (Exhibit 4)

- the earlier - less carefully researched- projects show greater returns so far, suggesting that far more is in the pipeline (Exhibit 5)

EXHIBIT 4

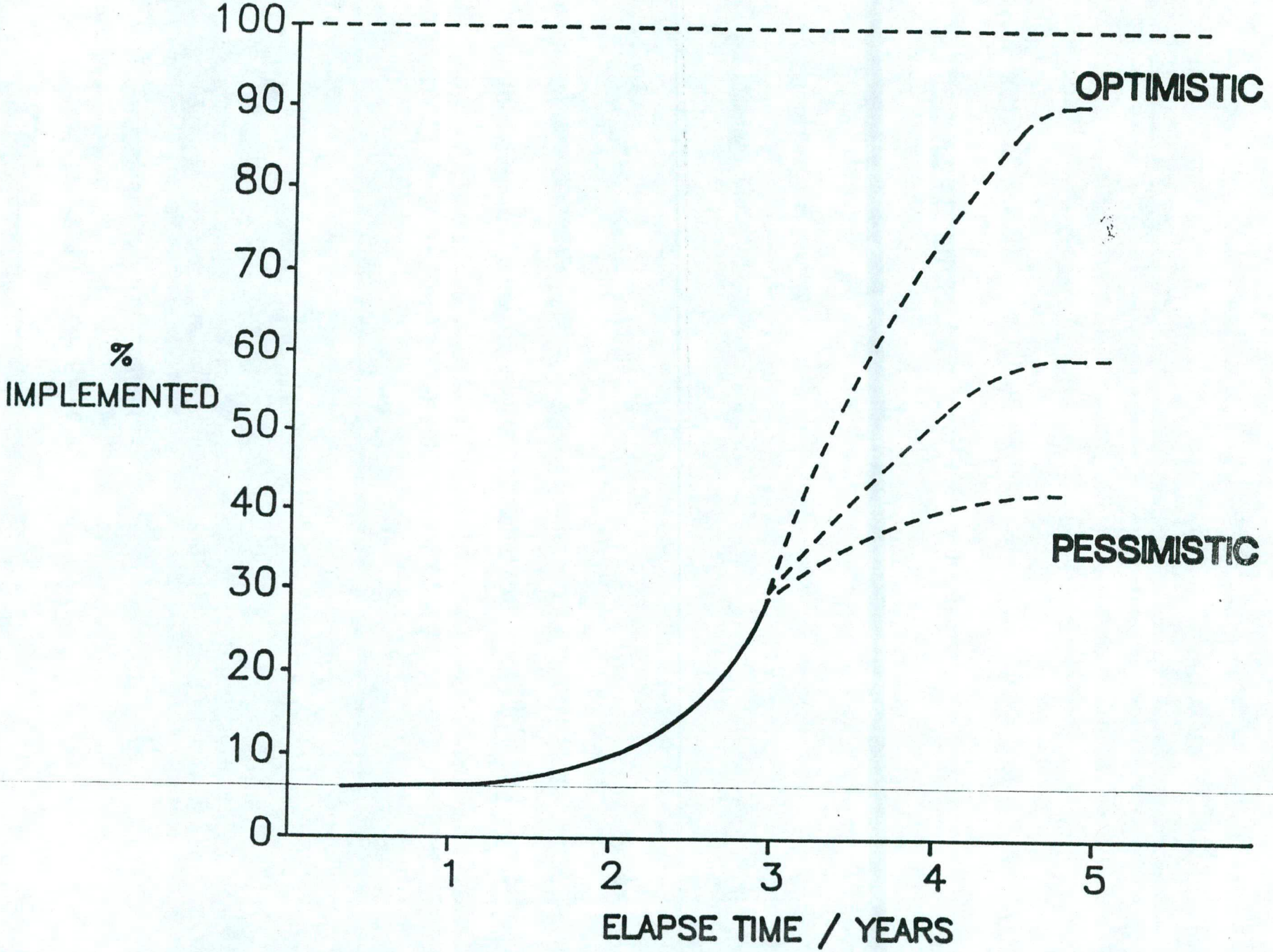
VALUE IMPROVEMENTS

Total £499m identified, £80m achieved



	1983 / 84	1984 / 85	1985 / 86
Identified (£m)	164	173	173
Achieved (£m)	50	22	9

EXHIBIT 5


100
90
80
70
60
50
40
30
20
10
0
% IMPLEMENTED
OPTIMISTIC
PESSIMISTIC
1
2
3
4
5
ELAPSE TIME / YEARS

VALUE FOR MONEY STUDIES AND AUDITS FOR THE NHS

1. It is envisaged for any particular area identified for VFM work that a comparative study would be carried out in a number of volunteer authorities to identify both measures and levels of performance and good management practices. Using material gained from this, audit guides would be produced so that the following year a nationwide VFM audit of that subject could be carried out in every authority. It would be possible to carry out one, two or three such studies and subsequent VFM audits in each financial year. The level of activity would depend on the urgency with which improvements were viewed and could be funded. A suitable start up rate might be three topics per year. The first subjects to be chosen should be those on which the Commission already has considerable expertise.

2. At the beginning of a new initiative of this type it is essential to go for areas where there is a good chance of identifying significant opportunities but which are unlikely to be sensitive in terms of medical or other professional practice. Once confidence has been established it would then be feasible to take on the more sensitive areas and demonstrate that opportunities exist providing working practices are changed. At the same time, it has never been the Commission's policy to rely solely on its own work and careful sifting of existing work on efficiency, effectiveness and economy, would need to be carried out before final decisions of a start-up programme were made.

3. The Commission has carried out within local authorities many VFM studies including ones on purchasing and supply, energy conservation, cash management, vehicle fleet management, cleaning and computing, all of which would have direct relevance and application to the health service. It should be possible to develop fairly quickly material for auditors relevant to the NHS so that audit guides and national reports could be prepared within 12 months of starting work. In addition, it would be reasonably easy to develop audit guides on a number of other topics including laundry services, x-ray and pathology departments, sterile supplies and catering.

4. There are clearly much more significant areas of expenditure and opportunities for improvement in the health service than the support services and studies would need to be started on some of these early on in order to develop enough material to produce the more sophisticated audit guides and national comparisons required to carry conviction within the service. Amongst these are issues such as:-

- improving throughput of various specialties by better balancing of the respective resources required for treatment;

- improving the efficiency in the use of existing resources, for example by identifying the best means of theatre scheduling etc;
- identifying the most efficient balance between central DGH beds and beds for convalescence and minor treatment in smaller peripheral hospitals;
- identifying effective admissions and discharge policies;
- ensuring proper overall management arrangements and staffing levels at regional, district and hospital levels;
- examination of options for contracting-out, support services;
- improving the performance of community health services.

5. Clearly a good deal of work needs to be done on examining the programme to determine the one likely to bring maximum benefit to the management, staff and patients of the NHS, but a possible programme is set out below identifying the year in which the value for money audit would start and, hence, determining the topics and the timings that need to be carried out by a preceding central study.

A.C. Appointed Auditor	VFM Audits	VFM Audits	VFM Audits	VFM Audits
	Energy	Vehicle fleet management	Sterile supply	Out-patient clinics
	Purchasing	Cash management	Estate management	Theatre schedul-ing
	Catering	GP pres-cribing	Pathology services	Com-munity care services
Year 0	1	2	3	4

11/2914

NOT FOR NAO EYES
CONFIDENTIAL

FROM: SIR ANTHONY WILSON
DATE: 25 February 1988

SIR PETER MIDDLETON

cc PS/Chancellor
PS/Financial Secretary
Mr Anson
Mr Phillips
Mr Beastall
Mr Hawtin
Miss Peirson
Mr Turnbull
Mr Parsonage
Mr Potter
Mr Saunders
Mr Call
Mr Elias

THE AUDIT COMMISSION AND THE NHS

I have read the recent exchange of minutes with considerable interest because I was a member of a Steering Group appointed in December 1985 by DHSS Ministers to review the experiment of appointing commercial auditors to conduct statutory audit in the National Health Service. In the course of that work I was able to gain some insight into the way in which audit is structured, both in the DHSS and NHS, and to perceive not only its strengths and weaknesses, but also the scope for something akin to the local government comparative approach adopted by the Audit Commission.

2. Following our recommendations, the appointment of private sector auditors to carry out external audit work in the NHS on behalf of the DHSS Audit Department was extended to cover about 50 unit audits comprising about 15% of the total in the NHS. The number of firms involved was also reduced to five in order to give each of them a larger sample, thus enabling them to look across the boundaries of individual small units and compare what they found in a representative sample.

3. We found that the private sector firms were good at external statutory audit work because this is what their staff had been trained to do, but they were not good at value for money exercises because this kind of work could not be done by the audit staff, and the proportion of their strictly controlled fees allocated to VFM type operations was quite inadequate for them to engage their management consultancy practices on it to any great extent. Almost without exception the private sector accounting firms look to their management consultancy wings to carry out VFM work, which requires skills other than those possessed by the financial accountant and auditor.

4. We recommended that the private sector audit input to the DHSS' overall audit responsibility should be consciously managed in such a way as to encourage interaction between the private sector auditors and the DHSS auditors, because this was not then being done and so there was little synergy from the way in which the two groups were supposed to compete with each other.

5. With this background experience I am supportive of the idea that the Audit Commission should replace the role of the DHSS auditors in performing the external audit of the individual authorities and committees and reporting on their work to the Secretary of State. This would bring forward problems in dealing with NAO, as well as the DHSS audit staff and private sector firms engaged by them to do the work at the present time. Presumably the Audit Commission would wish to continue to use some of the private sector firms for some part of the audit work, just as they do now in the local government field.

6. There is, however, one further option which could be considered, and that is to engage the Audit Commission to perform an identified but large and representative part of the DHSS audit function as contractors to the DHSS audit department in just the same way as private sector firms are already used for some 50 of the units. If this was accompanied by a real

strengthening of the management of DHSS audit there would be a good opportunity to compare the performance of the Audit Commission with the private sector firms presently engaged in NHSS audit, as well as the DHSS domestic audit performance, before coming to a final decision to move the whole exercise over to the Audit Commission. It may be that the replacement of the present DHSS audit management by new-comers would take too long and be too difficult to make this experiment worthwhile, in which case I would agree the right decision would be to move the whole exercise to the Audit Commission right away once Parliamentary approval has been obtained.

A WILSON

C5/081

FROM: MISS M P WALLACE
DATE: 26 February 1988

MR SAUNDERS

cc PS/Chancellor
PS/Financial Secretary
Sir Peter Middleton
Mr Anson
Mr Phillips
Mr Beastall
Mr Hawtin
Miss Pierson
Mr Turnbull
Mr Parsonage
Mr Potter
Mr Saunders
Mr Call
Mr Elias

THE AUDIT COMMISSION AND THE NHS

The Chancellor has seen Sir A Wilson's minute of 25 February to Sir P Middleton. He would be grateful if his briefing for Monday's NHS meeting could include a summary of the points Sir A Wilson makes.

MISS M P WALLACE

003/3291

SECRET

Arrived 29/2

FROM: **CHIEF SECRETARY**
DATE: **26 February 1988**

CHANCELLOR

cc:
Sir Peter Middleton
Mr Anson
Sir A Wilson
Mr Phillips
Miss M E Peirson
Mr Beastall
Mr Hawtin
Mr Turnbull
Mr Parsonage
Mr Potter
Mr Saunders
Mr Call

AUDIT COMMISSION AND THE NHS

You asked for my views on whether the Audit Commission could be used for the NHS, and if so, how. I expressed my view that it should at this morning's meeting but I should like to elaborate on it. I should also like to record some of the points which Mr Davies made at a resumed discussion, and some views which officials have elicited, at my request, from some Coopers and Lybrand people who do both local authority work (for the Audit Commission) and health authority audits (for DHSS).

2 You have of course already seen the draft paper on audit which, as requested at the Prime Minister's meeting on 8 February, officials are preparing for the Ministerial group to consider.

3 My conclusion is that we can use the Audit Commission if we wish, to carry out the audit at present done by the DHSS, and that we should.

Background

4 By way of background, I attach;

- annex A, summarising what the Audit Commission do at present; and

- annex B, summarising the view expressed by Mr Davies and by Coopers and Lybrand concerning the DHSS audit.

Possible role for Audit Commission in NHS

5 As you see from the draft paper for the Ministerial group, the DHSS audit of the NHS is the middle tier of audit. It is that tier of audit which, if we so decided, could be taken over by the Audit Commission. (I discuss below the arguments for so doing.) We should of course need to consult Nicholas Ridley; and we should have to square the NAO (who carry out the top tier of audit of the NHS - they have no such role in the case of the local authorities).

6 On the latter point, I am convinced that we have a good case to put, and I understand that Sir Peter Middleton is now content for the option to be pursued, though he stresses the need to take great care in approaching the NAO and PAC. The NAO have steadily been expanding in value-for-money audit (generally, not just in the health service) and might be inclined to resent the intrusion of another organisation with a high profile. But replacing the DHSS by the Audit Commission would not affect the role of the NAO. Moreover, the PAC have just published a report criticising the DHSS audit, and ought to welcome a move to improve it.

Reasons for choosing the Audit Commission

7 Some real drive has got to be put behind the VFM audit of the NHS, to increase it in quantity and quality. Since any new auditors would still report to the Secretary of State, or the NHS Management Board, there could be a problem in establishing a genuinely more independent audit than the present. On the other hand, the example of the Audit Commission shows how determined leadership can carve out an independent role.

8 The draft paper for the Ministerial group sets out the three broad options. As regards the first (beefing-up the existing DHSS audit), which is the only one not requiring legislation, much could no doubt be done by putting some high-level people onto the job - perhaps recruiting a private sector head - and contracting out much more of the work. But that would not tap the experience of the Audit Commission in doing precisely those things for the LAs which we want done for the NHS.

9 As regards the second option- a new more independent body - that might avoid any tension with the NAO but otherwise seems to have little to commend it.

10 I am convinced that the best option is to bring in the Audit Commission, since they have built up an independent outlook and some track record (quite apart from the valuable read-across there would be from their local authority work).

11 There could still be problems about acquiring the necessary quality of staff. There is considerable competition, and the Audit Commission themselves have not got all the best people: our impression is that the private sector firms, which pay more, are better at the individual audits, though not at the national VFM reports. But if we want an effective audit, we must be willing to pay for it.

Conclusion

12 I conclude that we should advocate the third option in the Treasury paper, namely replacing the DHSS audit by the Audit Commission.

Jim Ruth

pp JOHN MAJOR

(Signed on behalf of the Chief Secretary).

ANNEX A

Local Authority Background

1. As you know from the note of the first meeting I had, Mr Davies explained what the Audit Commission do for local authorities, as follows. There are two basic types of audit, the annual "regulatory" audit, and "value for money" audits. Mr Davies said that the Audit Commission combined these into a package of 3 elements:-

(i) an "integrated" audit at local level, covering both regulatory and VFM audit;

(ii) statistics of comparative performance; and

(iii) central "value for money" studies.

2. The integrated local audits at (i) are roughly half and half "regularity" and "value for money"; the AC use the central value for money studies at (iii) as a benchmark for the local audits. The local audits follow up the VFM ideas to see how far they are being put into practice.

3. The statistical comparison at (ii) is based on data which have been collected for years by CIPFA; it compares the performance of an authority on individual services with the average for a group of local authorities with similar characteristics; and it is published, by being given to the full Council.

4. The central value for money studies at (iii) are also published; they take a couple of years or so, and around 3 are completed each year; half a dozen local authorities are looked at to identify best practice. Again, the results are fed back into the audits of individual LAs.

5. The Audit Commission contract out a great deal of their work. First, the analysis of the CIPFA statistics is contracted out, at a cost of £48,000 per annum. Secondly, about 30% of the local audits are carried by private sector firms.

6. Mr Davies stressed the importance of the AC being seen by the local authorities as helping them, not simply imposed on them. The AC are in fact accountable to the Secretary of State for the Environment, but that does not seem to have prevented them from building up a reputation for independence. The Coopers people apparently endorsed this view. And although the response in inner London has perhaps been disappointing, there is clear evidence that the AC approach is forcing changes in management and achieving greater efficiency.

ANNEX B

Audit Commission and Coopers views on DHSS audit of NHS

1 By contrast with the Audit Commission work on local authorities, audit in the NHS focuses on regulatory work. Mr Davies said that only 10% of the external audit done by DHSS on the NHS was "value for money", and some of the private firms which were employed by the DHSS to do part of the work for them had grumbled about this low proportion. No research was carried out, and there was no real analysis of the statistics.

2. Mr Davies did not know whether the Korner data would supply what was needed for the kind of statistical comparison of performance done for local authorities ((ii) of Annex A). But there is clearly a mass of performance indicators available, and so there should be some basis for published comparative statistics for the various health authorities.

3. Mr Davies thought that the DHSS audit staff were underpaid, poor quality and not forward-looking. Of course, one suspects that he would say that, and so would the Coopers people (apparently they did): both want the work. But it is undeniable that:

(a) the audit branch in DHSS is headed at a not very senior level;

(b) few of the people in it are qualified accountants (though accountants are not needed for VFM work: the Coopers people stressed that the latter would be done by their management consultancy side); and

(c) their approach to the health authorities is coloured by their being part of the DHSS.

4. The Coopers people were, I understand, pretty scathing about the abilities and approach of the DHSS auditors: Coopers felt they did not so much look for possibilities of fruitful managerial

change, as try to ensure that DHSS circulars were adhered to. Initiatives for improving managerial practice came from other parts of the DHSS, but were not adequately thought through or followed up.

5. Mr Davies felt that there remained plenty of scope in the NHS for economies in the support areas, such as energy saving (which would require extra capital investment) and fleet maintenance. If he were doing an independent audit of the NHS, he would wish to start with those areas, before venturing on the clinical areas. But he saw no overriding difficulty in dealing with the problem of clinical freedom; the Audit Commission had plenty of experience of dealing with people claiming similar problems (eg the police). I understand that the Coopers people were more hesitant about the problem, but felt it could be tackled by stressing the improved medical care which better information would facilitate.

RM6.16

CONFIDENTIAL

FROM: MOIRA WALLACE
DATE: 29 February 1988

PS/CHIEF SECRETARY

cc Sir P Middleton
Mr Anson
Sir A Wilson
Mr Phillips
Miss M E Peirson
Mr Beastall
Mr Hawtin
Mr Turnbull
Mr Parsonage
Mr Potter
Mr Saunders
Mr Call

AUDIT COMMISSION AND THE NHS

The Chancellor was most grateful for the Chief Secretary's minute of 26 February.

MOIRA WALLACE

NAO & VFM

RM6.35

NOT FOR NAO EYES

BF next PEM/ bilateral (again) (next one after Washington) Yet again! And again

FROM: MOIRA WALLACE
DATE: 3 March 1988

SIR P MIDDLETON

NAO VALUE FOR MONEY EXAMINATION

The Chancellor noted Mr Beastall's comment in paragraph 8 of his minute of 29 February, to the effect that the NAO are seeking to extend the scope of their VFM examinations in ways which are bringing them into policy areas. He would be grateful if you could let him have some examples of this at your next bilateral.

MOIRA WALLACE

1595/10

NOT FOR NAO EYES

TYPISTS

2 minutes

FROM: J S BEASTALL
DATE: 29 February 1988

1. SIR PETER MIDDLETON
2. CHANCELLOR

Copies attached for:
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary

cc Mr Anson
Dame Anne Mueller
Mr G H Philips
Mr Monck
Mr Turnbull
Mr Luce
Mr Kelly
Mr Harris
Mr Moore
Mr Shore

NAO ACCESS TO NATIONALISED INDUSTRIES AND TO TREASURY AND CABINET PAPERS

Sir Peter Middleton felt that you might like to be brought up to date on this topic.

2. The PAC considered the position at a private session on 8 February. On Nationalised Industries, they decided for the present to take no oral evidence and to make no report. They will merely monitor developments, including the future activities of the MMC. The Clerk thinks that they are unlikely to return to this matter for about a year.

3. On Treasury and Cabinet papers, they formally did no more than take note of the memorandum submitted by the C&AG. However they asked the C&AG to let them know if he considered he had any problems about access to papers in the future; in which case they might take up the issue again. In the meantime they do not propose to call for oral evidence or to issue a report.

4. At a subsequent meeting with Sir Peter Middleton, the C&AG (Mr Bourn) claimed credit for steering the PAC towards their conclusion not to take action at present. He had told the PAC that while he was anxious that the NAO should have full access to papers, he had not encountered any problems personally and had suggested that the PAC should leave the matter in his hands. He proposed to report back to the PAC in about a year's time (assuming that he encountered no difficulties requiring an earlier report).

5. Sir Peter Middleton said that he did not think that there was any difficulty about NAO access to papers dealing with the Treasury's own responsibilities. His only concern was that Treasury papers should not be used as a basis for the NAO to pursue other departments. However the Treasury would do all it could to prevent any problems arising in practice. Mr Bourn was quite content to leave matters on this basis.

6. We shall be issuing guidance to Treasury divisions on dealings with the NAO generally. On the question of access to Treasury papers, we will seek to ensure that, while we do not compromise our principles, any cases which come up are handled if possible in such a way as to avoid provoking the C&AG into reporting to the PAC.

7. We understand that Mr Bourn also had a talk with Sir Robin Butler about access to Cabinet Papers, with a similarly amicable result. OMCS are considering whether they should circulate guidance to Departments encouraging them to be co-operative with NAO, while stopping short of giving them access to Cabinet papers.

8. It is good news that the PAC have decided, for the time being at least, to avoid a confrontation with the Government on the question of access to papers and, given Mr Bourn's conciliatory attitude, we hope that it will be possible to avoid difficulties in practice on this issue. There are however increasing signs that NAO are seeking to extent the scope of their value-for-money examinations in ways which are bringing them into the field of

policy. We suspect that this issue, rather than the subsidiary one of access to papers, will cause difficulties for the Government over the next year or two.

JSB

J S BEASTALL

42/2.BTW.4372/52

Sir Anthony Wilson

CC: PPS, CST, PMG, EST, Sir P. Middleton, Mr Monck, Mr Culpin, Mr MacAuslan, Mr Cropper, Mr Tyrie, Mr Beighton-IR, PS/IR, Mr Trevett-Cab

Treasury Chambers, Parliament Street, SW1P 3AG

Stanley Thomson Esq
President
The Chartered Association of
Certified Accountants
29 Lincoln's Inn Fields
LONDON
WC2A 3EE

29th February 1988

Dear Stan

AUDIT OF THE ACCOUNTS OF SMALL COMPANIES

Thank you for your letter of 18 February 1988 concerning the suggestion that the next Companies Bill should include a provision to substitute voluntary audit for the statutory obligation to have the accounts of small companies independently audited.

Sir Anthony Wilson has been holding a series of meetings with officials in the Department of Trade and Industry, Inland Revenue and Customs and Excise about this, and I think it would be appropriate if he were to arrange a meeting to discuss the matter with you and your colleagues.

Yours ever

Norman

NORMAN LAMONT

4/2914

FROM: SIR ANTHONY WILSON
DATE: 23 February 1988

FINANCIAL SECRETARY

cc PPS 12/2
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Monck
Mr Culpin
Mr MacAuslan
Mr Cropper
Mr Tyrie
Mr Beighton - IR
PS/IR
Mr Trevett - C&E

AUDIT OF THE ACCOUNTS OF SMALL COMPANIES

The President of the Chartered Association of Certified Accountants wrote to you on 18 February registering the opposition of his professional Institute to the proposed removal of the universal audit requirement in the next Companies Bill. I do not believe that you would wish to hold a meeting on this matter yourself and I am prepared to arrrange a meeting with Mr Stanley Thomson, which I would chair and at which the Inland Revenue and Customs and Excise representatives could be present, if you so desire. I attach a letter which you may wish to send to Mr Thomson.

2. As the contents of Mr Cope's letter to you of 19 February are largely concerned with the special interests of the Inland Revenue in preserving, if not the audit, at least some satisfactory independent review of the accounts of small companies, I have asked Mr Beighton of the Inland Revenue to draft a suitable response for you to send to Mr Cope.

A WILSON

5/2914

DRAFT LETTER TO THE PRESIDENT OF THE CHARTERED ASSOCIATION OF CERTIFIED ACCOUNTANTS FROM THE FINANCIAL SECRETARY

AUDIT OF THE ACCOUNTS OF SMALL COMPANIES

Thank you for your letter of 18 February 1988 concerning the suggestion that the next Companies Bill should include a provision to substitute voluntary audit for the statutory obligation to have the accounts of small companies independently audited.

Sir Anthony Wilson has been holding a series of meetings with officials in the Department of Trade and Industry, Inland Revenue and Customs and Excise about this, and I think it would be appropriate if he were to arrange a meeting to discuss the matter with you and your colleagues.

[NL]

Inland Revenue

Policy Division
Somerset House

FROM: D L SHAW
DATE: 29 FEBRUARY 1988

I am concerned that this topic is now leaking into the press as a dispute between the DTI and the Revenue. It will not make it any easier to find a satisfactory alternative along the lines you commissioned at your 9 Feb. meeting.

1. MR BEIGHTON ✓

2. FINANCIAL SECRETARY

AUDIT OF THE ACCOUNTS OF SMALL COMPANIES

1. Mr Cope wrote to you on 19 February following your meeting of 9 February with Mr Maude.

2. Mr Cope's letter suggests that there is a clear distinction between the requirements for statutory audit as a check on fraud against creditors, shareholders etc and the Revenue's needs for information to check tax liability and tax fraud. We do not agree. The Exchequer is frequently a major creditor and the Revenue has a clear interest in defending the Crown from fraud as a creditor as well as in detecting error and fraud in the tax computation.

---

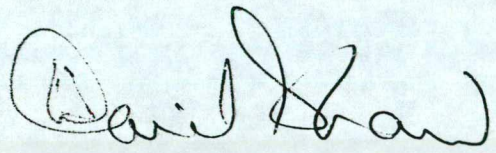
cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Monck
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Trevett - C&E
Mr Battishill
Mr Isaac
Mr Painter
Mr Rogers
Mr Pollard
Mr Deacon
Mr Beighton
Mr Corlett
Mr Campbell
Mr Page
Mr G Miller
Mr K Shaw
Mr D Shaw - P2
Mr Fitzpatrick
PS/IR

3. By concentrating on fraud, Mr Cope ignores the real importance of audit for the Revenue which is the greater reliability that audit gives to the accounts. A clear distinction cannot be drawn between the needs of the Revenue and the needs of other users when we come to greater reliability. It is obviously true that all users of accounts should value greater reliability, and third party users certainly do.

4. Mr Cope suggests that the Revenue's needs should be the same for small companies as for unincorporated businesses of a similar size. This does ignore the very real differences between a company, which exists only upon paper, and a self employed man or partnership which are tangible and cannot easily disappear! We do find that the tax affairs of small companies are more complex than those of similar sized unincorporated businesses and that we have to use more highly trained Inspectors for company work. Company accounts and computations are worked by fully trained Inspectors, and you will know the difficulties that we have in recruiting and retaining these. Unincorporated businesses, being simpler, can be worked at a lower level by our Grade 3 Inspectors, and there is less of a problem in finding these.

