VFM audits for private sector?

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Abstract
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Legislation is long overdue: recent public sector developments could apply to a wide variety of profit and non-profit organisations in the private sector

by John Glynn

Two previous articles on the theme of value for money (VFM) auditing (ACCOUNTANCY, December 1982, pp 129-130, and March 1983, pp 135-136) discussed the move towards expanding the traditional role of the public sector auditor away from a straightforward examination of the financial statements of an organisation. Since then, of course, there have been two important developments.

First, in England and Wales, the Audit Commission for Local Authorities came into being on 1 April 1983. While most local authority audit appointments at present remain with the District Audit Service, it is intended that future appointments will increase the share of the private sector accountability firms. This transfer of work to the private sector reflects the Commission's organisational structure and operating style, which is designed to encourage a sense of partnership between the District Audit Service and private sector firms, accountants and consultants, the Commission and local authorities.

The Commission will be buying in services, rather than providing them internally. It regards VFM auditing as being particularly important.

Second, the National Audit Act 1983 came into force on 1 January 1984. Part I of the Act provides: (i) that the C & AG shall now be an officer of the House of Commons (previously, he was an officer under the Crown); and (ii) that a body known as the Public Accounts Commission be established to oversee the provisions of this Act.

Part II of the Act is devoted to economy, efficiency and effectiveness examinations. At the Government's insistence, Sch 4 of the Act specifically excludes more than 20 nationalised industries and other public bodies from these provisions.

The view of the Public Accounts Committee in their special report (Session 1980-81) was that the present arrangements for the financial audit of the nationalised industries and other public corporations, including the NEB and BNOC should continue, but that the C & AG should have access to the books and records of these bodies to enable him to report to the House of Commons. By virtue of the National Audit Act 1983, more emphasis on VFM auditing is expected.

The essential reason for audit is accountability, and these changes in the public sector offer the potential for encouraging better accountability and for obtaining better value for money at all levels of government. In local authorities, those receiving such reports obtain better information about improved local authority administration; improved cost-effectiveness in operations and increased accountability within the system. A number of government agencies, CIPFA and international firms of chartered accountants and management consultants are devoting considerable resources to developing the techniques and training needed to support the VFM audit philosophy.

The concept of using audit to assess and help improve value for money is not unique to Britain: similar developments have also taken place in many other countries. As time passes, standardised approaches and techniques can be developed which should lead to a commensurate reduction in development costs and time. Even though much remains to be done, the public sector to achieve the full potential of VFM auditing, it must surely now be time to consider its adoption in the private sector.

The arguments previously presented in favour of VFM auditing are equally applicable to private sector non-profit-making organisations. Those who provide funds for example, to charitable institutions, need to be assured on two points: (i) that there are no financial irregularities, and (ii) that the funds collected have been spent efficiently and on effective programmes. While there is no requirement under the Charities Act 1960, many charities are either subject to other legislation or write a financial audit requirement into their constitution.

In 1981, Bird and Morgan-Jones (FINANCIAL REPORTING for Charities, ICAEW 1981) completed a major research project which highlighted the variable standard of financial reporting by British charities. Smaller organisations should perhaps be subject to what might be termed an 'overview' VFM audit, while larger organisations should have a small selection of their activities examined in detail.

Bird and Morgan-Jones warned (p 213): 'Charities are complicated organisations, with difficult accounting and auditing problems which can be adequately dealt with by novice staff in an odd spare hour.' A practising accountant should not accept a charity audit on a non-commercial fee basis unless he is prepared to put into that audit the time and skill which its problems deserve.

For profit-making organisations in the private sector, the arguments in favour of VFM audits may also be applicable. In addition to the debate about the desirability of removing the full audit requirements from small companies, some commentators would also question the value of service that the external auditor provides to shareholders of large companies.

Brinton and Perks ('The external auditor - his role and cost to society', ACCOUNTANCY, November 1977, pp 48-52) stated (p 48): '... the information given ...'
The VFM auditor would wish to see that managers manage; that they monitor their own and subordinates performance, that they periodically review their operations and, if necessary, initiate actions that increase efficiency and curtail operations that do not contribute to the long-term profitability of the firm.

For reasons of independence, VFM auditing should be the prerogative of the external auditor. However, much valuable assistance can be offered by the company's own internal audit department. Internal audit has an important role to play in monitoring the functional efficiency of the company's internal control systems.

The approach followed by the internal audit department is usually termed 'operational audit', and is concerned with both the financial and non-financial systems of internal control. It is therefore, as with management statutory audit, the external auditor's first priority to examine the effectiveness of the internal audit department's operations. This then enables the VFM auditor to determine the extent of his own tests and examinations.

In many ways, the tasks performed by commercial companies are easier to determine than those performed by public sector organizations. If objectives are not clearly defined, and goals/sub-goals determined, the VFM auditor should say so.

While in the public sector it may not always be possible to relate efficiency directly with effectiveness, such problems are less likely to arise in the private sector. In the commercial environment, many measures (productivity, sales volume and so on) are readily available. Very often in the public sector, proxy measures have to be developed. For example, in the NHS, one might be able to use indirect measures, such as the population served, or the number of times that a service is taken up.

The development of the operational audit led to the management audit approach, though some writers tend to use these terms synonymously. In 1969, a Companies Bill was introduced into the House of Commons as a private members' Bill. One of its main provisions was to give power to shareholders to require the directors of a company to allow a management audit. S 6(1) of the Bill defined a management audit as: "... an enquiry into the advisability of any of the policies of the directors in furthering the objectives of the company as defined in the memorandum, or into the efficiency with which they are securing the execution of those policies."

More recently, Sherer and Kent ('Auditing and Accountability', Pitman, 1983) have defined a management audit as (p 114): "... an independent review and investigation which is concerned with the identification of those functional and operational areas where management has failed to achieve the required external standards. As with the evaluation of management decisions with the aim of monitoring and improving the total efficiency and effectiveness of the organisation.'

More often than not, those management audits that have been carried out have been on an ad hoc basis. For example, in 1982 a firm of accountants