5. Mr Cope asks whether we rely upon the audit to any extent. The answer is that we do. We employ less resources on policing small companies than similar unincorporated businesses. If we lost the assurance that the audit gives, we would need 400 extra fully trained Inspectors to bring the level of policing for small companies up to the level for unincorporated businesses. And we could not find 400 extra fully trained Inspectors, even if you wished us to do so. This is why it is so important that the audit is not removed without something being put in its place which gives the Revenue equal reassurance.

6. I attach a draft reply to Mr Cope.



D L SHAW

cc Mr Francis Maude

DRAFT LETTER FROM FST TO MR JOHN COPE

1. Thank you for your letter of 19 February. We should not forget that the Exchequer is frequently a major creditor with a clear public interest in checks upon fraud. So the distinction between checks upon fraud against creditors and the Revenue's checks upon error and fraud in the computations is not as clear as you suggest. And the wide ranging consultation which the DTI carried out in 1985 did reveal quite a list of other benefits that the audit brought to managers, shareholders and third parties. The most important of these for the Revenue is the greater reliability of audited accounts. This would seem of benefit to all users of accounts and the DTI consultation, and other reports since, have shown that other third party users such as banks and credit agencies find it of particular importance.

I do think that there is a difference between a small company and an unincorporated business of a similar size. A company is altogether more nebulous than a sole trader or a partnership. The company only exists on paper and is only as good as that paper - which is why such importance is attached to the reliability of the accounts. The Revenue does find that this makes a company's affairs much more difficult to unravel, besides bringing other problems such as phoenixism in its wake.

This added complexity does justify placing stricter requirements upon a company than an unincorporated business. But even if this were not so, I am not sure that we would necessarily want to impose the same requirements upon unincorporated businesses, particularly ones just starting up, as we have for companies. It is one thing to keep the controls for companies that are already in place if to remove them would put shareholders, creditors and the Exchequer at risk. It is quite another to impose additional burdens upon other businesses, even it if it would save work for the Revenue.

The Revenue do rely on the audit certificate to quite an extent. They devote much smaller resources to policing companies than they do to similar unincorporated businesses. If they were not able to rely on the audit in this way and had to police companies to the same extent as similar unincorporated businesses, they would need an extra 400 fully trained Inspectors. And the Revenue could not find 400 fully trained Inspectors, even if we wished them to do so.

I have passed your suggested amendments to my private secretary to correct the notes of our meeting. I am copying this letter to Francis Maude.

NORMAN LAMONT

1009.TXT

3651/56

PERSONAL AND CONFIDENTIAL

FROM: A G TYRIE

DATE: 2 MARCH 1988

FINANCIAL SECRETARY

cc PS/Chancellor
Mr Cropper
Mr Call

SMALL COMPANY AUDIT

I have seen Mr Shaw's minute to you of 29 February, with its attached letter for you to send to Mr Cope.

2. I don't think you should send this letter in its present form. The logic is pretty ropey. If the Revenue think that they need the same defence against fraud, that shareholders, creditors and others need, then why does the Revenue alone among these groups think that the audit requirement gives them protection? Either the Revenue's interests are the same as these other groups, in which case the Revenue are out on a limb in thinking that the audit requirement is useful, or the Revenue's position is not the same, in which case there is some point, as Mr Cope implies, in asking the Revenue to set out what information they require to check tax liability and tax fraud.

3. Unless that information is forthcoming, I don't know how we can possibly justify the Revenue's reliance on the audit certificate.

4. Furthermore, the Revenue draft contradicts earlier points

the Revenue have made to justify retention of the audit requirement. On several occasions, the Revenue have argued that the audit requirement is not in practice much, if anything, of an additional burden on companies. But the bottom of paragraph 3 talks about "the additional burdens" that would result if unincorporated companies were put under "audit type" regulation.

5. What we say to the DTI on this depends crucially on what we think the policy ought to be. We have not yet decided that. But in the meantime, I think we cannot send this draft. Could we have a word about a possible reply?

6. Incidentally, I entirely agree with Len Beighton about the recent Press comment. This attempt by the DTI to put the Revenue in the firing line is quite unacceptable. I think it might be worth saying in your reply how regrettable it is that such articles have appeared.

A G TYRIE

63/2914

cc: PPS, CST, FST, PMG, EST, Sir P Middleton, Mr Monck, Mr Culpin, Mr MacAuslan, Mr Inglis, Mr Cropper, Mr Tyrie, Mr Beighton-IR, PS/IR Mr Trevett-CCE, Mrs S. Brown-DTI.

H M Treasury

Parliament Street London SW1P 3AG

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Direct Dialling 01-270 4530

Sir Anthony Wilson FCA
Accountancy Adviser to the Treasury
and Head of the Government
Accountancy Service

Stanley Thomson Esq
President
The Chartered Association of
Certified Accountants
29 Lincoln's Inn Fields
London WC2A 3EE

2 March 1988

Dear Stanley,

AUDIT OF THE ACCOUNTS OF SMALL COMPANIES

You wrote on 18 February to the Financial Secretary emphasising the importance which the Chartered Association places on the continuation of a requirement for universal audit of companies and suggesting that it might be useful to have another meeting at which you could propound your views.

I have been doing a good deal of work with the Department of Trade and Industry, as well as the Treasury and the Inland Revenue, in this field in recent months and would be happy to chair the kind of meeting you have suggested, at which it would be helpful if Inland Revenue and DTI officials were present, as well as your team. If you would like to take the matter forward in this way perhaps you could ask your secretary to ring mine to arrange a mutually convenient date as soon as possible, bearing in mind that I shall need to liaise with others to make quite sure that they can attend.

Yours sincerely,

A WILSON

PSM

c.c. PCC
HEGs
Mr. Beastall
Mr. C. D. Butler
Mr. Luce
Mr. Shore
Miss Wheldon, T.Sol.
Mr. Spencer, OMCS

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-270 3000
Direct Dialling 01-270 .....

J Anson, CB
Second Permanent Secretary
Public Expenditure

CONFIDENTIAL

NOT FOR NAO EYES

Sir Robin Butler, KCB, CVO,
Cabinet Office,
70 Whitehall,
LONDON, SW1A 2AS

3rd March, 1988.

Dear Robin,

NATIONAL AUDIT OFFICE

As requested at our meeting on Wednesday 17th February, I attach, as a basis for discussion, a note on relations with NAO. We have found it convenient to separate the questions of access to papers (the material on which has been prepared in collaboration with OMCS) and that of the scope of NAO enquiries, but the two issues are of course interlinked.

2. I very much hope, in view of John Bourn's conciliatory attitude on access to papers, that any problems on this point can in practice be dealt with satisfactorily with a bit of understanding on both sides, though the note suggests that there may be scope for amplifying the guidance on handling Cabinet papers and related documents.

3. I suspect, however, that we may be in for an increasingly difficult time on the scope of NAO reports. The basic point in the attached note is that we should steer the NAO in the direction of commenting on the department's performance in the use of its resources, which is their business, rather than on absolute levels of output or resources, which are for Ministers to decide. But the boundary between the two is not always clear cut, and if the NAO insist on strying over it, the only answer is to ask for the department's view to be clearly expressed in the report.

4. I will write separately on the question of the "Not for NAO eyes" designation which was raised this week.

5. I am copying this letter and enclosure to others who attend the Wednesday meeting.

Yours ever,

J. ANSON

NATIONAL AUDIT OFFICE

1. ACCESS TO PAPERS

Guidance on NAO access to departmental papers was contained in a note circulated by the Treasury on 23rd November 1984 (copy attached, without annexes). Since then the relevant paragraphs of Government Accounting, now E27 - 28, have been amended to take account of the National Audit Act 1983 and are reproduced at Annex A. Paragraph E27 describes the statutory position.

2. Two more recent developments are worthy of mention. First, one of the recommendations in the PAC report on Financial Reporting to Parliament (8th report, Session 1986-87) was that "there is a strong case for Parliament to have an independent, audit-based assurance that the PES procedures operate as a system in a satisfactory way". However, the Treasury Minute in response to this report, published in July 1987, said that while details of the PES process were available in published documents the Government did not believe that the Survey itself, which was in essence a series of policy decisions about spending priorities and plans, was appropriate for audit in the accepted sense of the word.

3. Secondly, in December 1987 the former C&AG submitted a memorandum to the PAC on NAO access to Cabinet and Treasury documents. This arose out of an NAO enquiry into a particular Ministry of Defence procurement project. In this memorandum the C&AG claimed:-

a. that, contrary to the Treasury view that it was inappropriate for him to examine Treasury papers in the course of a value-for-money examination of another department's handling of a project,

there might be occasions (which would be rare) when he needed to examine how effectively the Treasury had been able to perform their responsibilities relating to the approval of major capital projects, for example if he was in doubt as to whether all relevant financial information had been disclosed to - and considered by - the Treasury, and fully disclosed to Ministers;

b. that, in order to ensure that departments had provided Ministers with accurate and relevant information, it would be reasonable for him to have a right of access to copies of departmental submissions to the Cabinet (and approved drafts) where these are retained on departmental files; and that in those very rare circumstances where there was doubt about the accuracy and relevance of the information put before Ministers it would be reasonable for him to request access to Cabinet papers not on departmental files. This was in contrast to the Cabinet Office view that the considerations taken into account in the formulation of policy objectives were not the concern of NAO; that it was unnecessary for the C&AG to have access to documents on departmental files concerning advice to Ministers collectively about policy proposals, such as near final drafts of Ministerial papers for Cabinet or Cabinet Committees; and that he had no right of access to any departmental memoranda to the Cabinet or Cabinet Committees held outside the department.

4. The C&AG's memorandum also recorded the view of the Treasury and Cabinet Office that the National Audit Act 1983 was not intended to change the longstanding convention

under which NAO did not have access to certain papers; that the Government stated at the time that they intended no change to present practice but rather to embody that practice, and that they believed this to have been accepted by the Bill's sponsors; and that the intentions of Parliament as then expressed would be highly relevant when Parliament considered what was "reasonable" under the Act. However legal advice is that the definition of "reasonable" access must be determined according to the wording of the statute.

5. This memorandum was considered by the PAC in private session on 8th February 1988. They decided not to call for oral evidence or to issue a report; but they asked the C&AG to let them know if he had any problems about access in the future, in which case they might take up the issue again.

6. In the Treasury's view the guidance issued in November 1984 still stands. It needs to be read as a whole, and it suggests that in practice a balance may need to be struck between Parliament's right to have information about the economy, efficiency and effectiveness of departmental expenditure, and Ministers' right to confidentiality in the making of their policy decisions; there is therefore a presumption against showing the NAO papers concerned with the discussion of policy objectives, such as PES papers, and a convention that Cabinet and Cabinet Committee papers, and drafts of these, are not shown to NAO; but even in these cases decisions to withhold papers formally requested by NAO should be very carefully considered and confined to cases where Ministers would be prepared to uphold the Department's position in Parliament.

7. The 1984 guidance did not refer to the principle mentioned in paragraph 3a. above that an Accounting Officer should only be examined on the basis of his own Department's

papers. In the Treasury's view there should be a presumption that this principle will be maintained.

8. Earlier versions of the C&AG's memorandum referred to his staff often seeing Departmental submissions to Cabinet or approved drafts, though no evidence of this was provided. In the view of OMCS this suggests that consideration should be given to amplifying the guidance in "The Handbook for Cabinet Documents Officers" on the handling of Cabinet papers, in particular papers for Official Committees and approved drafts; and promulgating that guidance more widely in departments, so that it is generally available to officials initiating papers for Cabinet and Cabinet Committees.

9. The new C&AG has indicated informally that he does not seek confrontation on the issue of access to papers and hopes that any difficulties can be resolved case by case. Given the terms of the National Audit Act 1983, it is unlikely to be to the Government's advantage to provoke the PAC into a formal report. It would therefore be desirable for departments to seek an accommodation with the NAO in cases of difficulty, where this is possible without compromising the essential interests of Ministers. One way of doing this may be, in suitable cases, to allow access to papers on an ex gratia basis, without conceding the NAO's right to see them. In those cases where it is judged necessary to withhold papers it may be appropriate to invite NAO to identify questions to which replies could be provided. If Departments wish to show Cabinet or Cabinet Committee papers to the NAO, they should continue to seek prior agreement from the Cabinet Office (which in general, as in the past, is unlikely to be given).

2. SCOPE OF NAO ENQUIRIES

10. Concern has been expressed about the scope of some recent NAO enquiries and the nature of certain NAO

conclusions. There seem to be two main types of case which are likely to cause difficulty:-

a. where NAO suggest alternative methods of achieving any objective, eg compulsory wearing of rear seat belts or random breath testing in order to improve road safety;

b. where NAO suggest that more resources are required to meet an objective, especially where that objective has not in fact been set by Ministers, eg to improve the quality of service in local DHSS offices.

It is clear from a number of recent cases that NAO are deliberately extending the scope of their value-for-money enquiries.

11. The National Audit Act 1983 empowers the C&AG to carry out examinations into the economy, efficiency and effectiveness with which a department has used its resources in discharging its functions; but does not entitle him to question the merits of the policy objectives of the department concerned.

12. There does not seem to be much dispute about NAO's role in relation to economy and efficiency. The problem arises over the intepretation of "effectiveness" in this context. NAO would probably argue:-

a. that even though they are not entitled to question the merits of a department's policy objectives, they are entitled to ask what those objectives are, and what targets have been set for their achievement;

b. that if in their view an objective could be better met by a different means, ie through resources

being deployed differently, it is legitimate for them to report on this as being relevant to effectiveness;

c. that it is only the merits of "policy objectives" which they cannot question and that they are therefore free to comment on the second-order policies or measures designed to meet those objectives;

d. that if they conclude that the resources deployed are not sufficient to allow objectives to be met they are entitled to say so; and that deployment of inadequate resources may be an ineffective or inefficient use of resources.

13. Treasury comments on the above points are as follows:-

a. we must accept this; but it is for the department to decide, as a matter of policy, what objectives and targets to set;

b. it is difficult to resist this argument in principle; however, NAO's reports should be audit-based and are less likely to be persuasive if they are speculating on hypothetical policy options;

c. this is legally correct; but in practice it is a matter of judgement what is a "policy objective" as opposed to a second-order policy issue or a measure for achieving the policy objective; and some policies which might appear to be second-order, eg breath tests in the context of road safety, may involve wider policy considerations which arguably preclude the NAO from questioning their merits.

d. the level of resources to be applied to meeting an objective is itself a policy decision. It is legitimate for NAO to draw attention to a mis-match between the resources and the objective, and to conclude that to remove this mis-match either the resources or the objective need to be modified or the objective will take longer to achieve. If the matter is expressed in this fashion in the report, this leaves the department free to decide, as a matter of policy, which way the dilemma is to be resolved.

14. In dealing with NAO on these matters it should be borne in mind that the PAC require that the NAO report should be agreed in its entirety with the department concerned. Departments should therefore feel able to insist on their views being recorded in the report if they differ from those of the NAO.

15. It is difficult to lay down rules in this area and departments will need to consider carefully how to proceed in each case, subject to the general principle that they should only adopt positions which they feel Ministers would, if necessary, defend in Parliament. In some cases, rather than arguing that NAO are not entitled to pursue a particular aspect of an enquiry, it might be better to seek to persuade them that their reports will carry less weight if they make controversial recommendations which stray into policy and which the government are unlikely to accept. However the following points of guidance are offered;

a. NAO's essential function is to focus on the use of resources, eg whether performance targets have been set or achieved, and whether performance by the staff of the department has been satisfactory, given the policy objectives;

b. failure to achieve policy objectives, eg targets for final output, does not necessarily result from inadequate resources and the NAO interest is how far the outcome can be attributed to departmental performance;

c. while it is legitimate for NAO to note that the resources allocated are insufficient to achieve a given objective, it is not for them to decide whether the resources should be increased or the objective should be modified;

d. in the debate about whether particular decisions fall in the category of "policy objectives" rather than second-order policies, NAO may be receptive to the argument that decisions specifically taken by Ministers and announced to Parliament should not be open to question by NAO;

e. NAO enquiries should be audit-based and their powers of enquiry relate only to how a department has used its resources; they do not have a role where consideration is currently being given to how to implement a policy objective, ie where the issue is the future use of resources;

f. where there is a disagreement, departments should insist on their position being recorded in the NAO report; and if appropriate this could include the view that NAO's observations relate to Ministers' policy objectives rather than to the economic, efficient and effective use of resources.

H.M. Treasury

3rd March, 1988.

ANNEX A

GOVERNMENT ACCOUNTING E27-28

27. The C&AG has a statutory right to free access to the books of account of departments and "other documents relating to the accounts" for the purposes of audit. In addition, for the purpose of carrying out VFM examinations, section 8 of the National Audit Act 1983 defines the C&AG's statutory right of access, at all reasonable times to all such documents as he may reasonably require, subject to those documents being in the custody or under the control of the department or body to which the examination relates.

28. Because of the wide-ranging nature of the C&AG's audit functions, his right of access has, by agreement, been widely interpreted over the years. The C&AG will normally be given access, not only to all manual or computerised records relating to the payments and receipts appearing in the accounts, but also departmental correspondence and minutes held on files and working papers which are relevant to VFM examinations being undertaken. Papers primarily concerned with the formation of policy by Ministers will not normally be relevant to VFM examinations. On this ground it has not been the practice for the C&AG to be given access to Cabinet or Cabinet Committee papers or minutes. If he should request access to specified Cabinet or Cabinet Committee papers on the ground that he considers it necessary for the purpose of his audit, the matter should be referred to the Cabinet Office.

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-233 3000
Direct Dialling 01-233 8898

: H A Judd
Inder Secretary

23 November 1984

J D Bryars Esq CB
Ministry of Defence
Main Building
Whitehall
LONDON SW1A 2HB

Dear Desmond,

C & AG's ACCESS TO DEPARTMENTAL PAPERS

Permanent Secretaries have discussed recently the question of the C & AG's rights of access to departmental papers. They have now accepted the enclosed memorandum of guidance prepared by the Treasury which attempts to explain a position which is not and cannot be clearly defined. I therefore now circulate it to all departments and ask them to have it in mind in any dealings they may have over the access sought in their departments by NAO staff.

The guidance has not been discussed or agreed with the C & AG and it cannot therefore be quoted to the NAO as something they must necessarily accept. It represents the Treasury's advice on a problem which has been posed for a number of departments recently. The reason it has not been discussed with the C & AG is that he must remain free to take his own view of his rights in a particular case and could not be expected to compromise them in advance via a document of this kind. The document is, however, agreed with the Treasury Solicitor and represents a stance which we are advised is fully consistent with the Law.

This letter and its enclosure are copied to PFO's and FO's on the list attached. They are free to disseminate the advice within their departments or to non departmental bodies as they think fit and with the above qualifications about its status via a vis the NAO. I suggest that it would be unnecessarily provocative to show it to the NAO although there is nothing in it which it is positively desired to conceal from them.

Yours ever
Clifford

C H A JUDD
Treasury Officer of Accounts

C & AG'S ACCESS TO DEPARTMENTAL FILES AND PAPERS

Note by the Treasury

1. This paper is concerned with the C & AG's basic right to see departmental papers. It is not concerned with such matters as security classification, which will require the particular NAO staff concerned to have the appropriate security clearance before they can see papers.

Select Committees - General

2. The general guidance, for which MPO is responsible, on the relationship of officials with Select Committees (GEN 80/38) is relevant; but this paper concerns departments' relationships with the NAO which serves the PAC in particular.

3. It is possible for a situation to arise in which the NAO may have seen papers that have been specifically denied to other Select Committees. In that case the C & AG may be expected not to report the content of such papers to Parliament without consent (though he may feel a need to report that that is what he has done and why).

The Statutory Position

4. This is contained in s.28 of the Exchequer and Audit Departments Act, 1866 so far as the basic certification audit is concerned and s.8 of the National Audit Act 1983 so far as VFM audit is concerned. The texts are given in Annex A.

The Administrative Position

5. Paragraphs E14-15 of Government Accounting say - in relation to the situation before the 1983 Act -

> C & AG's right to information
>
> "The C & AG has a statutory right to free access to the books of account of departments and 'other documents relating to the accounts'. For access to information, however, the C & AG relies less on this statutory provision than on the fact that, on each account, he certifies that he has 'obtained all the information and explanations' that he has required. If a department withheld information which he considered necessary for the purposes of his examination he would qualify his certificate and report the matter to Parliament. The department withholding access to information would then have to satisfy the Public Accounts Committee as to the reasons.
>
> Similarly if the C & AG asks for information or explanations which in the Accounting Officer's opinion are not directly related to the

accounts the department may legitimately withhold them, but the Accounting Officer must again be prepared if necessary to defend his action before the Public Accounts Committee.

The right of access is exercised largely by the C & AG's officers, most of whom are stationed in the departments with which they are concerned and carry on a continuous audit."

6. Although the 1983 Act merely enacts what was already E & AD practice in the way of VFM audit, developed over many years without statutory powers, the fact is that the development of C & AG's systematic attempt to provide Parliament with comprehensive VFM coverage, as described in his memorandum attached to the PAC's 9th Report of 1981-82 (Annex B), is comparatively recent. Previously his VFM reports arose out of his certification audit, for which purpose departments normally accorded the auditors a very free access indeed - on the basis that they need not then attempt to segregate their files and that the risk of embarrassment was low given the main purpose of the audit examination and the fact that the VFM work was in practice about economy and efficiency rather than the newer concern for "effectiveness". On this basis the auditors often saw policy papers and advice to Ministers, or drafts of these, but were not very likely to want to use them in the context of their examinations.

7. This fairly free access was often rationalised as enabling the auditor to understand better that which he was actually auditing.

Present Developments

8. Although certification audit still requires a very substantial commitment of the NAO's resources, the conventions of Parliamentary propriety have become well established over more than 100 years, and it is not often nowadays that the PAC actually need to examine departments n such matters. Most of its attention is now focussed on VFM and, as described above, that is now extending much more into the "effectiveness" field than in the past. As the last section of the memorandum at Annex B explains, the C & AG's intention is to develop a systematic coverage of the whole field of Government expenditure.

9. Thus what has in the past been seen as a legitimate by-product of the certification audit has now become the main subject of the PAC's attention, and the question of access to papers needs to be considered with this in mind. Indeed when it came to writing down the C & AG's powers in respect of VFM examinations in Sections 6-9 of the National

Audit Act the words were carefully chosen to give him adequate access but not totally free access.

Analysis of Sections 6-9

10. the tense used in s.6 is important. This retains the audit based nature of VFM examinations and does not include consideration of future or alternative policies by the C & AG. Subsection (2) specifically rules out consideration of the merits of "policy objectives". This expression is imprecise but obviously wider than plain "policies".

11. S.7 provides similarly for the examination of bodies other than departments.

12. Then in s.8 the right of access is to such documents as he may reasonably require for carrying out a (legitimate) examination. S.8(2) prevents departments being required to procure documents from others for the C & AG.

13. There is thus a series of questions involved to which the answers will inevitably be subjective on the part of any department concrned and in the context of the particular case:

(a) In the case of authorities and bodies falling within the description in ss.6(3) or 7(4) of the Act, and not covered by ss.6(4) -6(6), does the subject matter of the examination come within ss.6(1) or 7(1)?

(b) If the answer to (a) is yes, does the examination extend to the merits of policy objectives (which are precluded by ss.6(2) and 7(2))?

(c) Can the NAO "reasonably" require the documents requested for the purpose of the proposed examination?

(d) Is the department, authority or body concerned able to release the documents requested on its own authority?

Discussion

14. It is extremely difficult to justify denying many papers to the C & AG or his officers, and in general there has been no cause for concern about the eventual use made of the generous access afforded in the past. It is no part of the intention of this paper to encourage concealment of any papers which it is legitimate for the NAO to see. In general, it remains right that the NAO should have as wide access to departmental papers as is needed in the interest of serving Parliament

properly; and papers should not be withheld unless there is a positive reason for doing so and there are grounds upon which Ministers would be prepared to defend that course in Parliament if necessary.

15. But it is equally right to take account of the fact that the scope of the NAO's work is changing, and that there are now statutory provisions which can if necessary be invoked. What has proved to be harmless in the past may not necessarily be so in the future. Since the relevant statutes are administrative in character the ultimate test for denying a particular paper remains, in practice, whether the Minister concerned would be prepared to uphold his department's position in Parliament.

16. In short, the position remains not significantly different from that stated in Government Accounting, but there are differences in the environment in which the matter falls to be considered.

(a) The C & AG is now formally an officer of the House of Commons and his staff are no longer civil servants.

(b) The C & AG's activities are deliberately and systematically extending into areas, and therefore papers, with which they have not been concerned previously.

(c) The C & AG's powers of access for VFM examinations are now statutorily if imprecisely defined (and therefore limited) where previously they were not.

17. It would be prudent and legitimate for departments to bear these changes in mind when considering any particular case.

18. The terms of the legislation do not amount to a set of clear and unequivocal "rules". The prohibition in s.6(2) does not, for example, prohibit the auditors from seeing papers about the merits of policy objectives. Nor does it define a "policy objective", which it is possible to conceive of at several levels. There is certainly scope for policy issues to be raised without criticising the objectives.

19. The legislation does however contemplate a balance to be struck between Parliament's right to have information about the "economy, efficiency and effectiveness" of expenditure and Ministers' right to confidentiality in the making of their policy decisions. If the NAO have seen all of the papers which led to those decisions it is ultimately up to the C & AG to decide what he reports to Parliament. If they have

not,it is up to the department concerned to provide explanations, as required by s.8(1) of the National Audit Act, in response to the NAO's questions. This does not entitle a department simply to prefer the second position, and in this connection it is salutary to note the fate of attempts to withhold papers in the United States and Canada (see Annex C). But it does explain the significance of the means by which the NAO may obtain the explanations they require.

20. Access has always been declined in the past to Cabinet and Cabinet Committee papers - indeed Cabinet Committees are seldom even acknowledged to exist in Parliament. If any request to see such papers is received it should not be conceded without Cabinet Office consent (which is, in general, unlikely to be given). Access has similarly been declined to a CPRS Report on the ground that this was policy advice to Ministers and not part of any department's use of its resources. It is also relevant that the Government declined to accept a TCSC recommendation that the C & AG, with his access to papers, might render reports to Parliament for the benefit of other Committees than the PAC (Cmnd 8616 paras 34-36), who of course are not precluded from inquiring into the merits of policy objectives.

21. A practical consideration for departments is the cost and/or inconvenience of trying to "filter" papers which the C & AG is not entitled to see. The benefit to be balanced against this is very much an insurance benefit - what might or might not be included in the C & AG's report to Parliament (or his brief for the PAC Chairman when the report comes to be examined). The C & AG always consults Accounting Officers about the content of his reports to Parliament and has not so far failed to secure consent to what he has reported.

Conclusions

22. (i) From Parliament's point of view, it will always be preferable that the C & AG's reports should be based on his staff's independent findings from the evidence, rather than on departmental replies to questions which will inevitably be regarded as subjective.

(ii) Nevertheless Ministers are entitled to confidentiality over the making of their decisions on policy objectives, and the C & AG is not entitled to question the merits of those objectives.

(iii) The cost and inconvenience of maintaining a watch over NAO access to files is a factor to be balanced against the advantage. It might be not worthwhile in a largely executive

organisation. It might be well worthwhile in a largely policy-making one.

(iv) The past record does not suggest that in practice there is a great deal to be gained by the withholding of papers. That may not necessarily be a good guide to the future, however, in which NAO examinations will be much closer to the politically sensitive policy area.

(v) Whenever a paper is withheld the question inevitably arises - what is being "hidden"? It is obviously undesirable to provoke contitutional arguments which the Government is more likely to lose than to win. It follows that while the question of withholding papers should be considered, decisions to withhold should be rare and strictly confined to cases where Ministers would be prepared to uphold the department's position in Parliament.

(vi) It is an accepted convention that Cabinet and Cabinet Committee papers, and drafts of these, are not shown to NAO; if there is a request to see them, it should not be conceded without Cabinet Office consent.

(vii) Otherwise it is difficult to define whole classes of papers which should definitely not be made available to NAO. But there is a presumption against showing them papers concerned with the discussion of policy objectives, such as basic PESC papers. It is important that policy decisions arising from such papers are set out in policy statements or in other documents which can be made available to the NAO, in such a way that the NAO will know clearly what are the objectives of the policy, and can thus assess means and methods employed to achieve them.

(viii) The distinction between policy objectives (whose "merits" the NAO must not question) and policy instruments (whose "effectiveness" the NAO has to judge in relation to the objectives) is difficult to draw. The word "reasonably" in s.8(1) was however specifically designed to avoid leaving the C & AG with the absolute right to determine what the NAO could see, and was understood as intended to leave present practice unchanged.

(ix) To keep a check on access, departments may find it helpful to discuss with NAO officers, at an earlier stage of VFM enquiries, what papers they expect to need to see, and with whom it would be useful for them to discuss specific aspects to clarify policy objectives.

(x) The Treasury Officer of Accounts is available for consultation on any cases of doubt. He should be informed of any cases where a department decides to withhold papers, or where general questions arise which could affect other departments.

H.M. TREASURY

November 1984

3977/53

PERSONAL AND CONFIDENTIAL

FROM: P J CROPPER
DATE: 3 March 1988

FINANCIAL SECRETARY

cc PS/Chancellor
Sir A Wilson
Mr Tyrie
Mr Call

SMALL COMPANY AUDIT

Very sensible letter from the CBI, for once. ('Times' 3 March).

P J CROPPER

'THE TIMES' 3/3/88.

Annual audits

From Mr H. Kleeman

Sir, I should like to comment on the recent exchange of correspondence (February 20, 25) on the statutory audit for small businesses, not as one of those vested interests, as referred to (February 25) by Arthur Green, President of the Institute of Chartered Accountants, but as an owner of a small business and Chairman of the CBI's Smaller Firms Council.

I have to say that CBI's smaller firms have not found the production of a statutory audit one of the more onerous burdens placed upon them. The information produced is invariably required for other outside purposes and, furthermore, the production of regular financial information is an essential discipline and important for creditors as well as shareholders.

However, there is certainly scope for simplifying and reducing the amount of information companies are required to produce and we would hope that if the Government does decide to look at this issue, it will consult closely with those organisations representing the views of the smaller firms themselves.

Yours,
H. KLEEMAN (Chairman,
CBI Smaller Firms Council),
Centre Point,
103 New Oxford Street, WC1.

2524/1

FROM: SIR ANTHONY WILSON
DATE: 4 March 1988

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Anson
Mr Monck
Mrs Lomax
Mr Mason
Mr Ilett
Mr MacAuslan
Mr Inglis
Mr Wynn Owen
Mr Flanagan
Mr Tyrie
Mr Cropper
Mr Call
Mr Beighton - IR
Mr D Shaw - IR
Mr Fryett - C&E

SMALL COMPANIES AUDIT AND ACCOUNTS

This submission notes the progress being made in the area of small companies' audit and accounts since your meeting with Mr Maude and Mr Cope on 9 February 1988.

Small companies' audit

Two separate exercises are being carried out:

1. "Review" or "compilation" statements

The DTI is now exploring with the professional bodies and some representatives of accountancy firms the practicality and cost of various alternatives to the present audit of small companies. These range from a minimalist option of a statement by the directors that the accounts comply with the Companies Act to the option of an independent review which provides limited assurance on the accounts. The DTI will report the outcome to me as soon as possible.

2. **Tax attestation**

I have met officials of the Inland Revenue and Customs & Excise and have agreed that, once the Budget is delivered, the Inland Revenue will prepare a paper setting out their joint requirements in the shape of a review for tax attestation purposes as an alternative to audit. Such a combined view from the Chancellor's departments will then be discussed with the DTI.

Eventually a system of tax attestation might satisfy the requirements of the Revenue Authorities and allow any other mandatory form of review for small companies to be dispensed with. A fully considered system of tax attestation may take 2-3 years to develop and implement. The Inland Revenue are rightly concerned about any proposals to remove existing audit requirements which would leave a vacuum in small company reporting until such a system is in place.

Small companies' accounts

Any changes in accounting disclosure requirements for small companies are thought by DTI to be capable of introduction by secondary legislation. There is thus more breathing space in which to settle any changes to be made. That said, we must ensure that the situation is not allowed to stagnate. It has therefore been agreed that as soon as they are free of budget commitments, Inland Revenue and DTI officials should meet to try to extend the list of items which can be excluded from small companies' accounts. The starting point for this work will be the list of concessions to small companies' accounting requirements agreed two years ago as the result of an extensive exercise.

Public reaction

You may be interested in the attached correspondence which has recently appeared in 'The Times'. It may represent no more than a lobbying effort on the part of those who wish to

maintain the status quo, but I am receiving widespread indications that the attitude expressed by the President of the English Institute is far from universally supported by its members.

A WILSON

'THE TIMES' 3/3/88.

Annual audits

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Sir, I should like to comment on the recent exchange of correspondence (February 20, 25) on the statutory audit for small businesses, not as one of those vested interests, as referred to (February 25) by Arthur Green, President of the Institute of Chartered Accountants, but as an owner of a small business and Chairman of the CBI's Smaller Firms Council.

I have to say that CBI's smaller firms have not found the production of a statutory audit one of the more onerous burdens placed upon them. The information produced is invariably required for other outside purposes and, furthermore, the production of regular financial information is an essential discipline and important for creditors as well as shareholders.

However, there is certainly scope for simplifying and reducing the amount of information companies are required to produce and we would hope that if the Government does decide to look at this issue, it will consult closely with those organisations representing the views of the smaller firms themselves.

Yours,

H. KLEEMAN (Chairman,
CBI Smaller Firms Council),
Centre Point,
103 New Oxford Street, WC1.

The Times - Saturday 20 February 1988

Need to retain compulsory audit

From Mr Desmond Goch

Sir, It is to be hoped that the Government, in its desire to be seen to be doing something about easing the burdens on small businesses, does not succumb to the pressures that are being exerted upon it to abolish the statutory audit of accounts of small companies.

The requirement for a statutory audit goes hand in hand with the limited-liability concept and it is so widely used by the business community that it ought not to be abandoned simply as a gesture to those who are seeking its abolition as a way around difficulties which they cannot overcome by other means.

The case that is being made for abolition appears to rest on the argument that those proprietor-controlled "corner shop" businesses which are constituted as limited companies do not need to undergo the discipline of a formal statutory audit. It is undoubtedly true that many such businesses are, by their very nature, unsuited to wear the mantle of limited liability and perhaps in the past it has been made too readily accessible. Maybe we should consider the possibilty of introducing an alternative form of incorporation. The Government's 1981 consultative document covered much of the ground.

However, those businesses that want to retain full limited-liability status, be they large or small, should be expected to continue to be bound by the requirement for a statutory audit. Professionally-audited accounts are used by the business community in many ways. Banks and other financial institutions rely on them when dealing with borrowing applications. Large companies use them for assessing financial management competence and financial stability when they are considering dealership appointments and supply contracts.

Tax inspectors are more likely to agree assessments when accounts have been certified by audit firms of standing in their locality. Credit-rating agencies rely on them when compiling status reports.

There is a danger that withdrawal of the requirement for statutory audit might be interpreted by some directors of small companies as giving absolution from the necessity to produce any kind of formal accounts and the commercial consequences of this possibility must be a matter for considerable concern.

Limited liability confers highly valued benefits on those businesses which choose to trade in this way, but it also imposes responsibilities which they should be expected to accept without complaint. The independent professional audit is a fundamental cornerstone of this responsibility and it behoves those who are supporting its abolition to ponder on the long term consequences.

There are ways in which the Government can ease the burdens on small businesses, some of which they have themselves imposed in recent years. But abolishing the independent audit is not one of them.

Yours sincerely,

DESMOND GOCH (Deputy President),
The Chartered Association of Certified Accountants,
29 Lincoln's Inn Fields, WC2.

February 18.

The Times 25/2/88

Annual audits for small businesses

From Lord Bruce of Donington

Sir, It is to be hoped that the entire accountancy profession will support the initiative of the Deputy President of the Chartered Association of Certified Accountants in his letter to you (February 20).

Far from being a burden on small businesses enjoying the benefits of limited liability, the statutory annual audit of their accounts is in fact a very considerable advantage to them. The formal disciplines imposed by the Companies Act ensure that the proprietors/managing directors of these small concerns are made fully aware, at least once a year, of their financial state and profitability.

That this is fully appreciated by those engaged in running small businesses is completely confirmed by the Government's own 1985 report, "Burdens on Business", which showed that only 1 per cent of small firms regarded the requirements of company law (including audit) to be a burden.

Moreover, for so long as the tax liability of small business, whether limited-liability companies or not, is determined by reference to their profits, annual accounts will continue to be required by the Inland Revenue and will therefore have to be prepared in any event – unless of course the Treasury instructs the Commissioners of Inland Revenue to accept a rough figure of voluntary declaration of profits by a mere mention in the tax return!

One therefore ventures to doubt whether the small entrepreneur, were he to be rid of the present audit requirements, would welcome further intrusions into his hard-working day, as would arise from the requirements thrust upon him of replying to queries from his inspector of taxes on matters concerned with the unauthorised, and possibly inaccurate, accounts sent in for examination.

The Government might do well to ponder further on this matter, regardless of what pressure may be put upon them by a European Commission singularly insensitive to such considerations.

Yours sincerely,
BRUCE,
House of Lords.
February 22.

From the President of the Institute of Chartered Accountants

Sir, This institute welcomes the re-emergence into the public arena of the debate on the current statutory requirement for all companies, regardless of size, to have an audit. We believe that for small companies this requirement should be relaxed. We recommend that if all the shareholders agree, the company should be allowed not to have an audit.

At present, the statutory audit requirement is an unnecessary burden on many small companies. The directors and shareholders of the company are often the same people. As directors, they prepare accounts and report to themselves as shareholders. As shareholders, they employ auditors to ensure that they, as directors, have satisfactorily discharged their responsibilities to themselves. This is a nonsense. It is a waste of time and money.

Our proposal ensures that minority shareholders would be protected. All shareholders would have to agree to dispense with an audit; so any shareholder, by not agreeing, could effectively ensure that there is an audit.

If creditors are unwilling to lend money or to provide goods to a company that does not have an audit, this is a matter between them and the company; it is not a reason for a statutory audit requirement. Our proposal would ensure that if the directors wished to have an audit for the benefit of creditors, they would be free to do so.

There is no good reason why the Inland Revenue should insist on retention of the small company audit. It copes perfectly well with unincorporated businesses whose accounts are not audited.

The Government is under pressure from vested interests to retain the existing statutory requirement. It should resist these pressures. No other major industrial country has a statutory audit requirement for small companies. It is time this pointless burden was lifted.

Yours etc,
ARTHUR GREEN, President,
The Institute of Chartered Accountants,
PO Box 433,
Chartered Accountants' Hall,
Moorgate Place, EC2.

4370/052

FROM: J J HEYWOOD
DATE: 8 March 1988

SIR ANTHONY WILSON

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Anson
Mr Monck
Mrs Lomax
Mr Mason
Mr Ilett
Mr MacAuslan
Mr Inglis
Mr Wynn Owen
Mr Flanagan
Mr Tyrie
Mr Cropper
Mr Call
Mr Beighton - IR
Mr D Shaw - IR
Mr Fryett - C&E

SMALL COMPANIES AUDIT AND ACCOUNTS

The Financial Secretary was most grateful for your report of 4 March. He has commented that it is important that the review progresses as speedily as possible.

J J HEYWOOD
Private Secretary

4/2917

FROM: SIR ANTHONY WILSON
DATE: 24 March 1988

FINANCIAL SECRETARY

cc PPS 12/2
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr MacAuslan
Mr Bradley
Mr Inglis
Mr Cropper
Mr Tyrie
Mr Beighton - IR
Mr Shaw - IR
Mr Finlinson - C&E
Mr Worman - DTI

SMALL COMPANY AUDITS: REPRESENTATIONS BY THE CHARTERED ASSOCIATION OF CERTIFIED ACCOUNTANTS

Mr Stanley Thomson, the President of the Chartered Association of Certified Accountants, attended a meeting in the Treasury on 23 March to promote the CACA's case for retention of the audit requirement for small companies. This matter was raised in Mr Thomson's letter to you of 18 February 1988, written because of your special responsibility for Inland Revenue matters.

2. Nothing new emerged from the points put by Mr Thomson and his colleagues at the meeting. He expressed a personal view that many small companies, particularly those run by a one or two-man board or a family team which did not require external finance, should not be trading as companies with limited liability in any event. This seemed to be rather contrary to the CACA requirement for a continuing audit of all companies.

3. Mr Thomson is the Finance Director of Ford Motor Company and it was interesting to hear the extent to which Ford relies on audited accounts from all its suppliers and dealerships. It insists that audited accounts are presented regularly by all companies which have a continuing supplier or dealership

relationship with the company, and these must be sent within six months of the individual company's year end. In cases where a new contractual arrangement is sought by a supplier or dealer, Ford will call for audited accounts covering the previous five years, so if a company wishes to enter into a business relationship with Ford it must have foreseen this possibility well in advance, for it is very difficult and expensive to create audited accounts for several years retrospectively. I pointed out that I thought the Ford practice was not used by the major clearing banks which would require much more detailed and up-to-date information from a potential borrower than that contained in its annual accounts; this would not mean that annual accounts would not have to be filed with the lender in due course, but he would regard them only as corroborative in respect of other information obtained in a more timely fashion.

4. I asked Mr Thomson, as I have put to many of those who have talked to me about this issue, how many companies would continue to have an audit on a voluntary basis if the statutory requirement was removed. He was unable to give any kind of indication, but my suspicion remains that most companies (perhaps two-thirds of them) would continue to opt for full audit. Ambitious businessmen, looking to the future when they would need more capital for growth, would want to be assured that their house-keeping was good enough to meet the requirements of a potential lender, and the cost of preparing audited accounts regularly as they go along would be much less then having to do a major exercise retrospectively against a sudden need for it.

5. Mr Thomson made the interesting point that most of the very small companies without any in-house accounting capabilities rely on what they call "accounts", but these are very different from statutory accounts prepared in accordance with the requirements of the Companies Act. These primitive "management accounts" are little more than cash control documents, and many businesses can get by without anything more elaborate. To the small businessman therefore "accounts" means what he

does himself on the back of an envelope, together with the bank statements, and he has little use or understanding of the more sophisticated accounts with far reaching disclosures which have to be audited and filed. Mr Thomson thought that this lay behind the view of some small business groups that the audit was an unnecessary burden on business.

6. Mr Thomson wondered where the initiative to remove universal audit had originated because, he said, so far as the CBI Small Business Group was concerned, he knew they were strongly opposed feeling that removal of audit would inhibit the credibility of smaller companies, particularly at a time when encouragement was being given by Government and others to establish small business units. He was also aware that the Irish Institute had come out formally in opposition to the removal of universal audit, as well as his own Chartered Association of Certified Accountants. As two of the accounting bodies, CIPFA and the Chartered Institute of Management Accountants had no audit interest, it just left the English and Scottish Institutes in favour of the projected move. He doubted whether the membership of these bodies would support the line which their office holders are taking because the official line seems to have been developed under the influence of the larger firms of accountants which only have a minor connection with the audits of small businesses. He thought an intention on the part of Government to remove the mandatory audit of small businesses would meet a howl of protest because he feels that, based on a long-established usage, compulsory audit is seen by the business population of this country as being part of the acceptable price to pay for the privilege of incorporation with limited liability. He said he was not lobbying for the business interests of CACA members, some 3,000 of whom are in practise and concerned with the audit of smaller companies, but he was speaking largely as a businessman and citizen.

Current Situation

7. DTI is continuing its limited consultation with the

Technical Committees of the Accounting Institutes and with a number of large and medium sized practising firms to establish the feasibility and cost of substituting a review of some sort for audit of the smaller companies. This process will be completed soon after Easter and there is no scope for further research beyond that in view of the timescale within which a decision whether to proceed or not with the removal of the statutory universal audit requirement must be taken.

8. I remain of the opinion that Government should not remove the statutory audit requirement for smaller companies without putting a less burdensome alternative in its place. Removal of the statutory universal audit requirement would not deny companies the chance to have an audit if they wished to continue with this on a voluntary basis. If they did choose to continue, then the standard of audit would, of course, be that appropriate to larger companies as well as themselves. But if many of the smaller companies opted to continue with full audit, it would defeat one of the objectives, which is to have "real effective audit", as applied to all listed and larger companies, enforceable by the professional accounting institutes through enhanced monitoring and disciplinary processes. The real aim of any change should be seen clearly as the association of the cost of any audit or lesser review with those who actively call for it, rather than as a burden placed automatically on a company as an overhead expense by "them" in the shape of the Government.

A WILSON

3652/042

FROM: A J TYRIE

DATE: 25 March 1988

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir Anthony Wilson
Mr Cropper
Mr Call

SMALL COMPANY AUDIT: MEETING WITH THE CERTIFIED ACCOUNTANTS

I attended this, on which Sir Anthony Wilson has given a full report.

2. I asked Stanley Thompson whether he thought that the removal of the small company audit requirement would do any damage to his association. After some prevarication he decided not. He thought businesses would demand other sorts of financial advice and assistance from their accountants.

3. If this is true, it strengthens the case for removal of the audit requirement. Setting aside Revenue/shareholder protection considerations etc, it would imply that businesses would not suddenly become irresponsible, but would demand the kind of financial advice that they would find most useful.

4. Unlike Sir Anthony, I am not entirely convinced that we need to replace the statutory audit requirement with anything. A more appropriate response to the Revenue's concerns would be to look carefully at whether some modest increase in the number of company accounts examined should be considered, even if this had resource implications. Although I am not <u>at all</u> convinced by the Revenue's case, I think this would be preferable to unveiling, amid much deregulatory trumpeting, nothing more than 'son of Audit!'

5. I also think that we are reaching the point at which we can take a decision.

A G TYRIE

3632/1

papers pse

CONFIDENTIAL

FROM: P J CROPPER
DATE: 29 March 1988

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Tyrie
Mr Call

SMALL COMPANY AUDIT: MEETING WITH THE CERTIFIED ACCOUNTANTS

It is clear from his minute of 25 March that my colleague Tyrie has learnt nothing from the discussions of the past few weeks. Neither have I.

2. It remains my view that the compulsory audit should remain firmly in place. As a bad second best I would go for a tax orientated "son of audit". Straight abolition, nowhere.

3. If Touche Ross want to get shot of auditing a whole mass of small clients' accounts they should pass the job over to a Certified Accountant. This would be a perfectly reasonable thing to do - just as Hoare Govett are trying to get of their tiresome private clients and concentrate on the big boys.

4. Meanwhile, with the CBI Small Firms Council and the Inland Revenue firmly on the side of retention I can see no merit in the DTI case at all.

P J CROPPER

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

Ch/Yes will wish to see this and the other most recent contributions to this rigorous debate!

FROM : L J H BEIGHTON
DATE : 8 April 1988

MPW 8/4

FINANCIAL SECRETARY

ABOLITION OF THE STATUTORY AUDIT FOR SMALL COMPANIES

1. As you may recall the future of the audit requirement for small companies is not a matter where the main issues involved concern taxation (although there is a danger that the Revenue is now being presented, at least to the press, as the villain in the piece). However, we do believe that the audit is a useful safeguard and that there would be implications for the Exchequer and for our investigation targets if it were dropped. The need is to find a balance between the deregulation initiative and the concern about fraud.

2. A new suggestion has emerged which seems to us to point a possible way forward. The purpose of this note is to seek your agreement to our floating it with DTI officials. We are due to meet them on Tuesday afternoon (12 April) as you asked when you saw Mr Maude and Mr Cope

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Scholar
Mr Culpin
Mr Inglis
Mr Cropper
Mr Tyrie
PS/C&E

Chairman
Mr Isaac
Mr Painter
Mr Rogers
Mr Beighton
Mr Cherry
Mr Corlett
Mr Deacon
Mr Page
Mr G Miller
Mr D Shaw
Mr K Shaw
PS/IR

3. I have had the opportunity of only a brief discussion with Sir Anthony Wilson about this, but he has said that he agrees that the suggestion is worth pursuit.

Views of the CBI small companies council and the Chartered Association of Certified Accountants

4. As you may know, it is mainly the large accountancy firms and their representative bodies, who in practice do few small company audits, who are in favour of abolition of the audit. By contrast a number of representative bodies working in the small company area are opposed to its abolition. In particular, both the CBI small companies council and the Chartered Association of Certified Accountants (CACA) have suggested that it would be a retrograde step.

5. The views of Stanley Thomson, the president of the CACA and finance director of Ford UK, are of particular interest. Sir Anthony Wilson chaired a meeting with the CACA, Revenue and DTI on 23 March, and reported the outcome to you on 24 March.

6. One of the main arguments advanced by Stanley Thomson was that the statutory audit is the price of limited liability. He thought that abolition of the audit for companies with limited liability would encourage fraud against minority shareholders and creditors in general. He applauded the stand the Government had taken against fraud in other fields and expressed both concern and surprise that the Government should be considering the removal of this first line of defence in this case.

Stanley Thomson's radical alternative

7. Stanley Thomson's view that the statutory audit is the price of limited liability allows a radical new approach to this question. If the audit is the price of limited liability, then one can ask whether an audit is needed for a company without limited liability.

8. The risks of fraud upon minority shareholders and creditors in

generally are reduced if the company does not have limited liability. An unlimited company is, in this respect, broadly similar to an unincorporated business. And it would make a lot of sense to treat them in the same way. Whereas a company may find that disincorporation is a major step, with difficult company and tax law implications until the proposals in last year's consultative document can be implemented, the removal of limited liability would achieve many of the same advantages more simply.

The Government's position

9. By retaining the statutory audit for companies with limited liability, the Government would be seen to be keeping to its commitment in Lord Young's White Paper "Building Businesses .... Not Barriers" which said:

> "The Government have decided to retain the requirement for small companies to have their accounts audited. The consultation revealed no strong balance of opinion in favour of abolition. The Government are determined to clamp down on fraud and have decided that removal of this first defence against fraud would be inappropriate."

10. But by abolishing the statutory audit for companies with unlimited liability the Government would give companies a choice. The statutory audit would clearly be seen to be the price of limited liability. Companies would have the choice to have limited liability and bear the cost of the audit, or give up limited liability and remove this obligation.

11. The proposal put forward by Lord Young is that the audit should be abolished for companies whose turnover is below a certain size - various figures from £ml/4 to £m2 have been considered. But whatever figure was chosen would inevitably be arbitrary and lack logic. (Indeed Mr Tyrie suggested that the logic of the position was that it was the smallest and largest companies for which the audit was needed, and medium sized companies where the case for it was less strong.) Near the limit companies might find themselves moving into and out of the audit requirement from year to year and

they might not know until the end of the year if they fell within it or not. Nor would others concerned, such as trade creditors, know whether their accounts were being audited. By contrast a distinction between limited and unlimited companies would be logical, certain and clear.

Further relaxations for companies with unlimited liability

12. This approach opens up the further possibility of removing the accounting requirements altogether for small proprietorial corporate businesses with unlimited liability. Mr Cope suggested at your meeting that corporate businesses which were in all respects similar to unincorporated businesses should be treated in a similar fashion. The approach suggested by Stanley Thomson would pave the way towards this, and towards a very real measure of genuine deregulation for these small businesses.

Interest of the Revenue

13. The previous consideration of this issue, in 1985 and 1986, was largely about company law issues and fraud. One of the reasons why your predecessor opposed the abolition of the audit was its likely impact on the Exchequer but this issue has not been at the centre of the discussion. Nonetheless the risks to the Exchequer would be increased if the accounts of limited liability companies were not audited. The Exchequer is frequently the major creditor of a small company and one of the major casualties of fraud. Hence the reduction of risks which unlimited liability carries would allow the audit and accounting requirements to be reduced at lower cost.

14. We should also need to consider the implication of any change for our investigation targets. On Lord Young's proposal under which the audit requirement would be linked to turnover, some 300,000 company accounts might cease to be audited: if, however, the change were linked to the dropping of limited liability the number would probably be considerably less, possibly of the order of a third of that figure.

15. Our investigation target for the accounts of unincorporated

businesses is currently around 2% though we hope to be able to move back over the next few years towards the original figure of 3%. The target for the accounts of companies is 1%. If we were to treat unaudited company accounts in the same way as those of unincorporated businesses and attempt to investigate them on the same basis, we should need additional Inspectors of Taxes of an order approaching 100 for each 100,000 accounts involved.

16. Further consideration would be needed into how this work could be done. If it were left with fully trained Inspectors the additional numbers required could be found only by diverting them from the more remunerative review work. If, on the other hand, it were to be passed to Inspectors with investigation training only, there are at present no such Inspectors who could be diverted from other work so that the current investigation effort would have to be spread more thinly. We already need further Inspectors to cope with the increasing number of unincorporated businesses and to start raising our targets but we would hope in addition to increase our numbers of these Inspectors from 1991/92 onwards (1992/93 in London) at least to the extent implied by our estimate of the number of companies which might switch to unlimited status.

17. I should be grateful to know whether, despite these implications for our investigation targets, you would be content for us to put forward this proposal.

LJHB

L J H BEIGHTON

42/2.BTW.4372/42

CONFIDENTIAL

FROM: J J HEYWOOD
DATE: 12 April 1988

MR BEIGHTON IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Scholar
Mr Culpin
Mr Inglis
Mr Cropper
Mr Tyrie
PS/C&E
PS/IR

ABOLITION OF THE STATUTORY AUDIT FOR SMALL COMPANIES

The Financial Secretary was grateful for your note of 8 April.

2. He is content for you to float the idea of abolishing the audit for companies with unlimited liability. But he sees this proposal as inferior to replacing the audit with something less burdensome for a larger number of companies. The Financial Secretary is also greatly disturbed about the manpower implications of the proposal.

3. The Financial Secretary would like you or Sir A Wilson to report back to him after today's meeting. He will then hold a meeting himself next week to discuss how this issue can be brought to a speedy conclusion.

JEREMY HEYWOOD
Private Secretary

Inland Revenue

Central Division
Somerset House

1. Jonathan
2. pmp

papers pse

FROM : L J H BEIGHTON
DATE : 13 April 1988

FINANCIAL SECRETARY

ABOLITION OF THE STATUTORY AUDIT FOR SMALL COMPANIES

You asked (Mr Heywood's minute of 12 April) for a brief report on yesterday's meeting with the DTI: the EDU and Department of Employment were present as well as the Company Law Division.

In the event little of the discussion was about the statutory audit. The DTI are still analysing the responses to their informal discussion paper about a replacement for the audit and replies (including some from people to whom it was not sent) are still coming in. They said that the responses are varied (as they were to the original 1985 consultative document) and they will let us know the outcome shortly. We shall of course keep you informed. There was no substantive discussion of the issue and in the circumstances (and given your slightly cautious response) we did not float the proposal we had put to you.

Instead the discussion was about the other limb of the deregulation initiative - the reduction in company law

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Scholar
Mr Culpin
Mr Inglis
Mr Cropper
Mr Tyrie
PS/C&E

Chairman
Mr Isaac
Mr Painter
Mr Rogers
Mr Beighton
Mr Cherry
Mr Corlett
Mr Deacon
Mr Page
Mr Marshall
Mr D Shaw
Mr K Shaw
PS/IR

requirements. As you know, we need some of the information which companies are at present required to provide their shareholders because of the inadequacy of our own information powers to give us what we need when we need it and because Treasury Ministers decided, in the light of our own consultations, that we should continue to rely on company law requirements for CT Pay & File. The question then arises just how far we can agree that the requirements should be relaxed in areas where the DTI see no reason why companies should be required to provide it for shareholders unless they so request. The DTI gave us a list of 35 detailed requirements which they would like to see removed. We were able to agree that just over a half of these should be dropped completely and that nearly a half of the remainder could be simplified, in some cases very substantially. In only nine cases were we unable to agree to any change at all - these were cases where the information is essential for us because it runs to the heart of tax liability. For example, the breakdown of tangible assets between land, buildings, plant and fixtures and the breakdown of investments between shares and loans and between investments in other companies in the group and in unrelated companies.

The DTI agreed to consider what we had said and to evaluate the package with which they are left and we agreed to reconsider one or two points (though I must say at the margin). Naturally they would like to see the biggest package of relaxations possible and for us to move rather further from the line we took two years ago than this represents. However, over much of the range they appeared to accept that what we were saying was not unreasonable. We await their assessment of the overall position.

In the meantime you could, if you wished, say at tomorrow's deregulation meeting that -

a. we shall consider the question of the audit further - and of course report to you - as soon as we hear the outcome of the further DTI consultation; and

b. that progress has been made in establishing a package of company law accounting requirements which could be dropped and that officials from each Department will be considering further the outcome of yesterday's meeting. However, the Inland Revenue (which lack sufficient information powers of their own) will continue to need to rely on company law requirements to some extent: there would seem to be little point in dropping company law requirements simply to have them replaced by comparable Revenue requirements.

LJHB

L J H BEIGHTON

3/2914

CONFIDENTIAL

FROM: SIR ANTHONY WILSON
DATE: 14 April 1988

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Inglis
Mr Cropper
Mr Tyrie
Mr Beighton - IR
PS/C&E
PS/IR

ABOLITION OF THE STATUTORY AUDIT FOR SMALL COMPANIES

You are to hold a meeting to discuss evidence and to decide a way forward on Tuesday 19 April and it is time now to decide the line to take in a final round of discussions with DTI and the Deregulation Unit.

2. Responses from Accountancy Institutes and some firms of accountants to the consultative paper on alternatives to audit sent by DTI to a limited number of interested parties, show some preference for maintaining mandatory audit requirements for all companies. Except for the large and influential English Institute, those who favour abolition or are ambivalent express a desire to replace audit by some form of association of a "competent person" with the accounts.

3. In a private conversation with Mr Cope just before Easter I gathered that he is not strongly in favour personally (as a former practising chartered accountant) of abandoning the present universal audit requirement. Some of the small business groups, such as the Union of Independent Companies, press for abandonment of mandatory audit requirements, but in conversation

with them it is clear that they wish to preserve the credibility of the smaller units of business by having a continuing association with independent professional endorsement of their accounts.

4. Some of the larger firms of accountants have certainly been heavily concerned in developing the attitude of the English Institute, whose smaller members do not accept the abandonment of audit in the same way.

5. If abandonment of audit as a burden on smaller companies was the only consideration, therefore, I would have to advise you that it would probably result in a great deal of strongly felt and highly vocal opposition: hardly worth the candel in terms of deregulation benefit, and possibly a time-consuming obstacle to other contents of the Companies Bill.

6. It is not the only consideration, however, and I revert to the points made in the Chancellor's letter of 18 December, 1987 to Lord Young:

(i) If compulsory audit were to be removed without some public association by an independent professional accountant with the accounts in place of it, the credibility of the accounts of the small company business sector would suffer.

(ii) The substitution of a form of independent professional review for formal audit would not give any present relief from the administrative burden small businesses have to face, but it would stop the burden growing as compliance monitoring and developing auditing standards increase the impact of more sophisticated company auditing in the future.

7. Aside from audit considerations, there is seen to be a general feeling that the major accounts burden on smaller companies is the amount of information required by the Companies

Act 1985 and the Accounting Standards to be disclosed in them. This is being addressed by the DTI with the Inland Revenue.

Suggested Policy Line

9. It seems to me, therefore, and the Inland Revenue may wish to submit on this separately, that the Treasury line should be:

(i) To support the move away from mandatory audit for all companies to a voluntary audit for those below certain size criteria, but the mandatory association of an independent "competent" person with accounts of companies which choose not to continue with an audit. There will be some kinds of business, such as those within the ambit of the Financial Services Act, where universal compulsory audit will continue. It would be more understandable to have a defined "exempt company" category rather than to rely on pure size criteria.

(ii) To suggest that audit should no longer be mandatory for unlimited companies, or companies limited by guarantee. With the comparatively easy move from limited to unlimited status now available to companies, this may slow down the formation of many small companies which should never be formed with limited liability in the first place and encourage some of the companies now on the register to make themselves "unlimited".

(iii) The form of association of an independent "competent person" must be decided once the evaluation of responses to the DTI consultative paper is completed, but I think it would be important to insist on the "independence" aspect and not to press for a professional opinion as distinct from a "compliance and proper records" statement.

A WILSON

18 APR 1988

SMALL FIRMS' LIAISON GROUP

FINANCIAL SECRETARY	
REC.	18 APR 1988
ACTION	Mr. Sharman
COPIES TO	PPS, CST, PMG, EST Sir P. Middleton Sir A. Wilson Mr. Scholar Mr. Culpin Mr. Inglis

The Rt Hon Lord Young of Graffham,
Secretary of State,
Department of Trade & Industry
1-19, Victoria Street,
London, SW1H OET.

8th April 1988.

Dear Lord Young,

THE AUDIT OF SMALL COMPANIES

At its March meeting the Small Firms' Liaison Group discussed the UK statutory requirement for the audit of small companies.

We are writing on behalf of the following organisations:

Association of British Chambers of Commerce
Association of Independent Businesses
Forum of Private Business
Institute of Directors
National Chamber of Trade
National Federation of Self-Employed & Small Businesses
Union of Independent Companies

to express their support for the proposal that the UK should exercise the option available under the European Community 4th Directive to exempt small companies from the statutory audit requirement, provided that such a change in UK legislation includes a safeguard for minority shareholders in such companies by enabling any shareholder to require the appointment of independent auditors for the purpose of reporting on the annual statutory accounts of the company.

In view of their close interest in this issue, we are sending copies of this letter to the Chancellor of the Exchequer, the Minister for Small Firms and the Financial Secretary to the Treasury.

Yours sincerely,

cc. Mr. Cropper
Mr. Jackie
PS/CFE
PS/IC

Tom Lyon
National Chairman
Union of Independent Companies

42/2/CG/21/4368

CONFIDENTIAL

FROM: J J HEYWOOD
DATE: 19 April 1988

SIR ANTHONY WILSON

cc PS/Chancellor
Sir P Middleton
Mr Scholar
Mr Culpin
Mr MacAuslan
Mr Inglis
Mr Cropper
Mr Tyrie
Mr Beighton - IR
PS/IR
PS/C&E

AUDIT OF SMALL COMPANIES

The Financial Secretary discussed with you and others today the various outstanding papers on this, in particular your own note of 14 April.

2. The Financial Secretary considers it essential that you quickly reach an agreed position with the Revenue on what would be a satisfactory replacement for the statutory audit. The Financial Secretary thinks we need to get our own position clear before we respond to the DTI's report on the outcome of the latest consultative exercise. You said that this report would probably issue early next week and would not contain any surprises. (It would not, for example, reveal overwhelming support for the complete abolition of the audit with no replacement - the responses to the consultative exercise had been predictably mixed).

3. The Financial Secretary was content with the broad approach you suggested in paragraph 9 of your minute of 14 April. He agreed that a defined "exempt company" category would be better than a size criterion. He also felt that the exempt company criterion would make unnecessary the fuller "unlimited company" criterion which Mr Beighton floated in his minute of 11 April.

4. The Financial Secretary's provisional view was that your paragraph 9(iii) seemed promising. But his meeting revealed a continued disagreement between yourself and the Revenue on precisely what the "independent competent person" should put his name to, and what the implications of any new requirement would be for the quality of the accounts.

5. The Financial Secretary was clear that some form of replacement was required and that a tax-audit would not be an attractive proposition. He looks forward to seeing further urgent advice.

J J HEYWOOD
Private Secretary

2.25.4.

CONFIDENTIAL

FROM: MISS M E PEIRSON

DATE: 25 April 1988

CHIEF SECRETARY

cc Chancellor
Sir Peter Middleton
Mr Anson
Sir A Wilson
Mr Phillips
Mr Beastall
Mr Hawtin
Mr Turnbull
Mr Parsonage
Mr Potter
Mr Saunders
Mr Call

THE AUDIT COMMISSION AND THE NHS

1. We have now reached agreement with the DHSS on a note (attached) setting out the options for change. The way is now open for you to discuss the matter bilaterally with Mr Moore.

2. The aim is to reach agreement on a change which can be announced as part of the outcome of the health review. If bilateral agreement with Mr Moore is not possible, you may wish to discuss the matter with the Prime Minister and settle it in the health review group. Mr Ridley will also have to be consulted before a decision is reached (see below).

3. The DHSS paper sets out the background (paragraphs 1 to 14), the objectives of change (paragraph 15), and the three options for change (paragraphs 16 to 20). Those options are as in the original Treasury paper, namely:-

i. augmented existing arrangements;

ii. a new independent audit authority;

iii. the Audit Commission.

4. DHSS are now a shade happier about the options, but still resistant to all but the first. However, they have been in touch with the Audit Commission, who have changed their minds about legislative requirements. The Commission originally suggested that secondary legislation only would be required if they were

merely to help in beefing up the existing arrangements, but they now say that primary legislation would be required (see paragraph 16 of the DHSS paper). We therefore see no advantage in your offering, at this stage, any compromise such as that, whilst the longer term aim might be to hand over to the Audit Commission, in the interim they could merely assist. We recommend that instead you should go for legislation to enable the Audit Commission to take over fully (the third option) as soon as possible.

5. The earliest and most appropriate vehicle for such legislation would appear to be the prospective bill on local authority capital controls. Mr Ridley would of course have to agree to include such a clause in his bill, and indeed he would have to be consulted about the proposal that the Audit Commission should take on this extra and significant role.

6. A draft letter inviting Mr Moore to discuss the paper is attached.

MEP

MISS M E PEIRSON

CONFIDENTIAL

DRAFT LETTER FROM THE CHIEF SECRETARY TO MR MOORE

NHS Review: Audit

Our officials have now agreed a revised paper on this question, and I suggest that we might meet to discuss it.

I will ask my office to arrange it.

CONFIDENTIAL

SCOPE FOR INDEPENDENT AUDIT OF EFFICIENCY

1. This paper describes briefly the management systems that presently exist to measure and improve efficiency in the NHS; outlines further improvement to be implemented over the next 12 months; describes the current audit structure, and considers the scope for extending the role of audit.

Current management systems

2. All District and regional health authorities are required to produce each year short term programmes (normally for 2 years). These programmes include authorities' proposals for the development of services and for substantial and sustained cost improvement programmes. Regional health authorities are required annually to account for their performance against their plans, firstly to the NHS Management Board and, secondly, to DHSS Ministers. Action plans following these Ministerial reviews are drawn up and published; copies are made available to Parliament.

3. The cost improvement programmes of health authorities have generated very substantial cash savings since 1984 which will amount to £600 million in 1987-88, largely in non-clinical areas, and which are growing at an annual rate of £150 millions. In addition, productivity savings have enabled the service to absorb a significant proportion of the growing demand which would otherwise require additional annual funding of about £400 millions.

4. Similar arrangements are in place for the administration of the 90 Family Practitioner Committees (FPCs), though here accountability is through a 5-yearly cycle of comprehensive reviews with less detailed annual scrutinies.

5. Other VFM work under existing arrangements is carried out under the aegis of the DHSS by the Health Advisory Service and the National Development Team, both of which promulgate good practice in services. Arrangements are also in hand to strengthen the central value for money unit which currently undertakes VFM studies, promotes local and regional VFM initiatives and disseminates good practice. The VFM studies have been developed out of the earlier Rayner scrutiny programme, and are particularly targetted towards areas of high spending like nursing and the use of facilities such as beds and operating theatres.

Further initiatives in hand

6. Significant progress has been made in recent years in developing management information systems in the NHS. The major part of the recommendations of the Korner Committee has been implemented during 1987-88 and the balance will be put in place in 1988-89. From April 1988, a range of quarterly data on national NHS performance will become

available. These data, by health district and major specialty, will include, for example, information on hospital activity, waiting lists and times, and on manpower and finance. The time-lag on the production of these data will vary from about one month for financial information to about four months for activity data, which have to undergo additional processing via the OPCS. The DHSS is considering the possibility of publishing these quarterly data.

7. In addition, based on pre-Korner information the DHSS has developed a system of computer-based performance indicators: 450 indicators in 191 health authorities. Three annual sets have been issued to date, and a further set was issued in March 1988, based on 1986-87 data. It is being made available also to Parliament. Indicators show, for example, differences in the length of stay in hospital beds, the amount of time a hospital bed stays empty (turnover interval) and the number of patients treated in each bed.

8. This information is used in the review system described above (para 2). Additionally, in April 1988 the DHSS is issuing, for the first time, a written national summary of the main 1986-87 indicators in order to report on health service performance and to stimulate public interest and discussion. In addition, health authorities will be required to analyse the major indicators relating to their authority, and to discuss that analysis with authority members, setting the results not only in the national and regional context but also in the context of progress over time. It is proposed that this analysis should also be made available to MPs.

9. The resource management initiative is crucial to achieving improved value for money and to providing a basis for establishing what given levels and mixes of care do and should cost. On the acute side, the programme involves five hospitals in different parts of the country. The objective of this initiative is to involve clinicians and other professionals in specifying their information requirements and to introduce new organisational and management structures to encourage the better use of resources. The initiative is jointly sponsored with representatives of the medical profession. It is hoped that these developments will demonstrate the practicality of costing inpatient treatment outputs at all acute hospitals on a continuing basis and will assist resource allocation at hospital level. Evaluation of the main programme is scheduled for October 1989, after the new processes have been operational at several sites for up to twelve months, after which decisions will be taken regarding national implementation. However a review is currently being undertaken into the possibility of using DRG costing procedures for "pricing" purposes at the sites and elsewhere from early in 1989.

NB

The current audit structure

10. There are currently three layers of audit function in the NHS: internal audit within health authorities and FPCs; the DHSS statutory external audit of health authorities and FPCs, which is responsible to the Secretary of State; and audit by the National Audit Office (NAO).

11. The NAO reported on internal audit in the NHS in April 1987, concluding that whilst considerable progress had been made since their

1981 study, shortcomings remained in audit planning and execution and coverage of FPCs and computer systems. PAC were concerned at these shortcomings and expect DHSS to ensure delivery of planned improvements and to monitor achievements.

12. The DHSS Audit Directorate audits 221 health authorities, 90 FPCs and 40 other bodies. Some 15% of these audits are performed by private sector firms. Of the Directorate's staff of about 210, 59 are qualified accountants/auditors and a further 104 are engaged in external training for qualifications. The Directorate's regularity audit provides the basis for the NAO audit of the NHS consolidated accounts. Some 10% (and increasing) of the audit effort is devoted to VFM audit. The Directorate is currently engaged in a number of VFM studies; for example, of health authorities' cost improvement programmes, medical and nursing staff levels, and hospital pharmacies. These studies are reported in the Director of Audit's annual report which is made available to Parliament and to the NHS.

13. The National Audit Act, 1983, provided statutory authority for the C&AG to carry out VFM audit examinations. Nationally, 40% of NAO's audit work is devoted to VFM work; but given their reliance on the regularity audit role performed by the DHSS statutory audit, the NAO are able to devote some 60% to VFM performance in the NHS. Over the last 18 months, the NAO has published reports on the employment of professional and technical staff; competitive tendering in the NHS; usage of operating theatres; and care in the community. Current studies include estate management; FPC management; NHS capital expenditure; and resource management.

14. The Audit Commission is responsible for the audit of local authorities in England and Wales. Some 30% of local authority audits are contracted out to private sector firms. Like the NAO, the Commission reckons to devote some 40% of its audit effort to VFM work. The Commission instructs its auditors in the course of their audit to gather figures for specific activities. The Commission then assembles and compares these figures and produces models of best practice. A report is produced for each authority, comparing their performance with best practice, and the auditors are instructed to follow up the authorities' progress in improving performance. Much is achieved by appealing to the professional pride of chief officers, but ultimately the accountability is to local councils. To date (1986-87) the Audit Commission has identified opportunities for value improvements amounting to some £500 millions a year, of which local authorities have so far delivered some £80 millions.

The objective of developing the role of NHS audit

15. One of the objectives of these various developments is to produce deeper and higher quality efficiency and value for money studies across a broader range of NHS activity. The advantage of audit reports in this context is that they can be demonstrably independent of health authorities. In order to achieve this they need to be published regularly and widely in order to enable comparisons to be made and stimulate public interest and discussion. There is no dispute about these objectives: the issues are how best they are achieved, and the timetable against which progress should be made. Any body charged with

the statutory external audit of the NHS would continue to be accountable to the Secretary of State for Social Services who would approve its programme and its audit reports. Three options for developing the capability of that audit body, in place of the present DHSS statutory audit, in order to meet the above objectives have been identified.

16. Augment existing arrangements

This could be done by a variety of measures, including greater use of outside recruitment into the DHSS Audit Directorate; more exchanges of staff with the private sector and the Audit Commission; contracting out more audits to private sector firms and to the Audit Commission; and introducing multi-disciplinary audit teams which included doctors and non-clinical professionals as well as accountants. Primary legislation would however be required to enable the Audit Commission to undertake work for NHS authorities.

17. The advantages of this approach are that it would be readily accepted by the parties presently involved and would build on the progress now being made. It is also likely to be less expensive than alternative options involving organisational change. However, it might provide less initial impetus than the other options.

18. A new independent audit authority

A second option would be to hive off the DHSS statutory audit service, with strengthened staffing, to a separate body accountable to the Secretary of State for regularity and VFM audit of the NHS. This would follow the precedent of the Audit Commission, which was originally set up from the former District Audit Service of the DOE. The new body could provide statutory audit reports for individual health authorities and FPCs, and undertake national studies on value for money. This option would require legislation which given the Government's legislative programme might be difficult to implement in the 1988-89 session.

19. Give statutory audit to Audit Commission

A further option would be to remove the audit function from the DHSS and transfer responsibility for regularity and VFM audit in the NHS to the Audit Commission, whilst making the Commission accountable to the Secretary of State for Social Services for its NHS work; the current arrangements for LA audit would remain unchanged. DHSS audit staff might be transferred to the Commission to provide the necessary expertise. The Commission's experience of working with local authorities would be helpful. On the other hand, this option would also require legislation (see para 18) and would be more expensive; and a period of disruption and uncertainty would be unavoidable while the new arrangements were established. This option would require the Audit Commission to report to DHSS Ministers for NHS audit, whilst remaining responsible to local authorities for local government audit.

20. Under any of these arrangements, the PAC would, of course, continue its oversight of NHS expenditure, with the NAO retaining its present audit responsibilities. This is inevitable given the large

amount of Voted money going to the NHS. It will be important to ensure that the NAO and the statutory auditors work together, rather than in competition. Nevertheless, any change, particularly to the Audit Commission, might create tensions with the PAC who might regard such change as usurping the NAO's proper role as scrutineers of public money Voted by Parliament. Careful handling of the change would be necessary to minimise this risk.

Conclusion

21. Ministers are invited to choose between the three options described in paras 16-20.

DHSS
22 April 1988

15

NOT FOR NAO EYES
CONFIDENTIAL

mp

From: S D H SARGENT
Date: 3 March 1988

SIR A WILSON

cc PS/Chancellor
PS/Financial Secretary
Mr Anson
Mr Phillips
Mr Beastall
Mr Hawtin
Miss Peirson
Mr Turnbull
Mr Parsonage
Mr Potter
Mr Saunders
Mr Call
Mr Elias

THE AUDIT COMISSION AND THE NHS

Sir Peter Middleton was grateful for your minute of 25 February which he found very helpful.

S D H SARGENT
Private Secretary

69/2912

FROM: SIR ANTHONY WILSON
DATE: 25 April 19888

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Inglis
Mr Cropper
Mr Tyrie

Mr Beighton - IR
Mr Shaw - IR
PS/C&E
PS/IR

ABOLITION OF THE STATUTORY AUDIT FOR SMALL COMPANIES

At a meeting on 19 April you asked for a submission setting out a joint Treasury/Inland Revenue view on an acceptable "son of audit" in advance of the DTI response to their consultations. Set out below are the principal features of a review process which would represent a saving on the current audit burden but would also provide most, although not quite all, of the safeguards the Inland Revenue would like to see.

2. Any company with turnover of less than, say, £500,000 should be allowed to convert itself into an "exempt" limited company by passing a Resolution by a majority of at least 95% of shares in each and every class. This decision would be reflected in the company's title. This option would not be available in the case of a company which is a subsidiary of another company or has active subsidiaries of its own. Nor could it be available to certain types of companies, such as those within the ambit of the Financial Services Act. When a company elects not to have an audit the accounts which its directors would have a continuing duty to prepare and file would still be subject to review by an independent accountant. The qualifications and arrangements for appointment for those able to undertake this

role should be the same as those required for auditors under the Companies Act at present. Directors of the company would still be primarily responsible for presenting annual accounts prepared in accordance with the requirements of the Companies Act and showing a true and fair view. The independent accountant would give a review report on the accounts in the following terms, the details of which would, of course, have to be settled by the professional accountancy institutes in conjunction with the DTI, the Treasury and the Inland Revenue:

> "My limited review of the records and accounts has not disclosed any material modifications to the attached accounts which would be needed for them to comply with the requirements of the Companies Act."

This would in effect mean that he was not expressing a formal opinion (which would be almost indistinguishable from an audit opinion), but he would be giving negative assurance that the accounts were in order.

3. A considerable benefit of such a report is that it would be clearly distinguishable from an audit, which would allow the latter to develop without being held back by the difficulties of applying the full rigours of auditing standards to smaller companies. Moreover, this approach would avoid the additional burdens which would otherwise be placed upon small businesses and the accountancy profession by the regulation of auditors which will be required under the EC Eighth Directive.

4. It is, of course, true that any reduction in the involvement of a professional accountant in the preparation of accounts or in his responsibility for their reliability, does put pressure upon the staffing resources of the Inland Revenue and increases the risks to Exchequer yield. Whilst the limited review described above would not provide as great a reassurance as the present audit, the Revenue believe that it would provide sufficient reassurance for them to keep within present and planned resources without putting undue additional risk upon Exchequer yield. To reduce the involvement and responsibilities of the accountant

any further would place burdens upon the Revenue which could not be met for some years, so delaying the time when they would begin to meet the medium term investigation targets just agreed with you, and would have a cost to the Exchequer yield which, although unquantifiable, would almost certainly be substantial.

A WILSON

AUDIT COMM. + THE NHS

NH6/13M

CONFIDENTIAL

FROM: MOIRA WALLACE
DATE: 27 April 1988

PS/CHIEF SECRETARY

cc Chancellor
Sir Peter Middleton
Mr Anson
Sir A Wilson
Mr Phillips
Mr Beastall
Mr Hawtin
Mr Turnbull
Mr Parsonage
Mr Potter
Mr Saunders
Mr Call
Miss Peirson

THE AUDIT COMMISSION AND THE NHS

The Chancellor has seen Miss Peirson's minute of 25 April. His view is that not only is option iii right on merits, but he believes it will also strongly commend itself to Government back benches.

MOIRA WALLACE

006/3653

PERSONAL AND CONFIDENTIAL

FROM: A G TYRIE

DATE: 28 APRIL 1988

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir A Wilson
Mr Cropper
Mr Call

ABOLITION OF STATUTORY AUDIT FOR SMALL COMPANIES

I have seen Sir Anthony's note of 25 April and have a few thoughts.

Do we need both a £500,000 turnover limit and a resolution by at least 95% of shares? I would have thought the 95% of shareholders restriction (together with the £2 million turnover floor for audited accounts proposed by the Commission) would be sufficient.

I think we need to examine very carefully the wording of the 'Review Report' proposed by Sir Anthony in his paragraph 2. What would Sir Anthony think a firm of accountants would charge to conduct this limited review? What would the reviewing accountant be expected to write if he did find aspects of the accounts which did not comply with the Companies Act? Apart from the Revenue, is there anybody else who would want to take notice of review reports along these lines?

Also, are we quite sure that we have pitched the 'Review Report' at the very point where any further reduction in the involvement and responsibilities of the accountant would result in 'substantial' Exchequer loss?

A G TYRIE

24/1/DJS/1807/20

UNCLASSIFIED

FROM: R M PERFECT
DATE: 29 April 1988

1. MR HAWTIN

2. PPS

cc Sir P Middleton
Mr Anson
Mr Potter
Mr Saunders

MEETING WITH HOWARD DAVIES

Mrs Thorpe's minute of 30 March noted that the Chancellor would be seeing Howard Davies (Audit Commission) on Tuesday, 3 May.

2. I attach a brief note on Audit Commission points that might be mentioned.

R. M. Perfect.

R M PERFECT

24/1/DJS/1807/21

AUDIT COMMISSION

NHS Review

Audit Commission have expressed interest in doing VFM audits for NHS. Treasury supports this approach. Under discussion with DHSS, who believe more and better VFM audit in NHS can be done without giving up their statutory audit function to Audit Commission completely.

Financial collapses

New realism among LAs following 1987 Election. So now less immediate danger of any local authority collapsing deliberately. But cannot be ruled out. Audit Commission have expressed concern about poor quality, and high turnover, of staff in some London boroughs. Collapse through incompetence possible.

Creative accounting

Environment Secretary announced latest package of measures to stop creative accounting on 9 March. New legislation will stop sale/leaseback and lease/leaseback deals.

Capital Controls

E(LF) considering proposals that meet many of Audit Commission's criticisms; including improving match of needs to resources and allowing revenue savings to be used for capital investment. Consultation document should issue shortly.

Prudential ratios

Following the Audit Commission's work on prudential ratios, they have set up a joint Working Group with the LA Associations to discuss what information LAs need to decide whether their borrowing is prudent. No prudential ratios are likely to emerge in the short term.

Stop power for auditors

Local Government Finance Bill includes new powers so LA auditors can prevent illegal acts. Supported by Audit Commission.

Audit Commission achievements and objectives

Audit Commission have identified over £2 billion potential VFM savings. Now concentrating on ensuring those savings achieved and on improving LA management.

CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 10 May 1988

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Inglis
Mr MacAuslan
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Beighton IR
Mr D Shaw IR
PS/IR
PS/C&E

ABOLITION OF STATUTORY AUDIT FOR SMALL COMPANIES

I have held a series of meetings over recent months working up an agreed Treasury/Revenue stance on the future of the statutory audit. Sir Anthony Wilson's minute of 25 April describes the position we have reached, subject to various points below.

Broad Proposal

2. What we are proposing is that any company with a turnover below some level should be able to dispense with an audit provided 100% of the shareholders agree. (Originally Sir A Wilson suggested that a 95% majority might be sufficient - but DTI believe that it would not).

3. A company which elected not to have an audit would instead face a "limited review" of its records and accounts. The review would be carried out by an independent accountant. The directors of the company would still, of course, be responsible for presenting annual accounts prepared in accordance with the requirements of the Companies Act and showing a "true and fair view."

Comments

4. Obviously, whether or not this broad proposal will commend itself to the DTI, to the accountancy groups, to the small business lobby and indeed to ourselves will depend on:

(i) What the "limited review" involves;

(ii) What the size threshold would be fixed at.

5. The "limited review" envisaged in the Treasury/Revenue proposal would effectively be a negative assurance that the accounts were in order rather than a formal opinion. The accountant would not sift through the detailed records underlying the accounts, but would simply look broadly at the accounting system in use and confirm that in doing so he had not come across anything to suggest that "material modifications" to the accounts would be necessary for them to comply with the requirements of the Company Act.

6. Obviously, this needs to be worked up in greater detail with the aid of the professional institutes. But I do think that it would represent a significant easement. If discussions with the institutes revealed that it was not, then we would have to think again. One factor in this will be the amount the accountants would charge for undertaking the "limited review."

7. As to the size threshold, the first question is whether we need one at all - the 100% shareholder approval requirement would in practice ensure that for the large majority of big companies, the statutory audit would continue. I am agnostic about this and think that in the first instance our proposal should not incorporate a specific threshold. But there are two relevant considerations:

(i) The Tyrie point that the main deregulatory benefits will not arise unless companies with turnovers of greater than £500,000 are able to dispense with the audit. For many smaller companies, the audit is done by the same external accountant who does the accounts, and is not in itself a significant extra burden.

(ii) The Revenue's view that if companies with turnovers greater than £2 million were allowed to dispense with the audit (ie. with shareholder approval), then the "limited review" which would replace the audit would not provide sufficient reassurance to them.

Conclusion

8. If you are content with the broad outline of the proposal which has now been agreed by Treasury and Revenue, I would propose to approach David Young and offer it for his consideration. DTI are still reviewing the responses to their latest consultative exercise, which I understand has produced a measure of agreement that something must be put in the audit's place if it is to be abolished for certain companies.

N.L.

NORMAN LAMONT

3648/68

FROM: SIR PETER MIDDLETON
DATE: 12 MAY 1988

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir T Burns
Sir A Wilson
Mr Anson
Mr Byatt
Mr Monck
Mr Burgner
Mr Moore
Mrs Lomax
Mr Scholar
Mrs Brown
Mr Houston
Mr Ilett
Mr MacAuslan
Mr Bradley
Mr Lyne
Mr Inglis
Mr Wynn Owen
Mr Flanagan

COMPANIES BILL: MERGERS AND ACQUISITIONS

DTI officials are about to put to their Ministers proposals for tightening the accounting and disclosure treatment of mergers and acquisitions for inclusion in the forthcoming Companies Bill. Treasury Ministers might like a brief progress report.

2. The EC 7th Directive, which is to be enacted in UK law as one of the components of the forthcoming Companies Bill, requires the legislative framework for accounting for mergers and acquisitions to be reviewed. There has been much comment recently to the effect that the variety of accounting treatments for business combinations and the inadequacy of disclosure Standards may have had the effect of distorting competition between different companies, although little evidence has been adduced to support such claims. So the DTI has carried out a consultation exercise on a number of options for inclusion in the forthcoming Bill.

DTI PROPOSALS

3. DTI officials will propose that the current range of accounting treatments available should not be restricted, but that they should in future be accompanied by very much higher disclosure standards. The aim of the additional disclosure requirements is to provide sufficient information about the business combination to enable a user of the accounts to understand the substance of the transaction whatever the accounting treatment adopted. The additional disclosure requirements should substantially reduce the scope for abuse in two important areas. First, they will require companies to disclose "nest egg" type provisions made for reorganisation costs on acquisition and thus enable the reader of accounts to understand the implications for future profitability. Second, they will require the real cost of all acquisitions to be shown in the accounts, whereas at the moment it is possible for companies to conceal them.

4. DTI officials also propose to clarify an area of uncertainty under the Companies Act, 1985 and make it clear that goodwill may not be written off against a revaluation reserve. This is a largely technical requirement of the EC directives. It is unlikely to have much effect in practice since other options will generally be available to companies.

LINE TO TAKE

5. Treasury officials have been in close contact with DTI officials through a Working Party under Sir Anthony Wilson's chairmanship. Within the context of the 7th Directive, the DTI proposals seem the best option available. DTI Ministers will no doubt wish to consult colleagues in due course, and we will provide further advice when that happens.

P E MIDDLETON

ps3/43T

UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 13 May 1988

PS/SIR P MIDDLETON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir T Burns
Sir A Wilson
Mr Anson
Mr Byatt
Mr Monck
Mr Scholar
Mr Burgner
Mr D J L Moore
Mrs Lomax
Mrs M E Brown
Mr Houston
Mr Ilett
Mr MacAuslan
Mr Bradley
Mr Lyne
Mr Inglis
Mr Wynn Owen
Mr Flanagan

COMPANIES BILL: MERGERS AND ACQUISITIONS

The Chancellor has seen Sir Peter Middleton's minute of 12 May. He has commented: "Fine".

J M G TAYLOR

ps2/66M

CONFIDENTIAL

FROM: MISS M P WALLACE
DATE: 16 May 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Inglis
Miss Sinclair
Mr MacAuslan
Mr Cropper
Mr Tyrie

Mr Beighton - IR
Mr D Shaw - IR
PS/IR
PS/C&E

ABOLITION OF STATUTORY AUDIT FOR SMALL COMPANIES

The Chancellor was most grateful for the Financial Secretary's minute of 10 May, and is content for this broad proposal to be put to Lord Young.

2. The Chancellor has also commented that, subject to the Financial Secretary's views, he sees a case for a limit of £2 million, in the light of the Revenue's view that the "limited review" would not provide sufficient reassurance to them above that level.

MOIRA WALLACE

Inland Revenue

Policy Division
Somerset House

FROM: D L SHAW
EXTN: 6300
DATE: 18 MAY 1988

PS/FINANCIAL SECRETARY

ABOLITION OF STATUTORY AUDIT FOR SMALL COMPANIES

1. I refer to Miss Wallace's note to you of 16 May. A slight misunderstanding has crept in over the question of limits. The upper limit of £2 million is, I believe, imposed by community law. Any abolition of statutory audit for small companies must be subject to this limit.

2. The Revenue's view remains, however, that a limit of £2 million for abolition may be too high. This would depend on the guidelines that are worked out for the limited review which will determine the extent of the review and of the reassurance that it provides.

3. We should therefore like the limit to be kept open until the extent of the review has been determined, noting in the meantime that a limit of less than £2 million may be needed.

D L SHAW

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cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Sir Anthony Wilson
Mr Inglis
Miss Sinclair
Mr MacAuslan
Mr Cropper
Mr Tyrie
PS/C&E
Mr Beighton
Mr Corlett
Mr D Shaw - P2
PS/IR

42/2.BTW.4376/26

CONFIDENTIAL

BF 27/5

FROM: J J HEYWOOD
DATE: 20 May 1988

APS/CHANCELLOR

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir A Wilson
Mr Inglis
Miss Sinclair
Mr MacAuslan
Mr Cropper
Mr Tyrie
Mr Beighton IR
Mr D Shaw IR
PS/IR
PS/C&E

ABOLITION OF STATUTORY AUDIT FOR SMALL COMPANIES

The Financial Secretary has seen your minute of 16 May and Mr Shaw's of 18 May.

2. The Financial Secretary agrees with the Chancellor that there may well be a case for a limit of £2 million. However, in the letter to Lord Young the Financial Secretary thought it better to be unspecific about this and so he referred only to "companies below a size threshold."

JEREMY HEYWOOD
Private Secretary

dti

the department for Enterprise

BF 7/6

The Hon. Francis Maude MP
Parliamentary Under Secretary of State for Corporate Affairs

Peter Lilley Esq MP
Financial Secretary
HM Treasury
Parliament Street
LONDON
SW1

ECONOMIC SECRETARY
Y.to

SIR A. WILSON.
PS/CHX PS/CST PS/FST PS/PMG
SIR P MIDDLETON SIR T. BURNS.
MR MONCK MR SCHOLAR
MRS COMAX
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Department of Trade and Industry

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Direct line 215 4417
Our ref
Your ref
Date 31 May 1988

Dear Peter

ACCOUNTING FOR MERGERS AND ACQUISITIONS

My officials have been considering, in consultation with the Treasury, what changes we should introduce in the Companies Bill planned for the 1988/89 Session in the area of accounting for mergers and acquisitions. You may like to see the result of that work which is reflected in the attached two detailed papers. The conclusions were endorsed recently by the DTI/Treasury Group on accounting issues which Sir Anthony Wilson chairs. I have now looked at this and I agree that we should go ahead on the lines proposed. I should be grateful if you could confirm that you are also content.

The main change we envisage is much improved statutory disclosure requirements which should end the confusing and sometimes misleading way in which certain companies show the effect of mergers and acquisitions in their accounts and make it difficult for the outsider to understand what has been happening. We considered more radical options but concluded that it would be wrong to try to restrict the permitted treatments by law at a time when the accounting profession is itself embarking on a full scale review of this subject. I would not in any event wish Government to step unnecessarily into territory best covered by accounting standards.

Yours

FRANCIS MAUDE

RH2DWN

the Enterprise initiative

RESERVES AVAILABLE FOR GOODWILL WRITE OFF

Issues

Should we further restrict the reserves available for goodwill write-off? In particular:

(i) should we restrict the ability of companies to seek the approval of the courts to cancel their share premium account for the purposes of creating a reserve which is used in the consolidated accounts for the purposes of writing off goodwill?

(ii) should we amend para 34 of Schedule 4 of the Companies Act to make it clear beyond doubt that it is not permissible to write-off goodwill to the revaluation reserve in (i) individual accounts and (ii) consolidated accounts?

Recommendations

2 **We recommend:**

(a) **that we do not pursue (i) above for the next Companies Bill. We should make clear, however, that this is an option we may want to reconsider in the light of the outcome of the current review of the accounting standard on the treatment of goodwill.**

(b) **that we amend Schedule 4 to make clear that purchased goodwill (i) in individual accounts or (ii) arising on consolidation cannot be written off to the revaluation reserve;**

Timing

3 We should announce our intentions together with the closely related proposals covered in the separate paper on

accounting for mergers and acquisitions.

Explanation of the Main Terms Used

4 Purchased Goodwill is the amount by which the fair value of the price paid for a business exceeds the fair value of its separate net assets. The prescribed treatment in the acquiring company's accounts is either to amortise goodwill through the annual profit and loss account or write it off to reserves. The Fourth Directive does not permit goodwill to be carried indefinitely as an asset.

5 The revaluation reserve is the reserve created when a company revalues an asset and initially represents an unrealised profit. Usually it is only reduced when the same asset is depreciated falls in value, is sold, or where the accounting convention changes (eg from current cost to historical cost). A number of companies write off acquired goodwill to the revaluation reserve.

6 The share premium account represents the excess of the fair value over the nominal value of shares issued. The Companies Act tightly restricts the purposes for which the share premium account can be used, on grounds of capital maintenance. However, sections 135-137 of the Companies Act enable companies to apply to the courts to reduce capital. These procedures are intended to be used by companies in severe financial difficulties but are increasingly used to create a reserve which can be used in the consolidated accounts for goodwill write-off.

INTRODUCTORY COMMENTS

7 In the consultative letter sent out in December on accounting for mergers and acquisitions we suggested that we wanted to look at the possibility of restricting the ability of the courts to cancel a company's share premium account for the purposes of writing off goodwill; we also said that following

earlier consultation we intended to clarify the law to make clear that goodwill cannot be written off to the revaluation reserve. The response on the first point from both companies and the accounting profession was almost uniformly hostile; on the second there were strong objections from companies who write off goodwill in this way but the views of the accountancy profession were mixed and on balance in favour of changing the law as proposed.

8 To give perspective to what to the non accountant seems a technical issue of only presentational significance, I address first the question as to why companies attach importance to the rules governing the reserves available for goodwill write-off. The simple answer is that companies are naturally keen to put the best available gloss on their accounts. For an acquisitive company, particularly one in the service sector, the figure for acquired goodwill to be dealt with in the consolidated accounts can be very large since much of the value of what is acquired, eg creative teams in advertising, cannot be treated as assets under accounting rules. The way in which this goodwill is dealt with can significantly affect the appearance of the accounts and, arguably, the perception of the company by the outside world. Until recently companies have had the option of retaining goodwill as a permanent asset. Were this still the position companies would probably attach little importance to the issue of reserves to which goodwill may be written off. Of the two available treatments for goodwill companies are generally reluctant to use amortisation where the goodwill figure is large since this will depress the reported figure for group profits. Most companies therefore have a policy of immediate write-off. (Companies which traditionally have amortised goodwill are tending to change their accounting policies in favour of immediate write-off.) Companies either with limited reserves available for write-off or who, for presentational reasons, do not wish to use the profit and loss reserve will be attracted to use any other reserve which is available or can be created. Some companies therefore use the revaluation reserve or seek (via the courts) to cancel the share premium account and use the reserve created in its place for

goodwill write off.

9 The two issues are considered separately below.

USE OF THE SHARE PREMIUM ACCOUNT FOR GOODWILL WRITE OFF

10 The idea of restricting the ability of companies to cancel their share premium account in order to write off goodwill was mentioned in our consultative letter but not developed. The reasoning behind the idea is that the Companies Act clearly prohibits direct write off to the share premium account. Seeking the court's approval to cancel the share premium to create a reserve for this purpose is a device to circumvent the restriction. In addition it is strange that a provision of the Act intended to assist companies in financial difficulties is being used by sound companies to deal with the presentational problem of goodwill arising on consolidation.

11 With one exception reaction has been hostile. **We recommend that this is not pursued for the next Companies Bill:** even though the arguments raised against the proposal are not conclusive, we would need to spend time working up a much more carefully developed proposal and then consult more widely. Since the proposal is clearly controversial we do not believe there is time to develop this idea. In announcing our intentions, however, we should make clear that we may wish to look again at this option once the Accounting Standards Committee has completed its review of SSAP 22 (accounting treatment of goodwill).

12 Consultees deploy the following arguments against the proposal:

(i) as long as companies cannot retain goodwill as a permanent asset there must be flexible options open to a company to enable immediate write-off;

(ii) there are safeguards against abuse since the process requires the approval of shareholders and the court is required to look to the interests of existing creditors;

(iii) the proposal confuses the role of individual accounts and consolidated accounts: the share premium account has a special status in individual accounts as a protection of a company's capital base but this concept has no real meaning in consolidated accounts.

13 These arguments are not conclusive.

- On (i), we recognise that companies need a means of writing-off goodwill immediately. However, where no other option is available, a company can create a goodwill write-off reserve with a zero opening balance to which the goodwill is debited. There is no bar on this in the Companies Act. This has the merit of showing clearly the cumulative amount of goodwill written off though there are mixed views on whether negative reserves are in principle desirable.

- On (ii), it should be borne in mind that the cancellation of the share premium account is reflected first in a company's individual accounts and is carried through to the consolidated accounts. A side effect of this - which we trust is fully appreciated by the courts - is that it can eventually enhance the realised reserves of the parent company. In gaining the Court's approval for the cancellation a company will typically give an undertaking that the special reserve created in place of the share premium account will not be treated as realised profit as long as any existing creditor remains unpaid. It is, however, relatively simple to pay off or re-finance existing creditors, in which case the reserve would be realised and thus distributable.

- Point (iii) is technically correct but ignores the potential effect on the individual company's distributable reserves explained at (ii).

USE OF THE REVALUATION RESERVE FOR GOODWILL WRITE OFF

History

14 The revaluation reserve is specifically covered in the Fourth Directive (Article 33.2 - extract at Annex A). In implementing the Directive as part of what became the 1981 Companies Act the UK decided to allow the revaluation reserve to be reduced only in the ways specified in the Directive. It was not the intention to allow the writing off of goodwill to the revaluation reserve.

15 The relevant legislation is now found in para 34 of Schedule 4. (extract at Annex B). Unfortunately the law did not unambiguously achieve the intended effect. The Directive provision, that the revaluation reserve must be reduced to the extent that the amounts transferred to it are no longer necessary "for the implementation of the valuation method used and the achievement of its purpose", is implemented in para 34(3) by reference to the amounts being no longer necessary "for the purpose of the accounting policies adopted by the company." A number of companies believe this can be taken to refer to all of their accounting policies, not just those relating to revaluations and in consequence write off goodwill to the revaluation reserve.

16 This problem came to light in 1985 when the accounting profession expressed concern that the law was unclear. In consequence the Department published a consultative note (Annex C) in 1986 which argued that the law should be changed to make clear that the revaluation reserve could not be used in this way. This was presented primarily on the basis that the Fourth Directive did not permit this use of the revaluation reserve.

Results of Consultation

17 Most respondents to the 1986 consultative note agree that legislation is desirable since the existing law is uncertain. A majority - but by no means all - consider that the solution is to make clear that such write-offs are not permissible. Some argue that more debate is needed within the profession and doubt that the practice involves a real abuse; others draw a distinction between individual and consolidated accounts; and a number argue that this issue has to be considered in a broader context. Recent responses to our consultative letter of 23 December 1987 (which said that the Department intended to legislate on the lines proposed in the earlier consultative note) also reflect mixed views - even if one allows for the vested interests of some of the companies who have replied. Several people suggest that Article 33 of the 4th Directive allows member states to "lay down rules governing the application of the revaluation reserve ..." and that this would allow the UK to provide specifically that the writing-off of goodwill is a permitted use of the revaluation reserve.

Where do we go from here?

18 It is superficially attractive to say that this should be a matter for accounting standards rather than the law. Unfortunately the structure of the Fourth Directive prevents this. The revaluation reserve can only be used in this way if specifically permitted by law. We must therefore consider the legal and policy aspects as regards (i) individual accounts (ii) consolidated accounts.

Interpretation of Article 33(c) of the 4th Directive

19 Whether or not the 4th Directive allows Member States to permit the writing-off of goodwill to the revaluation reserve turns on the interpretation of the second paragraph of Article 33(c). Could the "rules" referred to in the first line

cover this?

20 The wording itself is opaque. It is difficult purely on a textual analysis to conclude with certainty that such a rule is not permitted. However, from consideration of the context in which Article 33 was prepared, and from recent discussion with the Commission, it is clear to us beyond doubt that this was not the intention. The Commission has made clear that the second para of 33(c) is intended to permit reductions (i) where part of the reserve becomes realised as the asset to which it relates is depreciated and (ii) where the reserve may become realised in whole or in part on disposal of the asset to which it relates, and for no other purpose. The revaluation reserve is seen as a capital reserve; it should indicate the extent to which the basis of valuation in the accounts has moved away from purely historical cost. For these reasons it is singled out for specific rules under the Fourth Directive. Taken in context it would be extremely curious if Member States were free to allow reductions for quite different purposes.

21 Given the obscurity of the wording, we believe that the European Court would try to make sense of the Directive by reference to the context and intention. We consider it likely, were the question to be put, that the Court would uphold the argument that the Fourth Directive does not allow a Member State to permit the write off of goodwill to the revaluation reserve.

22 Article 29.1 of the Seventh Directive applies the Fourth Directive valuation rules, including Article 33, to consolidated accounts. Legally therefore, it is difficult to argue that the position is different in consolidated accounts than in individual accounts.

Policy Considerations: (i) Individual Accounts

23 The reason for distinguishing between the writing off of goodwill in individual company accounts (which arises where a

company buys an unincorporated body) and goodwill arising on consolidation (which is much more common) is that only in the former case does the effect on the ability of a company to make a distribution have to be considered.

24 Whether a reserve is realised (and thus available for distribution) is relevant only in the case of an individual company's accounts. The revaluation reserve is usually an unrealised reserve though over time may become realised because of the additional depreciation charged to the profit and loss account on the revalued assets. Although not strictly true, it is commonly held that write offs to this reserve have the advantage of enabling a company to preserve other distributable reserves.

25 In most cases goodwill is written off immediately as a matter of accounting policy, not because there has been a loss of value in a business just purchased. In such cases it is not self evident that an unrealised reserve such as the revaluation reserve should not be used for the initial write-off. SSAP 22 does not rule this out in principle though an ED which preceded it did so. However, SSAP 22 requires, since goodwill cannot be retained as a permanent asset, that any initial write off to an unrealised reserve should be followed by a series of transfers so as to deplete realised reserves in the same way as if the amortisation route had been followed. Unless transfers are made the resulting revaluation reserve could comprise a mixture of realised and unrealised profits and losses. The interpretation of the resulting balance could be impossible for readers of accounts and is potentially misleading.

26 On balance we favour a bar on write offs of goodwill to the revaluation reserve in individual accounts. This will:

(a) prevent confusion as to the extent of distributable reserves.

(b) ensures that the revaluation reserve relates solely to the

revaluation of assets which will improve the transparency of accounts.

Policy Considerations: (ii) Consolidated Accounts

27 Most goodwill arises from the acquisition of one company by another and thus affects the consolidated accounts. The treatment of goodwill on consolidation is thus of much more practical importance to companies than the treatment in individual accounts.

28 It is more difficult to see a strong case for prohibition in consolidated accounts where the ability to distribute profits is not an issue. It is in any event difficult to read too much into the split or level of consolidated reserves.

29 It must also be remembered that the alternatives to the use of the revaluation reserve may not be preferable from our point of view. Possibilities include the creation of a negative goodwill write off reserve and applying to the courts for the reduction of share premium account. It is also conceivable - though perhaps fanciful - that a company might capitalise the revaluation reserve (as is permitted) and then apply to the courts to authorise the cancellation of the share capital so created for the purposes of writing off goodwill.

30 Purely on policy grounds we would be prepared to allow companies to write off goodwill to the revaluation reserve in the consolidated accounts, pending the review of the relevant standards.

Conclusions

31 In individual accounts we consider that policy and legal considerations point in the same direction and we do not propose to permit the use of the revaluation reserve for goodwill write off.

32 In consolidated accounts, the legal considerations indicate that we would need strong policy reasons for wishing to permit the writing off of goodwill to the revaluation reserve. We do not believe that strong enough reasons exist and we propose therefore to make clear that this is not a permitted use of the revaluation reserve.

Companies Division Branch 3
April 1988

ANNEX A

FOURTH DIRECTIVE

Article 33

2. (a) Where paragraph 1 is applied, the amount of the difference between valuation by the method used and valuation in accordance with the general rule laid down in Article 32 must be entered in the revaluation reserve under 'Liabilities'. The treatment of this item for taxation purposes must be explained either in the balance sheet or in the notes on the accounts.

For purposes of the application of the last subparagraph of paragraph 1, companies shall, whenever the amount of the reserve has been changed in the course of the financial year, publish in the notes on the accounts inter alia a table showing:

- the amount of the revaluation reserve at the beginning of the financial year,

- the revaluation differences transferred to the revaluation reserve during the financial year,

- the amounts capitalized or otherwise transferred from the revaluation reserve during the financial year, the nature of any such transfer being disclosed,

- the amount of the revaluation reserve at the end of the financial year.

(b) The revaluation reserve may be capitalized in whole or in part at any time.

(c) The revaluation reserve must be reduced to the extent that the amounts transferred are no longer necessary for the implementation of the valuation method used and the achievement of its purpose.

The Member States may lay down rules governing the application of the revaluation reserve, provided that transfers to the profit and loss account from the revaluation reserve may be made only to the extent that the amounts transferred have been entered as charges in the profit and loss account or reflect increases in value which have been actually realised. These amounts must be disclosed separately in the profit and loss account. No part of the revaluation reserve may be distributed, either directly or indirectly unless it represents gains actually realised.

(d) Save as provided under (b) and (c) the revaluation reserve may not be reduced.

ANNEX B

COMPANIES ACT 1985

SCHEDULE 4

Revaluation reserve

34 (1) With respect to any determination of the value of an asset of a company on any basis mentioned in paragraph 31, the amount of any profit or loss arising from that determination (after allowing, where appropriate, for any provisions for depreciation or diminution in value made otherwise than by reference to the value so determined and any adjustments of any such provisions made in the light of that determination) shall be credited or (as the case may be) debited to a separate reserve ("the revaluation reserve").

(2) The amount of the revaluation reserve shall be shown in the company's balance sheet under a separate sub-heading in the position given for the item "revaluation reserve" in Format 1 or 2 of the balance sheet formats set out in Part 1 of this Schedule, but need not be shown under that name.

(3) The revaluation reserve shall be reduced to the extent that the amounts standing to the credit of the reserve are in the opinion of the directors of the company no longer necessary for the purpose of the accounting policies adopted by the company; but an amount may only be transferred from the reserve to the profit and loss account if either -

(a) the amount in question was previously charged to that account; or

(b) it represents realised profit.

(3) The treatment for taxation purposes of amounts credited or debited to the revaluation reserve shall be disclosed in a note to the accounts.

ANNEX C

(EXTRACT)

SCHEDULE 4

COMPANIES ACT 1985

THE RULES RELATING TO DEPRECIATION CHARGED ON REVALUED ASSETS AND THE USE OF THE REVALUATION RESERVE

A CONSULTATIVE NOTE

THE DEPARTMENT OF TRADE AND INDUSTRY

April 1986

EC1AAY

SCHEDULE 4, COMPANIES ACT 1985: THE RULES RELATING TO DEPRECIATION CHARGED ON REVALUED ASSETS AND THE USE OF THE REVALUATION RESERVE

INTRODUCTION

This paper deals with two questions of interpretation of accounting law in the Companies Act 1985 on which it has become apparent that there are differences of opinion among companies and in the legal and accountancy professions. The first concerns the rules relating to the valuation of fixed assets and the depreciation to be charged on them (paragraphs 17 to 19 and 32 of Schedule 4 to the 1985 Act) and the second concerns the uses which may be made of the revaluation reserve, particularly in relation to goodwill (paragraph 34 of Schedule 4). On each of these issues the paper sets out the interpretation of the rules which the Department believes to be legally correct and puts forward for consideration proposals to amend the rules so as to remove any ambiguity that currently exists.

Comments should be sent to:

The Department of Trade and Industry
Companies Division
Room 513
Sanctuary Buildings
16-20 Great Smith Street
London SW1P 3DB

and should arrive by 30 May 1986 .

A. Depreciation

1. The rules relating to the valuation of fixed assets and the depreciation to be charged on them are set out in paragraphs 17 to 19 of Schedule 4 to the Companies Act 1985. They implement Article 35(1) of the Fourth Directive. These provisions are set out in the Annex.

2. Paragraph 18 of Schedule 4 (Article 35(1)(b)) sets out the normal rules for depreciation by requiring that the value of every fixed asset which has a limited useful economic life must be reduced by provisions for depreciation on a systematic basis over its useful economic life. It is not stated explicitly in Schedule 4 or in the Directive that these provisions must be charged to the profit and loss account but the Department considers that it is implicit from the existence of format headings 7(a) and A4(a) in Formats 2 and 4 (and note 17 to the

7. Views would be welcome on the perceived need for and advisability of such an amendment.

B. Revaluation Reserve

8. The problem over the revaluation reserve has arisen specifically as a result of consideration in the profession of the guidance in SSAP22 over the write off of goodwill against undistributable reserves, but it is in fact of more general relevance.

The issues

9. SSAP22 provides that purchased goodwill should normally be eliminated from the accounts immediately on acquisition by writing off against reserves, but it may be eliminated by amortisation through the profit and loss account over its useful economic life. Appendix 2 to the Standard provides guidance for use in cases where companies write off the goodwill against reserves and suggests that where, for example, a company lacks sufficient distributable reserves to cover the purchase cost of the goodwill, it may be appropriate for that goodwill to be written off initially against a 'suitable unrealised reserve'. It goes on to say, 'it should be noted that the restrictions regarding the use of the revaluation reserve set out in paragraph 34(4) of Schedule 8 (now paragraph 34(3) of Schedule 4) may make it inappropriate to charge the amount written off against that reserve'. Finally, it suggests that in cases of doubt, legal advice should be sought.

10. Despite this note of caution, the Department is aware that an increasing number of companies are choosing to write off goodwill against the revaluation reserve, both in individual and consolidated accounts, and that there is concern within the profession.

11. This difference of views has arisen because of uncertainty over the interpretation of paragraph 34(3) of Schedule 4. That paragraph implements Article 33(2) of the Fourth Directive which states quite clearly the uses which may or must be made of the revaluation reserve. (See Annex)

12. No provision was made for Article 33(2)(b) in UK law because it was considered that there is nothing to prevent a company from capitalising its revaluation reserve if its Articles of Association provide for such capitalisation.

13. Article 33(2)(c) was implemented by paragraph 34(3) of Schedule 4 but while Article 33 says that the revaluation reserve must be reduced to the extent that the amounts transferred to it are no longer necessary 'for the implementation of the valuation method used and the achievement of its purpose', this was changed in paragraph 34(3) to refer to the amounts being no longer necessary 'for the purpose of the accounting policies adopted by the company'. The

Department understands that this phrase in the legislation has been interpreted by some companies as referring to all of their accounting policies and not only those relating to revaluation; thus, for example, in the case of goodwill, if they have an accounting policy of writing off goodwill against the revaluation reserve, they consider that to be permitted by paragraph 34.

14. It was never intended that this provision should be interpreted so broadly and the Department considers that since the revaluation reserve is created only as a result of the valuation accounting policies, it may be reduced only to the extent that the amounts credited to it are no longer necessary for the purpose of those valuations. This is consistent with Article 33(2)(c) of the Directive. The Department therefore proposes to make an amendment to paragraph 34(3) so that it reflects more clearly the provision of the Directive in Article 33(2)(c).

15. The remainder of Article 33(2)(c), concerning transfers to the profit and loss account from the revaluation reserve, is reflected in the latter part of paragraph 34(3) of Schedule 4.

16. Article 33(2)(d) is not specifically reflected in UK legislation. However, given the uncertainty that has arisen the Department now considers that it would be useful to add a specific provision along these lines.

17. In the specific case of goodwill, the Department considers that amendments as described in paragraphs 14 and 16 would prohibit the practice of writing off goodwill against the revaluation reserve, both in individual and, given paragraphs 61 and 62 of Schedule 4, consolidated accounts.

18. Views are invited on the proposals in paragraphs 14 and 16 above. Amendments would be made to paragraph 34, to bring the wording of sub-paragraph (3) more closely into line with Article 33(2)(c) and to add a new sub-paragraph reflecting Article 33(2)(d).

SEVENTH DIRECTIVE: ACCOUNTING FOR MERGERS AND ACQUISITIONS

ISSUE

What changes should we include in the Companies Bill on accounting for mergers and acquisitions in the light of responses to the Department's consultative letter of 23 December 1987?

RECOMMENDATIONS

2 In the next Companies Bill:

(i) we should implement Article 20 of the Directive, which permits "merger accounting" under stated conditions, at the option of the company in question. We should introduce broadly the legislative conditions specified in the Directive but leave it open to accounting standards to set tighter conditions for the use of merger accounting. (The net effect is to maintain the existing position with a slight tightening of the conditions under which merger accounting is available.) (para 17).

(ii) we should introduce additional statutory disclosure requirements to enable the effects of mergers and acquisitions to be clearly seen and compared. The details are at para 18.

3 We should not proceed with the other options on accounting for mergers and acquisitions floated in our consultative letter. However, in implementing the Directive provisions on acquisition accounting we should ensure that the calculation of goodwill reflects the difference between the fair value of the net assets acquired and the fair value of the consideration given.

4 In announcing these changes, (as soon as the policy is agreed) we should make clear that we intend to look again at some of the legislative options we identified in the light of the

outcome of the review of the standards on goodwill and accounting for acquisitions and mergers now being undertaken by the ASC. (Some of these can be made by regulation).

5 The closely related topic of the reserves against which it should be permissible to write off goodwill (touched on in our consultative letter) is dealt with in a separate paper.

INTRODUCTORY COMMENTS

6 The accounting treatment of mergers and acquisitions in consolidated accounts is a hotly debated subject amongst accountants and businesses and a wide range of views is held as to the suitability of the alternative methods - "merger accounting" and "acquisition accounting". The implementation of the Seventh Directive requires us to choose between certain options governing the use of these treatments which were set out in the note issued by the Department in December 1987 (Annex A). Comments on this note have now been received from interested parties.

7 Acquisition Accounting. This is the usual treatment and is the basic method prescribed by the Directive. It is at present covered in accounting standards, not the law. The assets and liabilities acquired are brought onto the consolidated balance sheet at fair value. Any excess of the fair value of the consideration over the net asset value is described as goodwill and must either be written off immediately to reserves or amortised against profits over its useful economic life. (The Fourth Directive does not allow goodwill to be carried forward permanently as an asset). Profits of the acquired company are included in the consolidated accounts only from the date of acquisition.

8 Merger Accounting. Merger accounting emerged as an alternative to acquisition accounting for cases where there is a true merger rather than a take-over of one company by another and where no resources leave the group. The essence is to treat the

combination as if the group had always been combined. In contrast to acquisition accounting the assets and liabilities of the combining companies are stated in the consolidated accounts at book values. Profits of the acquired company are included in the consolidated accounts for the whole year. The Directive gives member states the option of allowing merger accounting under stated conditions. Merger accounting is at present defined in accounting standards, not the law, though statutory merger relief (see below) is a necessary precondition for its use. Very few groups use merger accounting.

Merger Relief

9 Merger relief was introduced in the 1981 Companies Act. Basically it relieves companies of the obligation to set up a share premium account when it issues shares in exchange for at least 90% of the shares of another company. Thus the company can show the shares so issued at nominal values in its own accounts. Merger relief is necessary where merger accounting is to be used in the consolidated accounts - though merger relief and merger accounting are conceptually quite distinct. The other effect of merger relief is that it will in certain cases increase the ability of the issuing company to make distributions.

AREAS OF CONCERN

10 One concern is that the different accounting treatments permitted might distort take-over activity itself. The variety and flexibility of treatment, it is argued, encourages take-overs which would be difficult to justify purely on economic fundamentals: post merger performance suggests that by no means all mergers and acquisitions have been unqualified economic success stories. These concerns emerged to some extent during the recent review of mergers policy. But, by the very nature of the problem, evidence is hard to come by. Some companies have put forward the argument in our current consultation exercise that a tightening of the accounting rules would remove the competitive edge they believe they have in bidding in North America against US

competitors who are subject to a less permissive accounting regime. This argument is of course two-edged. The companies wish to preserve their advantage in making acquisitions but, equally, it can be argued that this simply enables them to pay over the odds for acquisitions. Another argument which is logical, if difficult to demonstrate, is that permitted accounting treatments currently tilt the playing field more than would otherwise be the case in favour of the listed company who can issue shares in a takeover and against the unlisted company who by and large must make a cash bid. But overall the evidence of distorting effects is sparse and subjective. We do not favour legislating to change the permitted accounting treatments on the basis of these arguments.

11 The other principal area of concern is that too much flexibility in permitted accounting treatment leads to confusing and misleading accounts and makes inter company and inter year comparisons difficult. However, there is little pressure to cure this by eliminating either of the methods permitted at present. The main criticisms of the present situation are:

(a) the two forms of accounting present equivalent transactions in different lights, making it difficult to make meaningful comparisons between companies;

(b) the conditions intended to restrict merger accounting to "true" mergers are too wide and open to manipulation (though this criticism would have more force if merger accounting were used more widely);

(c) the ability to use acquisition accounting in consolidated accounts in cases where the acquiring company has taken merger relief in its own accounts is an abuse. In particular such treatments can be difficult to follow and may result in the wrong figure being shown for goodwill arising on consolidation.

(d) Disclosure of the impact of the acquisition on the consolidated accounts is inadequate, in particular very few companies give information about adjustments made to book values of assets and liabilities acquired.

12 Opinions range right across the spectrum on all these points. The Accounting Standards Committee is attempting to find a consensus in its review of the accounting standards on accounting for business combinations and goodwill. However, we need to take decisions on the legislative framework before the review is complete. The letter circulated in December said that we did not, in implementing the Directive, intend to step into territory best covered by accounting standards.

THE CONSULTATIVE LETTER

13 The consultative letter sought to focus consultees on legislative changes rather than prolong general debate on the merits and demerits of merger and acquisition accounting and the treatment of goodwill. It sought views in particular on the following:

(1) Should we take advantage of the option in the Seventh Directive to permit (but not require) merger accounting where certain conditions are met?

(2) Should we require additional disclosure to enable the effects of mergers and acquisitions on the consolidated accounts to be clearly seen whichever treatment is used?

(3) Should we bring the conditions for merger relief into line with those we introduce for merger accounting?

(4) Should we require consistent treatment between individual and consolidated accounts?

(5) Should we restrict merger accounting to "real" mergers?

RESULTS OF CONSULTATION

14 The consultation reveals a consensus in favour of steps (1) and (2) but relatively little support for going ahead at this stage with any of steps (3) to (5). A summary of the main responses is at Annex B.

15 The lack of enthusiasm for going beyond better disclosure reflects the controversy within the accounting profession on many of the issues raised in our letter:

(i) Many consultees argue that the Department should await the review of the relevant accounting standards. This review has of course been announced since we wrote and the "threat" of legislation was probably a factor in getting agreement to it. The argument is that the changes would be controversial and, regardless of one's view on the merits, would need much fuller debate before any changes to the law.

(ii) Some argue that many of the changes canvassed should be for accounting standards rather than the law. One reason for putting forward the legislative option; and seeking to take advantage of the opportunity provided by implementation of the Seventh Directive, was that we doubted the ability of the existing Accounting Standards Committee to get to grips with this issue. However, post-Dearing the accounting standards setting body may be in a better position to tackle this subject.

(iii) Others argue on the merits. A number emphasise the need to keep the current flexibility as long as companies are not able to retain goodwill on the balance sheet as a permanent asset. One of the attractions of merger accounting is that no goodwill arises on consolidation and the problems of dealing with it are thus side-stepped.

16 The general conclusion is that we would need an extremely strong case before enforcing radical change against the considerable doubts of the accounting profession.

DETAILED PROPOSALS

(1) PERMIT BUT NOT REQUIRE MERGER ACCOUNTING UNDER 7TH DIRECTIVE

17 The Directive requires explicit legislative provision to be made if merger accounting is to continue to be available. No consultee favours outlawing merger accounting though some favour restricting its use (at least in the longer term) to very tightly defined circumstances. **We recommend therefore that we follow the option in Article 20 of the Directive to permit the use of merger accounting.** The Directive lays down minimum conditions which must be met. We intend to introduce the Directive conditions with an addition designed to overcome a technical weakness. We also intend to make clear either when we announce firm proposals or during the passage of the Companies Bill that we consider that accounting standards can set conditions in addition to those specified in the Directive. This is important if existing conditions in accounting standards not taken from the Directive are to remain available.

(2) ADDITIONAL DISCLOSURE

18 **Consultees are almost unanimous in favour of more extensive disclosure and that this should be covered in legislation. There is also a wide measure of agreement on the detail. We recommend therefore requiring disclosure:**

(a) for all mergers and acquisitions in the financial year in question:

(i) the names of the combining undertakings;

(ii) whether merger or acquisition accounting has been used;

(b) in respect of each material acquisition or merger in the financial year in question:

(i) details of the composition and fair value of the consideration for the merger or acquisition;

(ii) where acquisition accounting has been used, a table showing the book values and fair values of the assets and liabilities acquired, including (a) the effect of applying consistent accounting policies, (b) an explanation of significant adjustments and (c) the amount of the goodwill arising on the acquisition;

(iii) where merger accounting has been used, the effect of applying consistent accounting policies on the assets and liabilities acquired, including an explanation of significant adjustments;

(iv) a breakdown of results for (i) the period up to the date of the acquisition or merger (or disposal) and (ii) the prior year.

Consultees tended to the view that it was unrealistic to seek a breakdown of results post merger or acquisition and we do not propose to require this.

(c) In respect of acquisitions, the cumulative amount of goodwill written off, net of disposals.

(3) ALIGN CONDITIONS FOR MERGER RELIEF WITH THOSE FOR MERGER ACCOUNTING

19 We put this forward on the basis that merger relief had

been introduced to facilitate merger accounting and that there was therefore no reason to set different conditions for merger relief and for merger accounting. A clear majority - though far from all - consultees take a different view.

20 The argument turns on one's views of the use of acquisition accounting in conjunction with merger relief. This has become an increasingly common practice since merger relief was introduced in 1981. It is attractive to companies in that it enables them to write off goodwill arising on consolidation against the share premium that would have been created in the absence of merger relief, whilst enjoying the advantages of using acquisition accounting (which tends to reflect the steepest profits growth). Critics of the practice see it as enabling companies to get the best of two worlds: certainly it was not envisaged when merger relief was introduced. On the other hand many argue that, whatever the original purpose of merger relief, its use in conjunction with acquisition accounting has proved beneficial, given that the Fourth Directive does not allow goodwill to be carried as a permanent asset.

21 If it is considered acceptable to take merger relief in the parent company's individual accounts and combine this with acquisition accounting on consolidation then there is no reason in principle for bringing the conditions for merger relief and merger accounting into line. A number of consultees recognise that this is a controversial topic within the profession and argue that the Department should stay its hand pending the review of accounting standards. Some go further and argue that the purposes of merger relief and merger accounting are quite distinct: merger relief is about capital maintenance and merger accounting about consolidated accounts. Whilst the first part of this argument is technically correct it ignores the fact that merger relief was introduced specifically as a necessary precondition to permit merger accounting.

22 On balance, however, we recommend that we do not introduce this into the next Companies Bill but await the review of the accounting standards. We should make clear that at that stage we shall reconsider. There is power in the Companies Act to amend the merger relief provisions by regulation. This would enable us to align the conditions for merger relief with those for merger accounting.

(4) CONSISTENT TREATMENT BETWEEN INDIVIDUAL AND CONSOLIDATED ACCOUNTS

23 We also favoured this option, though acknowledged it could have the undesirable side effect of affecting distributable reserves of some companies. Almost all consultees are against this option, on broadly the same grounds as for (3).

24 The thinking behind consistent treatment is that (i) it would prevent the more outlandish and difficult to follow accounting treatments found at present, in particular where goodwill arising on consolidation is not calculated by setting off the fair value of the consideration against the fair value of the acquisition and (ii) it is preferable that the value in the parent's accounts reflects whether the company perceives the acquisition as a merger or acquisition.

25 Since we wrote, however, we have thought further and we recommend that we do not go ahead with this option as such. The wrong set off tends to be made where merger relief is taken (and nominal values used in the parent company's accounts) and this is followed by acquisition accounting on consolidation. However, we are now clear that we can require the correct set-off to be shown in implementing Directive provisions on acquisition accounting. The effect will be that, where a company takes merger relief and uses nominal values in its individual accounts for the shares issued, it will be forced to make a consolidation adjustment to ensure that goodwill is calculated correctly. This does not go quite as far as requiring consistent treatment but, when coupled

with the disclosure at (2) above, should have much the same effect. We should make this clear in announcing our intentions.

(5) SHOULD WE RESTRICT MERGER ACCOUNTING TO "REAL MERGERS"?

26 This was included in the consultative letter but not as a serious option for legislation. Drafting legislation to achieve this end would be extremely difficult with every chance of it failing to achieve its purpose. Nothing has emerged from the consultation which inclines us to change our assessment and **we recommend that this is not pursued.** This does not mean that the option is without its attractions. A number of consultees favour moving in this direction but probably via accounting standards rather than the law and not within the timescale of the next Companies Bill.

Companies Division Branch 3
April 1988

Annex A

DEPARTMENT OF TRADE AND INDUSTRY
10–18 VICTORIA STREET
LONDON SW1H 0NN

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(Switchboard) 01-215 7877

E Tait Esq
Secretary
The Institute of Chartered
Accountants of Scotland
27 Queen Street
EDINBURGH EH2 1LA

23 December 1987

Dear Eric,

IMPLEMENTATION OF THE EC SEVENTH COMPANY LAW DIRECTIVE ON CONSOLIDATED ACCOUNTS: ACCOUNTING FOR MERGERS AND ACQUISITIONS

Since the formal consultation on implementation of the EC Seventh Company Law Directive in 1985/86 there has been a lively debate in the accountancy and business world on the possible shortcomings of acquisition and merger accounting and the flexibility of treatment presently permitted. Ann Wilks wrote to you on 1 May on the wider issues raised by this. We are grateful for the very helpful responses to her letter from you and other consultees.

In the light of this, and of the possible review of SSAPs 22 and 23, we have looked again at the legislative changes we might make, linked to implementation of Articles 19 and 20 of the EC Seventh Company Law Directive. I am writing to invite your views on this specific aspect.

I attach a note setting out the main legislative options we have identified. (As you will see, these are not mutually exclusive.) The requirement to show that we have implemented the directive in a binding manner means some legislation is inevitable. But it is not our intention to step into territory best covered by accounting standards. I should particularly welcome your comments on the respective roles of standards and the law in this area.

Our preliminary view is to favour the following legislative changes:

(i) permit but not require merger accounting where the directive conditions are met; otherwise require acquisition accounting;

(ii) require additional disclosure where businesses have combined, on the lines suggested in Option B;

(iii) bring the conditions for obtaining merger relief into line with the directive conditions for merger accounting, as in Option C;

(iv) require consistent treatment between parent and consolidated accounts, on the lines of Option D or Option E.

Another change which we believe merits serious consideration would be to restrict the ability of companies to cancel the share premium account through the courts using the procedures in sections 135-137 of the Companies Act where this is used to create a reserve against which to write-off the goodwill arising on consolidation.

I should welcome comments on both the desirability and practicability of these changes.

We believe that in the main accounting standards rather than legislation provide the best way of dealing with the related issues of the treatment of goodwill and of provisions made in the context of an acquisition. We intend to legislate, however, to make clear that it is not permissible to write-off goodwill to the revaluation reserve. You may recall that this proposal was floated in a consultation note issued by the Department in 1986.

I should be grateful for written comments by 19 February 1988.

I am writing in similar terms to the other CCAB bodies, the ASC, the CBI, the Stock Exchange, the Law Society and the Law Society of Scotland.

Yours sincerely,

Neil Worman

N M K WORMAN

EC6ABZ

999:20

Annex

ACCOUNTING FOR MERGERS AND ACQUISITIONS: OPTIONS FOR LEGISLATION

OPTION A - MINIMAL CHANGE

Implement the seventh directive so as to disturb the existing position as little as possible ie:

(a) allow merger accounting where the conditions set out in the directive are met. Require acquisition accounting otherwise.

(b) limit disclosure to that which is mandatory under the directive;

(c) make no change to the merger relief provisions.

Comment. This option is favoured either if we conclude that there is no serious problem or that any problems which warrant change should and will be dealt with by accounting standards.

OPTION B - ADDITIONAL DISCLOSURE

As Option A, but with additional disclosure required by law. The main disclosure requirements should be:

(a) the names of the combining companies (Article 20 of the Seventh Directive requires this for merger accounting);

(b) whether merger or acquisition accounting has been used;

(c) details of the composition and fair value of the consideration for the merger or acquisition;

(d) where acquisition accounting is used, a table showing the book values and fair values of the assets and liabilities acquired, including the effect of applying consistent accounting policies and an explanation of significant adjustments;

(e) where merger accounting is used, the effect of applying consistent accounting policies on the assets and liabilities acquired including the explanation of significant adjustment;

In addition we might require a breakdown of the results for (i) the period up to the date of the acquisition or merger (or disposal); (ii) the prior year; (iii) the period from the date of acquisition to the year end. We should welcome views in particular on whether such an additional requirement would lead to the provision of useful and meaningful information.

Comment. This is at present dealt with primarily in accounting standards. There is a broad consensus in favour of better disclosure, if not on precisely what this should cover. Since

the directive already requires some disclosure (in Article 28 for example) we favour a statutory requirement to disclose the most important information. This would not of course rule out further requirements in a revised accounting standard.

OPTION C - ALIGN CONDITIONS FOR MERGER RELIEF WITH THOSE FOR MERGER ACCOUNTING

As Option B, but with conditions for s131 merger relief tightened in line with the directive requirements for merger accounting.

Comment. This option would slightly restrict the availability of merger relief and with it the opportunities for taking merger relief followed by acquisition accounting. As at present, however, accounting standards would be able to set stricter conditions for merger accounting than the legislative conditions for merger relief (and merger accounting). Under this option, therefore, there would still be cases where a company took merger relief but had to use acquisition accounting in the consolidated accounts.

OPTION D - CONSISTENT TREATMENT BETWEEN PARENT AND CONSOLIDATED ACCOUNTS

As B or C, with the additional requirement that treatment in the consolidated accounts must be consistent with treatment in parent's accounts. This means:

Merger relief + merger reserve in the parent's accounts, followed by: acquisition accounting in the consolidated accounts.

Merger relief without merger reserve in the parent's accounts, followed by: merger accounting in the consolidated accounts.

No merger relief in the parent's accounts, followed by: acquisition accounting in the consolidated accounts.

One way of achieving this might be to specify how the "book value of shares" held by the parent in the subsidiary are to be valued (ie nominal or fair value).

Comment. This would avoid some of the more curious and difficult to follow treatments - in particular where merger relief is taken in the parent's accounts (without establishing a merger reserve) following this with acquisition accounting on consolidation. In consequence some companies do not calculate the goodwill element in an acquisition by setting off the fair value of the investment against the fair value of the net assets acquired. Moreover this may not be readily apparent from the accounts although good disclosure can help to remedy this defect. The accounting treatment required by this option could in certain circumstances affect the amount of a company's distributable reserves.

It would be unusual to make a treatment in the parent's accounts dependent on the accounting method used on consolidation but we do not see that this would cause any difficulty since in practice the accounting policies will be decided at the same time.

OPTION E - PROHIBIT MERGER RELIEF IN PARENT COMPANY'S ACCOUNTS WHERE ACQUISITION ACCOUNTING IS USED ON CONSOLIDATION

This is a tighter version of Option D. Companies which wished to use acquisition accounting on consolidation would be barred from taking merger relief in the parent's accounts.

Comment. Given that there are additional conditions in accounting standards (and possibly in legislation) which companies have to meet before they can merger account this option would also have the effect of restricting merger relief beyond the s 131 conditions. It should eliminate the treatment where companies take merger relief, create a merger reserve and acquisition account on consolidation.

Like Option D it may make the accounting treatment in the parent's accounts dependent on the treatment in the consolidated accounts.

OPTION F - MAKE MERGER ACCOUNTING MANDATORY WHERE MERGER RELIEF IS TAKEN

As Option C, with the additional requirement that merger accounting must follow merger relief and (by implication) acquisition accounting would apply where there was no merger relief.

Comment. This would remove one of the problem areas - the use of acquisition accounting with merger relief - and would cut down on the flexibility in the choice of accounting methods. There is a difficulty, however, in that the accounting standards would not be able to prescribe restrictions on the use of merger accounting over and above those in legislation.

OPTION G - RESTRICT MERGER ACCOUNTING TO "REAL" MERGERS

This is an alternative to Option C. It would involve either imposing much more restrictive conditions for the use of merger accounting than those set out in the directive (broadly on US or Canadian lines) or achieving the same effect indirectly by setting much tighter conditions for merger relief.

Comment. This would return more closely to what the Department had in mind when the merger relief concession was introduced. It would mark a substantial departure from current practice. It is likely that it would prove extremely difficult to draft legislation which could not be undermined in practice.

OPTION H - OUTLAW MERGER ACCOUNTING

Only the acquisition accounting provisions in the directive would be implemented. This could be done with or without altering the merger relief provisions. We could still require additional disclosure for acquisition accounting.

Comment. This is a radical option which would mark a sharp break with existing UK practice. We do not consider that there is sufficient evidence of abuse in this area to warrant such a change.

Companies Division 3
December 1987

ANNEX B

ACCOUNTING FOR MERGERS AND ACQUISITIONS

SUMMARY OF MAIN RESPONSES

Treasury

Share many of our concerns.

Agree on need for better disclosure: favour, in addition to our proposals, a permanent record of goodwill (now included).

Favour prohibition on use of merger relief where acquisition accounting used on consolidation.

Emphasise need to consider changes within comprehensive framework - in particular in relation to treatment of goodwill (favour inclusion in consolidated accounts at cost less provisions for permanent fall in value.) (We have sympathy with this but have to implement 7th Directive in the context of 4th Directive - change not realistic in short term - and fact that review of SSAPs 22 and 23 only just under way.)

ACCA

Favours:

- merger accounting restricted to "true mergers" with watertight criteria in standards

- minimum conditions which must be met for merger accounting prescribed in legislation

- bringing conditions for merger relief and merger accounting into line

- in place of our consistent treatment option, legislative provision that where merger relief is taken and acquisition accounting used company must either (i) create merger reserve in the holding company's own accounts or (ii) make a consolidation adjustment to give correct calculation of goodwill. (This is in line with our current thinking)

- by implication awaiting outcome of review of SSAPs 22 and 23 and Dearing Committee.

ICAEW

Favours:

- minimum changes necessary to implement directive

- allowing merger accounting and leaving circumstances to

accounting standards

- better disclosure.

Against options on consistent treatment.

Divided views as to whether conditions for merger relief and merger accounting should be brought into line. Propose that do not for the time being align the two.

Suggests aligning conditions for merger relief and merger accounting in case of S133(1) only.

ICAS

Favours minimal legislative changes for time being.

Favours discussion and consultation on radical approach to accounting for business combinations:

(i) all assets and liabilities to be revalued following any major change in the combination of the group;

(ii) consolidation to be on merger accounting basis;

(iii) reorganisation costs to be disclosed in the year of combination;

Against:

- alignment of conditions for merger relief and merger accounting

- consistent treatment.

ICAI

Favour minimum change.

Law Society

Overall in favour of minimum change but with additional disclosure.

Specifically against amendments to S131 and alignment of merger relief and merger accounting conditions.

Arthur Andersen

Favour:

- opportunity for all to express views before any legislation

- leaving as much to SSAPs as possible

- restricting merger accounting to cases where no dominant party (though recognises this cannot be agreed quickly)

- consistent treatment (in principle)

- additional disclosure (more extensive than we proposed)

Price Waterhouse

Regard use of S131 with acquisition accounting as unintended but beneficial.

Against legislative change until review of standards complete.

Can accept additional disclosure.

Arthur Young

Favour minimal changes to S131 since share premium to do with capital maintenance rather than financial reporting.

Also against alignment of merger relief and merger accounting conditions.

Also against consistent treatment.

Peat Marwick

Against precipitate change. .

Favour minimal change with additional disclosure.

Against other options.

Spicer & Oppenheim

Letter focuses on concern that Government might restrict use of merger relief to cases where merger accounting used on consolidation. Argues strongly against any such change.

International Stock Exchange

Favour implementing merger accounting option from Directive, additional disclosure and tightening of merger accounting conditions.

Other changes should be deferred until review of SSAPs complete.

N23AAO

CBI

(Interim reply only)

Favours restricting merger accounting to true mergers.

No change should be made to availability of merger relief until the "question of the treatment of goodwill had been finally agreed".

A summary table is attached.

N23AAO

ACCOUNTING FOR MERGERS AND ACQUISITIONS: SUMMARY OF PRINCIPAL RESPONSES TO CONSULTATIVE NOTE

	(1)	(2)	(3)	(4)	(5)
HMT	N	Y	Y	Y	Y(a)
ICAEW	Y	Y	N	N	N
ACCA	Y	Y	Y	N(b)	Y(c)
ICAS	Y	Y	N	N	N
ICAI	Y	N(d)	N	N	N
CIMA	N				Y
Law Society	Y	Y	N	N	N
Arthur Andersen	N	Y	Y	Y	Y(e)
Spicer & Oppenheim			N		
Deloittes (f)			N		
Arthur Young (g)	Y		N		
Peats	Y	Y	N	N	N
Stock Exchange	Y	Y	Y	N	N
CBI(h)					Y

Key

(1) Permit but not require merger accounting under 7th

(2) Additional disclosure beyond that mandatory under Directive

(3) Align conditions for merger relief and merger accounting

(4) Consistent treatment of individual and consol. accounts

(5) Restrict merger accounting by law to "real mergers"

Footnotes

(a) but sees possible EC complications
(b) but in favour of variant
(c) in principle - "watertight" criteria to be agreed in standards
(d) only disclosure required by directive
(e) in principle, if consensus could be found
(f) Mr Holgate's personal views
(g) Mr Paterson's personal views
(h) Preliminary reply only.

2915/029

FROM: SIR A WILSON
DATE: 3 June 1988

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr Monck
Mr Burr
Mr Cropper
Mr Tyrie
Mr Call
Mr Inglis

Mr Beighton - IR
Mr Shaw - IR
PS/IR
PS/C&E

STATUTORY AUDITS OF SMALLER COMPANIES

Lord Young's letter to you of 31 May indicates a determination within the DTI to resist suggestions for a review or other forms of association of an independent accountant with the accounts of smaller companies falling short of a full audit. The Secretary of State disregards the wider considerations set out in the Chancellor's letter to him of 18 December 1987 (attached for easy reference); he simply states that the Government must look to full abolition of the universal audit requirement in company law to achieve the more substantial and clear-cut benefits of deregulation. You are to hold a meeting with Mr Maude and others on this subject in the week commencing 13 June, but it seems to me that we are back at square one.

2. There is no need for me to rehearse the arguments for and against the audit of smaller companies - the ground has been covered many times in recent months, but I should perhaps remind you of the line-up within the accountancy profession as this will have a bearing on the reception of the Companies Bill when it is introduced. The

Certified Accountants and the Irish Chartered Accountants have come out strongly against abolishing the audit requirement, the Scottish Chartered Accountants want a review by an independent accountant, the English Institute favours abolition with nothing instead (although it must be doubtful whether the membership will back this Council view), and the Management Accountants are largely neutral as they are less concerned with published accounts and do not do audits. CIPFA is concerned with Local Authority and Health Service audits which will be unaffected by the Companies Bill.

3. My advice must be that as no "half-way house" appears to be acceptable to DTI Ministers, full universal audit as presently practised should remain. No clear preference was expressed during the DTI's consultative procedures for audit abolition and to remove it without putting anything in its place would create a vacuum which could prove highly damaging to the credibility of the smaller business sector and to the interests of the Inland Revenue. It should be borne in mind that after the future of audit for smaller companies had been considered by Ministers as recently as 1986, it was publicly announced that the audit should be retained as a first defence against fraud. A change of attitude only two years later would need a convincing explanation.

4. This is disappointing guidance for me to have to give for I believe that a limited review would satisfy most interests and would enable the proper audit, still required for all larger companies and special classes such as financial services companies whatever their size, to develop and improve without being held back by its application to small businesses for which it is less appropriate. It is also worth noting that the Auditing Practices Committee of the British accountancy profession is now actively considering ways in which a review could be developed as a generally accepted alternative to an audit; this work will, of course, continue whether or not universal company audit remains a statutory requirement.

5. You are aware of the risks to the Exchequer yield and of the implications for Inland Revenue staffing problems and costs if the statutory audit were to be abolished without replacement for any companies - however small.

SIR A WILSON

Rm.53/3/MD/2514/3

FROM: SIR ANTHONY WILSON
DATE: 2 June 1988

FINANCIAL SECRETARY

cc: PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Byatt
Mr Monck
Mr Burgner
Mr Houston
Mr MacAuslan
Mr Bradley
Mr Lyne
Mr Wynn Owen
Mr Inglis

COMPANIES BILL

This submission sets out the current DTI position on Off Balance Sheet Finance treatment in the forthcoming Companies Bill, and makes recommendations as to the action to take. I should be grateful for any comments by 7 June.

OFF BALANCE SHEET FINANCE

In implementing the EC 7th Directive requirements, the DTI is proposing to make two changes to existing legal requirements:

i. to expand the definition of subsidiary (in particular, to include companies in which another company holds a participating interest and over which the latter exercises a dominant influence); and

ii. to increase disclosure requirements to require disclosure of summarised profit and loss and balance sheet information for any companies which are not consolidated but where the parent "enjoys benefits or bears risks normally associated with majority ownership

or control". In addition, the DTI intends to make a public announcement re-affirming its view that, in preparing accounts, a parent company must, above all, present a true and fair view of its affairs and those of its subsidiaries taken as a whole.

These proposals will not by themselves completely solve the problems of off balance sheet finance, (they do not, for example, require consolidation of entities in which the "parent" has no shareholding, even though such vehicles are not uncommon methods of off balance sheet financing). They are, however, probably the best options available within the restrictions of the EC 7th Directive. Importantly, they should establish a climate in which the accounting profession, which is attempting to deal more comprehensively with the question of off balance sheet finance in all its forms through standards and guidance notes, has a greater chance of gaining acceptance for its proposals.

Recommendation

Correspondence has so far been at official level and I propose therefore to write to DTI officials to confirm that we are content with their proposals in this area. DTI Ministers will no doubt wish to consult colleagues in due course and, providing the proposals remain as outlined above, it is recommended that you should agree to them at that time.

A WILSON

2514/4

FROM: SIR ANTHONY WILSON
DATE: 6 JUNE 1988

FINANCIAL SECRETARY

cc: PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Byatt
Mr Monck
Mr Burgner
Mr Moore
Mrs Lomax
Mr Scholar
Mrs Brown
Mr Houston
Mr Ilett
Mr MacAuslan
Mr Bradley
Mr Lyne
Mr Wynn-Owen
Mr Flanagan

Can I have x p1
Thanks
PMP

COMPANIES BILL: ACCOUNTING FOR MERGERS AND ACQUISITIONS

Mr Maude's letter to the Economic Secretary of 31 May asks Treasury Ministers to indicate whether they are content with his proposals for revised accounting disclosure requirements about mergers and acquisitions to be included in the forthcoming Companies Bill. The proposals set out in Mr Maude's letter are unchanged from those included in Sir Peter Middleton's submission to the Chancellor of 12 May, 1988. No adverse comments have been received in response to that submission and I therefore recommend that, if no comments are forthcoming from copy recipients by close of play on 9 June, you should write to Mr Maude indicating that you are content with the proposals.

2. A draft letter is attached.

A WILSON

2514/5

DRAFT LETTER

TO: The Hon Francis Maude MP
Parliamentary Under Secretary of State
for Corporate Affairs
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1H OET

ACCOUNTING FOR MERGERS AND ACQUISITIONS

Thank you for your letter of 31 May 1988 addressed to Peter Lilley. I am content with the line you propose to take in the forthcoming Companies Bill on the subject of accounting for mergers and acquisitions.

(NL)

42/2.BTW.4372/55

FROM: J J HEYWOOD
DATE: 7 June 1988

SIR A WILSON

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Monck
Mr Burr
Mr Cropper
Mr Tyrie
Mr Call
Mr Inglis
Mr Beighton IR
Mr Shaw IR
PS/IR
PS/C&E

STATUTORY AUDITS OF SMALLER COMPANIES

The Financial Secretary was grateful for your minute of 3 June.

2. The Financial Secretary has agreed to see Mr Maude on 15 June. That meeting will also - at Mr Maude's request - cover small company accounts. I would be grateful if you could arrange for a short sit.rep on the latter to be provided for the Financial Secretary.

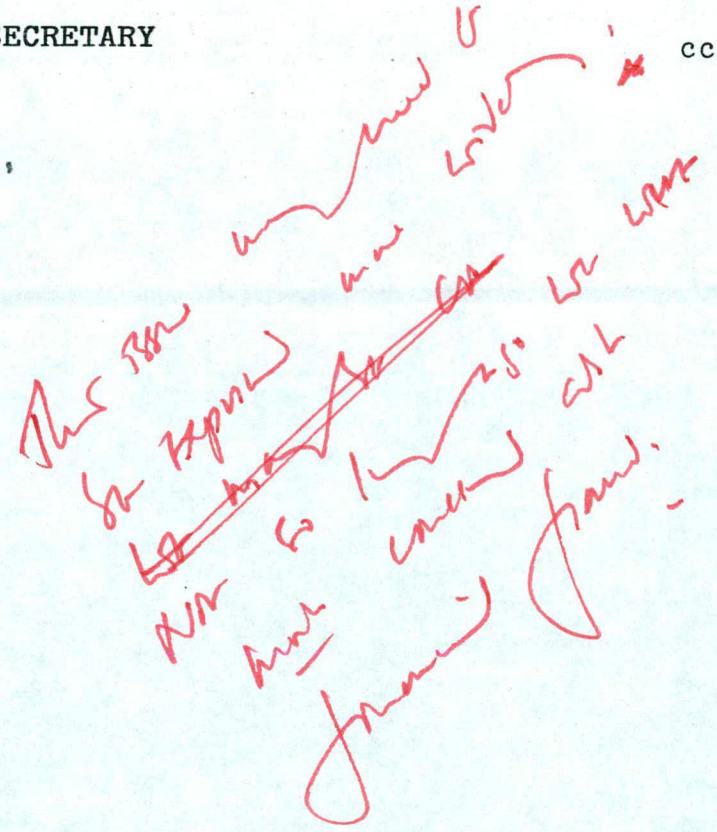
3. The meeting on 15 June will not involve officials.

JEREMY HEYWOOD
Private Secretary

85a/2/GBH/2915/001

FROM: SIR A WILSON
DATE: 8 JUNE 1988

FINANCIAL SECRETARY



cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir T Burns
Mr Anson
Mr Byatt
Mr Monck
Mr Burgner
Mr Moore
Mrs Lomax
Mr Scholar
Mrs Brown
Mr Houston
Mr Ilett
Mr MacAuslan
Mr Bradley
Mr Lyne
Mr Inglis
Mr Wynn Owen
Mr Flanagan
Mr Beighton - IR
Mr Shaw - IR
PS/IR
PS/C&E

ACCOUNTING CONTENT OF THE FORTHCOMING COMPANIES BILL

I understand from DTI officials that their Ministers have decided to take advantage of derogations in the EC 7th Directive which permit Member States to exempt small and medium sized groups of companies from the Companies Act requirement to prepare consolidated accounts. The decision, about which we have not previously been consulted, has apparently been taken entirely on deregulation grounds. The effect would be that holding companies would no longer have a Companies Act obligation to prepare consolidated accounts where the group does not exceed in size two of the following criteria:

(i) turnover £8m;

(ii) balance sheet total £3.9m;

(iii) employees 250.

2. We are told that, in practice, relatively few groups fall into this category, but I believe that a number of groups engaged in the provision of financial and other services may do so, for typically such enterprises do not employ many people or use large amounts of assets which would be reflected in their balance sheets. No group which contains a company subject to the Financial Services or Banking Acts should, in my view, be excused from preparing consolidated accounts and if the DTI is right in thinking that few groups would benefit from the derogation, it is questionable whether the advantage to be gained from it is worthwhile. There was little public support for this step in the DTI's consultation about translating the EC 7th Directive into UK law and although it would not have a major effect on Treasury interests Customs and Excise do rely on consolidated accounts as evidence of group structures for VAT purposes.

3. The benefits for individual groups are unlikely to be significant. In the case of most small groups the additional effort required to prepare consolidated accounts is minimal, requiring little more than the adding together of the accounts of the individual companies and, possibly, eliminating the effect of intra group transactions.

4. The result of removing the statutory obligation to prepare group (consolidated) accounts from small and medium sized groups would be rather odd in that

(a) all companies would continue to have to produce accounts which show a true and fair view of their results and financial position,

and (b) the Companies Act effectively states that where a company has subsidiaries it must prepare consolidated (or other forms of group accounts) in order to show a true and fair view,

so (c) small and medium sized groups, in the absence of consolidated accounts, couldn't show a true and fair view.

5. Group structures allow considerable scope for manipulating profits between companies by, for example, variable management charges. Only consolidated accounts, which eliminate such intra group transactions, can show the real picture. In the absence of group accounts a third party dealing with a group company will be unable to obtain a clear view of its true position; he will merely be able to see accounts of an individual company which may have been manipulated to preserve obscurity.

6. You may wish to raise this matter with Mr Maude when you discuss other potential company law changes effecting small and medium sized companies in the near future.

SIR A WILSON

ps3/39M

CONFIDENTIAL (1)

These, I think are pps I asked to be found, (they were missing from string + I didn't think they'd be on BF)

FROM: MISS M P WALLACE
DATE: 9 June 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir T Burns
Mr Anson
Mr Byatt
Mr Monck
Mr Burgner
Mr Moore
Mrs Lomax
Mr Scholar
Mrs Brown
Mr Houston
Mr Ilett
Mr MacAuslan
Mr Bradley
Mr Lyne
Mr Inglis
Mr Wynn Owen
Mr Flanagan

Mr Beighton - IR
Mr Shaw - IR
PS/IR

PS/C&E

BF ~~23/6~~ (2) pmp

ACCOUNTING CONTENT OF THE FORTHCOMING COMPANIES BILL

The Chancellor has seen Sir A Wilson's minute of 8 June. He has commented that this issue may need to be exposed more widely. Not so long ago, we were most concerned about financial fraud.

MOIRA WALLACE

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

CONFIDENTIAL

FROM: K V DEACON
DATE: 10 6 1988

1. MR BEIGHTON

2. FINANCIAL SECRETARY

ACCOUNTING REQUIREMENTS FOR SMALL COMPANIES

1. In his note of 7 June to Sir Anthony Wilson, Jeremy Heywood sought a brief situation report on the accounting requirements for small companies in preparation for the meeting with Mr Maude on 15 June. This is of course only one of of the major deregulatory issues under discussion with the DTI which have an impact on Revenue interests.

DTI Proposals

2. Under the Companies Act 1985, "small" and "medium sized" companies are permitted to file with the Registrar of Companies modified accounts in place of the full accounts which the directors are required to lay before shareholders in general meeting. In line with tax case law, the Revenue look for submission in support of the company's tax return

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Anthony Wilson
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Painter
Mr Rogers
Mr Beighton
Mr Cherry
Mr Corlett
Mr Crawley
Mr Deacon
Mr D Shaw
PS/IR

of those accounts laid before the general meeting. In seeking to reduce the burden on smaller companies, the DTI propose allowing modified accounts to be laid before shareholders. Discussions held on similar proposals between Revenue and DTI officials in 1986 resulted in a package which DTI tell us the accounting profession concluded would achieve minor savings only. For the current discussions, DTI resurrected their 1986 proposals.

Revenue concerns

3. During the negotiations with DTI officials we have borne in mind the priority the Government is giving to deregulation. But we have also been guided by the need to safeguard:

(i) the yield to the Exchequer;

(ii) the Revenue manpower levels and value for money returns in this area of work; and,

(iii) the companies themselves against the cost and annoyance from Revenue enquiries caused directly by the loss of vital information.

4. The cost/yield ratios for our compliance activities indicate high degrees of cost effectiveness, but even then they do not reflect the deterrent effect of safeguarding the yield from small companies of corporation tax and income tax and NIC on their directors estimated at around £b10.

5. The major resources available to the Revenue in our compliance activities are trained manpower and information. With the former in continuing short supply, the latter becomes even more crucial. Any reduction in the information automatically submitted to the Inspector with the company's accounts and tax computations could lead to a loss of yield

and an increase in the cost/yield ratio (and thus reduced value for money in this area). This is because in screening the accounts for further enquiry the Inspector, in the absence of vital information, may miss a potentially productive point, or decide on the inadequate information available to him not to proceed or instead put what must be mainly speculative enquiries to the company. If these enquiries turn out to be unnecessary, this may well cause annoyance and cost for the company; but even if relevant they will involve the company in the additional expense of retrieving information which could more easily have been obtained and presented when the accounts themselves were being drawn up.

6. Treasury Ministers decided last year that the Revenue should rely on Companies Act accounts for CT Pay and File, and this was stipulated in the legislation. This was seen as a valuable deregulatory saving for companies, who would be able to prepare a single set of accounts to meet their obligations under both the Taxes and the Companies accounts. If the contents of Companies Act accounts were to be reduced to the point where the accounts were insufficient for our needs, you would have to consider legislation to reverse this decision, giving the Revenue powers to require companies to produce separate accounts for Revenue purposes.

Outcome of discussions

7. With these Revenue concerns in mind we have nevertheless recognised DTI objectives and attempted to meet them as far as possible. We have been able to accept fully two thirds of their proposals and many of the remainder in large part without, in our judgement, putting significantly at risk proper Revenue concerns.

8. I attach as annex A a summary prepared by the DTI of the position reached at the end of our discussions which has been reported by them to their Ministers. I also attach as annex B a brief explanation of specific Revenue reasons for

not being able to accept the DTI proposals. It is most unlikely that Mr Maude will have been briefed on this aspect as DTI officials tell us that they have no explanatory note of how they reached the position shown in their summary. Their intention in the negotiations had been to assess the size of the gap between the two Departments rather than to explore the rationale for the different views.

Conclusion

9. DTI officials have told us that it is now a matter for their Ministers to decide what can be regarded as a worthwhile package. We have advised DTI that if Treasury Ministers considered that the decision exposed the Revenue to unacceptable risk, the Government could conceivably end up deregulating and reregulating (for tax purposes) in the same session.

K V DEACON

ANNEX B

a. General tax considerations:

i. Different rules apply to different types of income (for example, trading, property, interest) in computing profits and reliefs for tax.

ii. Different rules apply to different types of company; for example, a "close" company is determined by reference to control achieved, inter alia, through shareholdings or loans. Special rules extend the normal tax charge in the case of close companies (for example, on distributions).

iii. Special rules apply to group companies and to non-resident group companies; and to transactions between them.

iv. Gross profit ratios and debtor/sales and creditor/purchases ratios are important indicators for credibility of accounts.

v. Transfers of profit to reserves and provisions are allowable for tax only in specific circumstances.

vi. Not all debits are allowable deductions for tax.

vii. Debenture holders may rank as participators and therefore count in determining control of a company.

b. Specific items in Annex A

	Item	Revenue concern [cross reference to (a) above]
2.	Profit and loss account	Detail required as at present to identify individual items [(i), (vi)]
3B	III Investments	Need to distinguish between shares in group companies; loans in group companies; other investments; and the remainder [(ii), (iii), (iv)]

3E) Creditors 3H)	Need to distinguish between bank loans/ overdrafts; trade creditors, amounts owed to group companies; and the remainder. [(ii), (iii), (iv)]
3 I) Provisions and reserves 3 IV)	Information required on movements during year. [(vi)]
4(a) Debentures	Part of basic information on control of company. [(vii)]
4(f) Provisions and reserves	As for 3I,IV above.
4(n) Breakdown of turnover	Need to distinguish between different classes and whether overseas. [(i), (iii)]
4(p) Dealings etc with group companies	Need to identify [(iii)]

ACCOUNTING REQUIREMENTS FOR SMALL COMPANIES

Comparison of DTI and Inland Revenue position as at 19.5.88

Item	DTI View	IR View
1. Directors' report		
(a) dividends and transfers to reserves (Section 235(1)(b)	Exclude	As DTI
(b) significant changes in fixed assets (Schedule 7, paragraph 1(1))	Exclude	As DTI
(c) substantial difference between market value and balance sheet value of land (Schedule 7, paragraph 12)	Exclude	As DTI
(d) Political and charitable contributions (Schedule 7, paragraphs 3-5)	Exclude	As DTI
2. Profit and loss account		
Items making up "gross profit" (Formats 1-4)	Modification to combine items.	Retain in present form.
3. Balance Sheet (Format 1)		
B. Fixed Assets:		
I. Intangible assets	Two headings	As DTI
1. Development costs 2. Concessions, patents, licences etc 3. Goodwill 4. Payments on account		

Item	DTI View	IR View
II. Tangible assets	Two headings	As DTI
1. Land & buildings		
2. Plant & machinery		
3. Fixtures, fittings etc,		
4. Payments on account etc,		
III. Investments	Two headings	Four headings
1. Shares in group companies		
2. Loans in group companies		
3. Shares in related companies		
4. Loans to related companies		
5. Other investments other than loans		
6. Other loans		
7. Own shares		
C. Current Assets:		
I. Stocks	Two headings	As DTI
1. Raw materials and consumables		
2. Work in progress		
3. Finished goods etc,		
4. Payments on account		
II. Debtors	Three headings	As DTI
1. Trade Debtors		
2. Amounts owned by group companies		
3. Amounts owned by related companies		
4. Other debtors		
5. Called up shares capital not paid		
6. Prepayments and accrued income		

Item	DTI View	IR View
III. Investments	Two headings	As DTI
1. Shares in group companies		
2. Own shares		
3. Other investments		
E. Creditors: amounts falling due within one year	Two headings	Four headings
1. Debenture loans		
2. Bank loans and overdrafts		
3. Payments received on account		
4. Trade creditors		
5. Bills of exchange payable		
6. Amounts owed to group companies		
7. Amounts owed to related companies		
8. Other creditors		
9. Accruals and deferred income		
H. Creditors: over one year	Two headings	Four headings
As item E above (9 items)		
I. Provisions for liabilities and charges	One heading	One heading with note on underlying movement
1. Pensions and similar obligations		
2. Taxation including deferred taxation		
3. Other provisions		
IV. Other reserves	One heading	One heading with note on underlying movements
1. Capital redemption		
2. Reserve for own shares		
3. Reserves provided by articles		
4. Other reserves		

Item		DTI View	IR View
4.	Notes to the accounts		
(a)	Debentures issued during the year (Schedule 4, paragraph 41)	Exclude	Retain
(b)	Movements in fixed assets (Schedule 4, paragraph 42)	Modify	As DTI
(c)	Dates of revaluation of fixed assets etc (Schedule 4, paragraph 43)	Modify	As DTI
(d)	Breakdown of freehold and leasehold property (Schedule 4, paragraph 44)	Exclude	As DTI
(e)	Breakdown of investments (Schedule 4, paragraph 45)	Exclude	As DTI
(f)	Movements in reserves and provisions (Schedule 4, paragraph 46)	Exclude	Retain
(g)	Provisions for taxation Schedule, paragraph 47)	Exclude	As DTI
(h)	Amounts due to creditors in more than five years and amounts due to creditors that are secured. (Schedule 4, paragraph 48(1)	Modification so that aggregate amounts only are disclosed.	As DTI
(i)	Financial Commitments (Schedule 4, paragraph 50(3) and (4))	Exclude. Consequential amendment to paragraph 50(5)	As DTI
(j)	Outstanding loans for purchase of a company's own shares (Schedule 4, paragraph 51(2))	Exclude	As DTI

Item	DTI View	IR View
(k) Proposed dividend (Schedule 4,		
(l) Auditor's fees, breakdown of interest, rents and other miscellaneous charges (Schedule 4, paragraph 53)	Exclude	As DTI
(m) Particulars of the charge for taxation (Schedule 4, paragraph 54)	Exclude	As DTI
(n) Breakdown of turnover (Schedule 4, paragraph 55)	Exclude	Modify
(o) Particulars of staff (Schedule 4, paragraph 56)	Exclude	As DTI
(p) Amounts attributable to dealings with or interests in other group companies (Schedule 4, paragraph 59)	Exclude	Retain
(q) Directors emoluments (Schedule 4, paragraphs 24, 25 and 26)	Exclude	As DTI
(r) Higher paid staff enoluments (Schedule 5, paragraphs 35-37)	Exclude	As DTI

MANAGEMENT IN CONFIDENCE

FROM: SIR A WILSON
DATE: 16 JUNE 1988

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Culpin
Mr Burr
Mr Inglis
Mr MacAuslan
Mr Cropper
Mr Tyrie
Mr Battishill - I/R
Mr Beighton - I/R
Mr D L Shaw - I/R
P/S Inland Revenue
P/S Customs & Excise

STATUTORY AUDIT FOR SMALL COMPANIES

You have received a copy of a letter dated 14 June from Mr Cope to Mr Maude who you will meet on 20 June to discuss possible changes in the statutory audit requirements for small companies. I expect that you will not wish to write either to Mr Cope or to Mr Maude before your meeting, since the Treasury and Inland Revenue view of an effective compromise to meet Lord Young's deregulation wishes and the Inland Revenue needs was set out in your letter of 19 May to Lord Young and my letter of the same date to Mrs Brown of DTI, who is handling the preparation of the Companies Bill. Lord Young wrote to you on 31 May indicating that the compromise proposed did not go far enough for his deregulation purposes, and I summarised the position in my submission to you of 3 June. Since then Mr Battishill and Mr Beighton have minuted you separately summarising the Inland Revenue position.

2. Nothing has come to my notice since our earlier discussions to change my advice that the proposed compromise of a "negative assurance review" as an optional alternative to an audit for smaller companies, (below a threshold to be negotiated), would give a limited

deregulation relief and provide the minimum level of security which the Inland Revenue needs to avoid the risk of substantial loss of tax revenue. The deregulation point is that although a review may not yield a dramatic saving compared with full audit at the present time, it would be expected to do so in the future as audit standards improve and bite move effectively for those companies which must still have a full audit. The point made by Mr Cope in his letter to Mr Maude that "having a review would reduce the auditors'/reportees' liability without apparently reducing his work load very much" is a strange one for a chartered accountant to make. The liability for bad work will not change whether an audit or a review is the subject of a complaint, and the amount of time which a review would take would usually be considerably less than for an audit. If Mr Cope is correct in saying that a review would be less useful to the users of accounts of small companies than an audit, he is really arguing for a retention of universal audit.

SIR A WILSON

JH/T/23

15 JUN 1988

Department of Employment
Caxton House Tothill Street London SW1H 9NF
Telephone Direct Line 01-273 5805
Switchboard 01-273 3000

Minister of State

BF 17/6

The Hon Francis Maude
Parliamentary Under Secretary of State
Department of Trade and Industry
1 Victoria Street
LONDON
SW1H OET

FINANCIAL SECRETARY	
REC.	15 JUN 1988
ACTION	Sir A. Wilson
COPIES TO	PPS; CST; PMG; EJT Sir P. Middleton Mr. Colpin Mr. Burr Mr. Battishill-IR PS/IR ~~PS/Customs~~

14 June 1988

Dear Francis,

STATUTORY AUDIT FOR SMALL COMPANIES

I understand that you are meeting Norman Lamont on 15 June to discuss this issue. I have seen Norman's letter of 19 May, David Young's response of 31 May and Sir Anthony Wilson's letter of 19 May setting out ideas on how an independent review might operate. I thought I should write in advance of your meeting to set out my views on this matter.

It seems to me that the proposal outlined in Sir Anthony's letter does not really help with the problem except perhaps with the EC Eighth Directive. Having a review would reduce the auditors'/reporters' liability without apparently reducing his workload very much. It would not significantly reduce the current burden on small companies but it would be less useful to the users of the accounts, including the Revenue. I also note the views of the outside organisations that a report giving a negative assurance would not be significantly less costly than the current arrangements. I do not think, therefore, that the proposals in Sir Anthony's letter go far enough.

I would be grateful to be kept informed of developments in this matter. I am copying this letter to Norman Lamont.

Yours ever,
John

JOHN COPE

FROM: A M W BATTISHILL

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

10 June 1988

FINANCIAL SECRETARY

STATUTORY AUDIT OF SMALL COMPANIES

There is already a great deal of paper on this subject. But the issues are so important to our work on business accounts, and to our efficiency, that I hope you will allow me to add a little more. Mr Beighton's separate note considers the tactical options for Ministers.

2. As you know, we have all been searching for a compromise position which meets the needs of deregulation and the separate Treasury and Revenue interests. I am afraid this search looks in danger of foundering on the DTI's unyielding insistence on the deregulation objective, to the exclusion of all else. This seems to apply both on arrangements to replace the statutory audit and on the need for reasonable accounting requirements.

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Anthony Wilson
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Painter
Mr Rogers
Mr Beighton
Mr Cherry
Mr Corlett
Mr Crawley
Mr Deacon
Mr D Shaw
PS/IR

3. Despite your willingness to compromise we seem to be steadily losing ground. Lord Young now effectively rules out the idea of a limited review of small company accounts in place of the present audit. We are being driven further and further away from the minimum accounting information which our Inspectors need to assess business taxes. And we now hear that the DTI have decided to exempt small companies from preparing consolidated accounts.

4. Without some compromise I am afraid there will be a real threat to the information we need to tax businesses fairly and efficiently, and to the reliability of accounts. Sir Anthony Wilson has already expressed his concern at the turn of events. It does create a very difficult situation. None of us wants to impede the process of deregulation; but there are other interests which you and the Chancellor cannot ignore.

5. Over a very wide area we already effectively operate something close to self-assessment. Most smaller accounts receive only a cursory examination. Between 5% and 15% raise technical points which Inspectors have to settle. Only 1% or 2% (of companies and the self-employed respectively) are investigated in depth. The remainder are generally accepted without challenge. There is nothing wrong with this approach, so long as accounts are properly prepared and businesses are required to back them up with supporting information. The main weakness now is the widespread delay in submitting businesses accounts, with too many estimated assessments. The answer to that, as you know, lies in developing Keith Pay and File.

6. But the system does depend on the reasonable assurance given by an audit, or a review, and the support of adequate accounting information. Without that we should face worrying consequences:

(a) Inspectors would be much less able to scrutinise company accounts quickly and effectively in tax offices to select the minority needing closer examination or investigation. If DTI have their way we shall have less information and it will be less reliable.

(b) This must lead, I fear, to some loss in our cost-effectiveness and efficiency. Inspectors will have to spend more time looking at accounts, piecing information together, and raising points on them. They will find it less easy to clear the straightforward, satisfactory accounts on sight. Even with our safeguards small businesses may find themselves caught up with detailed enquiries, not because there is anything fundamentally wrong, but because the information about their profits is badly prepared or inadequately supported. That would itself run counter to deregulation. And Inspectors will have less time to concentrate on the minority of accounts where income is significantly understated.

(c) It will be more difficult to reverse the present declining trends in investigation coverage. And, without at least some form of independent review of the accounts of smaller companies, I can see the PAC urging us to raise the present 1% coverage to the 2% or 3% (currently tetering around 2%) we apply to unincorporated business. But without more Inspectors (and you know the problems there) even meeting the present targets will be difficult enough.

7. Then there is the possible effect on yield. I wish we could give you some better indication of the tax that might be at risk in going down the DTI road; but this can only be a matter of guesswork. The corporation tax from companies with a turnover of £b2 or less (and the income tax and NIC from their directors) is about £b10.

8. There is one final point on accounting requirements. Two years ago Ministers decided that the company law requirement should take account of Revenue needs. So you also decided last year not to seek separate powers for CT Pay and File. The DTI now wants to cut them further than we can safely go. To have to introduce powers for tax whilst removing them for company law (perhaps at much the same time) is pretty unappealing. Politically it could put the Chancellor in a difficult position.

9. Yet without reasonably good accounting information the move to CT Pay and File looks at first sight considerably more difficult. Certainly I think we should have to look at it again very carefully with you.

10. I apologise if these arguments are only too familiar; but I thought you might find it helpful for your meeting with Mr Maude to bring them together one more time. They do not argue against a large measure of deregulation - provided other considerations are not subordinated completely. But without some compromise, there is bound to be some cost in terms of tax and our efficient handling of business accounts. And more problems with CT Pay and File.

11. If we can be of any further help before your meeting with Mr Maude please let me know.

(A M W BATTISHILL)

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM : L J H BEIGHTON
DATE : 10 June 1988

FINANCIAL SECRETARY

STATUTORY AUDIT OF SMALL COMPANIES

1. For your meeting with Mr Francis Maude on the statutory audit and accounting arrangements for small companies you already have from Sir Anthony Wilson his minute of 3 June on the audit and of 8 June on consolidated accounts. Mr Deacon's attached note on accounting requirements completes the coverage. You will also have seen the Chancellor's comment of 9 June.

2. I hope that it might be helpful to set out the broad choices before Treasury Ministers in the following way without attempting to comment further substantively:

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Anthony Wilson
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Painter
Mr Rogers
Mr Beighton
Mr Cherry
Mr Corlett
Mr Crawley
Mr Deacon
Mr D Shaw(P2)
PS/IR

i. To challenge the DTI's latest proposals and attempt:

(a) to introduce a limited review in place of the statutory audit; and

(b) to protect the Revenue's needs on the content of accounts by sticking to the original policy set out in the 1986 White Paper which said "The Government intend to relax the rule governing the amount of information small companies are required to disclose in their accounts within the constraints of EC law and Inland Revenue needs.".

ii. To accept the latest DTI proposals but insist that for tax purposes the present requirements will need to be replaced by:

(a) a statutory modified tax audit (which in practice would be little different from, or less burdensome on companies than, the present requirement); and

(b) new statutory rules on the contents of separate tax accounts.

iii. To accept the latest DTI proposals and live with the consequences. In that event, in so far as there is a choice, it will be between:

(a) a considerable increase in Revenue resources (which are just not available in the short or medium term) to investigate small companies in order broadly to maintain the present level of compliance and yield; or

(b) accepting that for many small companies the level of compliance will fall with a consequential loss of Exchequer yield and increase in our cost/yield ratio.

LJHB

L J H BEIGHTON

4370/23/JRF

CONFIDENTIAL

FROM: R C M SATCHWELL

DATE: 6 September 1988

SIR A WILSON

MR BEIGHTON - IR

cc Mr Culpin
Mr Burr
Mr Inglis
Miss Hay
Mr Cropper
Mr Tyrie

PS/IR
Mr Shaw - IR

STATUTORY AUDIT FOR SMALL COMPANIES

The Financial Secretary yesterday discussed with you and others Mr Maude's letter of 26 August.

2. The Financial Secretary said that he did not wish to submit a joint Treasury/DTI paper to E(A). He had not yet decided whether to submit a separate Treasury paper, or merely wait and comment on the DTI's; he would do so shortly. In the meantime, it was important that we had fully prepared the arguments against the line that DTI might put forward. He specifically wanted briefing on

- audit practices in other countries and the extent to whch they rely on "independent" practitioners

- the differences in their tax compliance systems

- the basis for the previous Ministerial decision not to abolish the audit

- the counter arguments to the assertions that audit served no purpose and did little in practice

- the proposed turnover limits for abolition of the audit

You kindly agreed to put the necessary work in hand.

3. On the question of timing and implementation, the Financial Secretary said he would consider the Revenue's latest advice (in Mr Matheson's minute of 1 September) to break the link with CT Pay & File. But if he were to agree, the concession should be held back and not given prior to the E(A) meeting. The briefing would need to reflect this line.

R. C. M. S.

R C M SATCHWELL
Private Secretary

toa.jw/verge/min6

mp

1SS
160

FROM: GRAHAM VERGE
DATE: 16 SEPTEMBER 1988

1. MR BEASTALL

2. FINANCIAL SECRETARY

cc: PPS
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Anson
Mr Phillips
Mr C D Butler
Miss Peirson
Mr Willacy
Mr Gieve
Mr Shore
Mr Martin

PAC: CURRENT BUSINESS

1. The Committee will be publishing two further reports next week, both of which we have seen confidentially in draft.

2. The 39th Report, on the Government's Purchasing Initiative, will appear on Wednesday. The Treasury has the lead responsibility for this subject and the normal low-key background briefing will be supplied to the Press Office. (CUP will be circulating this, together with a fuller note on the report when the CFR is made available on Monday.) The report is critical of departments' failure to achieve savings of the order suggested in the management and personnel Office report of 1984 and of the targets agreed for 1986-87 between departments and the Central Unit on Purchasing (CUP), which in aggregate at £109m were £194m below the 5% target originally set by Ministers. It criticises the delays in setting up the CUP and considers that the Treasury should play a stronger central role. For example, in addition to sending them annual CUP reports, the Treasury should bring to Ministers' attention the short comings of individual departments. The report recommends that, in view of slow progress hitherto, targets should also be set for departments' stock reductions. The Committee is also of the view that capital receipts from disposals of land and buildings should not be counted as savings from the purchasing initiative. The report calls upon the Treasury to

ensure that departments always conduct proper investment appraisals before acquiring major capital assets. It should also seek to ensure that staff engaged on purchasing are given appropriate training and guidance, as a step towards a possible "functional specialism" for such staff.

3. On Thursday the Committee's 40th Report will be published. This looks at Estate Management in the National Health Service. The report expresses concern at current inadequacies in DHSS arrangements for surveying the condition, suitability and use of buildings. Much of the estate is in poor condition and there is a backlog of maintenance work. The Committee is also concerned that rationalisation is not being addressed more urgently in view of the very substantial savings that are to be achieved. The report welcomes the increase in proceeds from the disposal of NHS property but cautions that land sales should not be pursued simply to overcome short-term financial constraints. Problems in management of the NHS are of long standing but the report notes DHSS's assurance that in future local management would be improved by newly developed information and performance data.

Graham Verge

GRAHAM VERGE

chex.md/mw/29

CONFIDENTIAL

BF 28/9

Treasury Chambers, Parliament Street, SW
01-270 3000

PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Sir P Middleton
Mr Anson
Mr Monck
Mr Culpin
Mr Burr
Mr Inglis
Miss Hay
Mr MacPherson
Mr Cropper
Mr Tyrie

Mr Beighton - IR
Mr Shaw - IR
PS/IR
Mr Fryett - C&E
PS/C&E

PRIME MINISTER

STATUTORY AUDIT OF SMALL COMPANIES ACCOUNTS

In his minute of 19 September David Young proposes the abolition of the statutory audit for small companies. I can agree to this only if the present requirement is replaced by an obligatory compilation report, prepared by an independent, properly qualified accountant.

2. This is not the first time this issue has been raised. David Young, Paul Channon and I examined it fully in May 1986. We then concluded that the statutory audit should be retained because of its valuable role as a safeguard against fraud. The subsequent deregulation White Paper "Building Business..not Barriers" made this clear:

> "The Government have decided to retain the requirement for small companies to have their accounts audited. The consultation revealed no strong balance of opinion in favour of abolition. The Government are determined to clamp down on fraud and have decided that removal of this first defence against fraud would be inappropriate"

3. The only new factor to have emerged since then is the new EC requirements for monitoring auditors, which will be reflected in the forthcoming Companies Bill. As a result, audit standards will be tightened up and the cost of the statutory audit is likely to increase. I accept that, in these circumstances, it is right to try and find a less costly arrangement for small companies. But this in no way removes the need to involve an independent accountant in scrutinising the accounts of companies with a turnover of under £2 million, and to maintain our defences against

financial fraud. My suggestion of a compilation report signed by an independent accountant would achieve just this. It would provide a worthwhile measure of deregulation while maintaining a defence against fraud by directors of small companies. It would also help to maintain the financial credibility of the small company sector in the eyes of the public and in particular the business community which has always relied on audited accounts as evidence of the bona fides of small companies.

4. We simply cannot afford to rely on an in-house accountant's adherence to his code of professional ethics, when his livelihood depends on his doing what his directors instruct him to do. There is already concern in the profession that accountants who work in small companies are coming under pressure from their employers to act in unethical ways in relation to their duties. Removal of the obligation to have at least some independent involvement in small companies' accounting must increase such pressures further. Recent cases have served only to underline the importance of this issue.

5. We also need to recognise the risk to the Exchequer from David's proposal. The total yield of tax from small companies, including directors' PAYE and NIC, is £10 billion. The abolition of the audit will undoubtedly reduce the reliability of accounts. Every 1 per cent reduction in their reliability could result in a loss to the Exchequer of £100 million - and American experience suggests that the loss could be as high as 5 per cent overall. We can only keep this loss within reasonable bounds if we have an effective replacement.

6. It is true, as David says, that most other countries do not have a statutory audit for small companies. But this does not mean that regulation overseas is any less. Tax returns are very much more complicated; tax authorities employ more staff on investigating companies and are given greater and more intrusive

powers. For example the United States, where there is no statutory audit, undertakes twice as many tax audits of companies using twice as many staff - and their tax return is between 5 and 10 times as long. Even if we wanted to shift some of the private sector auditing effort on to the Inland Revenue in this way, we would not be able to find the extra Civil Servants we would need.

7. In short, provided we replace the statutory audit for small companies with a compilation report signed by an independent professional accountant, I can agree with David that the limit should be set as high as the EC directive allows, ie £2 million, which would benefit 95 per cent of all companies.

8. I am copying this note to David Young and Norman Fowler, to other E(A) members and to Sir Robin Butler.

Moira Wallace

pp N.L.

23 September 1988

Approved by the Chancellor and signed in his absence

chex.dg/docs/22.9.2

CONFIDENTIAL

FROM: P J CROPPER
DATE: 22 September 1988

CHANCELLOR

Ch/ I have scribbled on the Wilson draft, but if you want a clean copy there is one at flap.

Cc: FST
Sir A Wilson
Mr Tyrie

Mr Beighton

STATUTORY AUDIT FOR SMALL COMPANIES

Sir Anthony Wilson's draft looks fine. I would slightly amend paragraph 6 and say:

> "6. We also need to recognise the risk to the Exchequer from David's proposal. The total yield of tax from small companies, including directors' PAYE and NIC, is £10 billion. The abolition of the audit will undoubtedly reduce the reliability of accounts. Every 1% reduction in their reliability might result in a loss to the Exchequer of £100 million - and American experience suggests that the loss could be as high as 5% overall. We can only keep this loss within reasonable bounds if we have an effective replacement."

P J CROPPER

FROM: F MARTIN
DATE: 19 September 1988

1. MR ANSON
2. PAYMASTER GENERAL

cc Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Dame Anne Mueller
Mr G H Phillips
Mr Willacy o/r
Mr C D Butler
Mr Beastall
Mr C W Kelly
Mr F K Jones
Mr G Jordan
Mr Gieve
CUP/A/15

PAC 39th REPORT - THE GOVERNMENT'S PURCHASING INITIATIVE

This report will be published at noon on Wednesday 21 September; a copy of the CFR is attached (top only).

2. The report follows the Committee's examination of progress with the initiative launched following the 1984 "Government Purchasing" report. It is somewhat critical of progress, though the criticism is in comparatively mild terms and may be helpful in stimulating action by departments. In the summary of conclusions and recommendations the Committee:

(i) expresses concern about the delay in setting up the Central Unit on Purchasing (CUP), and that departments' targets for value for money improvements in 1986-87 fell short of the aggregate target of 5 per cent set by Ministers;

(ii) suggests that the Treasury and CUP "should have played a stronger co-ordinating role", imposing a "fair share" of the aggregate target on each department; that

the Treasury should bring to the attenion of relevant departmental Ministers any "failures" to set and achieve "realistic" targets in the period up to April 1989; and that targets beyond that date should be set;

(iii) records its view that receipts from the disposal of surplus land and buildings should not be counted as savings from the purchasing initiative;

(iv) urges faster progress in reducing stockholdings, recommending the setting of "firm overall targets";

(v) recommends that the Treasury should remind departments of the importance of investment appraisal for major capital assets, and to take steps to ensure that such appraisals are done;

(vi) emphasises the importance of training, and of written guidance to departments to assist improved purchasing practice, together with the Committee's view that the purchasing and supply function "should have equal status in departments with their mainstream activities"; and

(vii) expresses concern that the question of a functional specialism for purchasing and supply staff remains unresolved, urging the Treasury to "develop quickly appropriate structures".

3. The latter is a reference to the recommendation in "Government Purchasing" (recommendation 15) "that the Cabinet Office (MPO) in consultation with departments develops a functional specialism for purchasing and supply". Following a study commissioned by CUP and completed in January 1988, together with initial consultations (jointly by CUP and Personnel Management and Recruitment division) with major spending departments, proposals were put to departments' Principal Establishment Officers (PEOs) on

1 September. Departments have agreed that intensified training, career development and management arrangements are required for purchasing staff. An interdepartmental working group is being established to make detailed proposals on how a "functional specialism" (or equivalent, informal arrangements) might be organised for these purposes. The working group is to present interim proposals to the early November meeting of PEOs, which will give time for the Treasury Minute response (which will be required by 30 November) to be finalised.

4. We are also preparing a reply to the other conclusions and recommendations, and will submit the Treasury Minute to Ministers early in November. In part this will draw on work for CUP's 1988 report to Ministers, which is currently being finalised and will focus on departments' progress in 1987-88 towards the 5 per cent target. For 1987-88 departments have reported value for money improvements of the order of £250 million, just over 4 per cent of relevant expenditure; their targets for 1988-89 are for improvements totalling 5 per cent of relevant expenditure.

5. A short factual brief is attached for IDT's use.

F. Martin

F MARTIN

The PAC report is no more critical than might have been expected, given the delay by departments in reaching the 5% target. On point (ii) above, Ministers made it clear, at the No10 meeting in 1984, that the Unit should be limited to an advisory and "catalytic" role.

On point (v), a reminder to departments about appraisal will need to be linked with the outcome of the discount rate review. This is another reason why we need to bring that review to an early conclusion — but that is of course desirable in any event.

JA

BRIEFING

PAC REPORT - THE GOVERNMENT'S PURCHASING INITIATIVE

(House of Commons paper 464, published noon Wednesday 21 September: CFRs 2.30 pm Monday 19 September.)

Factual

(i) The PAC report comments on progress with the initiative launched following the report by the former Management and Personnel Office, "Government Purchasing", published December 1984 (HMSO, ISBN 011 430002 X). The 29 recommendations in "Government Purchasing" addressed non-warlike purchasing.

(ii) PAC took evidence from Treasury and CUP officials (Mr Anson and Mr Willacy) on 27 April. Minutes of evidence published as House of Commons paper 469-i, which also contains the C&AG's memorandum to the PAC. [Note: the small amount of press coverage of the evidence session focussed on the question of receipts from surplus land and buildings - see below.]

(iii) As part of the initiative, Ministers agreed that departments should set targets for value for money improvements in their purchasing totalling £400 million, 5 per cent of the figure for annual non-warlike purchasing expenditure estimated in "Government Purchasing" (see paragraph 6 of C&AG memorandum).

(iv) Ministers also agreed that CUP should be set up to monitor progress on these targets and to advise departments on how to improve their purchasing performance.

(v) CUP reported on progress towards this target in its report to the Prime Minister, published in November 1987 (HMSO, ISBN 0 11 56001 0).

(vi) Departments reported total value for money improvements in 1986-87 of £168 million, only 2.8 per cent of their total purchasing expenditure but exceeding their target for the year (which was £109 million, see paragraphs 2 and 3 of the 1987 CUP report).

(vii) CUP report on progress with the initiative in 1987-88 currently being prepared.

Line to take

(i) As usual, Government will respond formally to PAC report in due course: cannot anticipate response. And no comment on references to individual departments in the PAC report;

(ii) on treatment of receipts from surplus land and buildings (see paragraphs 8 and 2(vi) of PAC report) refer to Mr Anson's response to question 3849 in minutes of evidence;

(iii) Suggest C&AG memorandum worth a look:

(a) paragraph 10 explains reasons for delay in setting up CUP;

(b) paragraph 33(g) (see also paragraph 21) records the NAO's view that, "Except for the provision of written guidance on good purchasing practices ... the CUP has made satisfactory progress on the tasks assigned to it". (See paragraph 22 of the memorandum on written guidance.);

(c) and paragraph 34 records, "In the NAO's view, it seems evident from the CUP reports that departments have made material progress towards achieving the value for money improvements envisaged following the MPO report on Government Purchasing ... the value for money improvements are indicative of an increased drive and energy in departments' purchasing organisations ..."

Contact: F Martin, 270 6468; 995 4307.

Thursday September 22 1988

THE TIMES

MPs are critical of Whitehall effort to meet savings target

By Philip Webster, Chief Political Correspondent

Whitehall departments including the Treasury were strongly criticized by MPs yesterday for failing to make adequate savings in the purchase of goods and equipment.

Faced with a demand from ministers to make value-for-money savings of 5 per cent in their procurement spending, departments collectively set targets which were £194 million below that figure for 1987 and failed by £135 million to reach it.

The all-party Public Accounts Committee voiced concern at the failure to meet the savings target, fixed by the Government's so called "purchasing initiative" and designed to introduce a more professional approach within Whitehall to the buying of non-military goods and services.

It criticized the Treasury and the Central Unit on Purchasing, set up to oversee the savings drive and to report to the Prime Minister, for failing to play a stronger co-ordinating role. It said that departments needed a "stronger lead from the centre".

It singled out for particular criticism the Government's two largest purchasing departments, the Property Services Agency and the Department of Transport, which account for 54 per cent of procurement expenditure but which achieved savings of only 1.2 per cent and 1.9 per cent respectively. Criticizing the "poor professionalism" of the purchasing and supply arrangements within departments, the committee attacked the inadequate attention of senior management to the "basic functional activities" of their departments, called for proper professional training for purchasing staff, and told the Treasury to report to ministers if departments failed to set realistic targets or failed to achieve them by big margins.

When the initiative was launched in 1984 the management and personnel office (MPO) of the Treasury said that more professional practices could eventually bring savings of between 5 and 20 per cent in departments' expenditure on procurement.

At that time, ministers opted for a target of £400 million a year, equivalent to 5 per cent of annual spending.

The committee said yesterday that while the 20 per cent target might be optimistic, the Central Unit on Purchasing should establish a "demanding though realistic" target for savings beyond April 1989.

The MPO in 1984 had concluded that government-purchasing organizations compared badly with those in the private sector, who were more active, better informed and better motivated. Noting that the Treasury had been unable to say when fully professional supply arrangements would be in place in all Whitehall departments, the committee recommended that it agree firm timetables with each department

Only 40 of the 8,000 purchasing and supply staff employed by government departments are members of the Institute of Procurement and Supply.

The committee said: "The achievement of a more professional purchasing and supply organization is dependent upon purchasing and supply staff acquiring professional expertise. We emphasize the importance of proper training for purchasing and supply staff, and the need to issue formal written guidance so that improved practices are quickly established

"The Treasury were unwilling to put a figure on the additional cost of procurement and supply to the taxpayer from the failure of departments in the 1970s to adopt the best private sector practices.

"On the basis of the current 5 per cent savings target it is likely in our view to have been considerable."

Committee of Public Accounts: The Government's Purchasing Initiative (Stationery Office; £5.70).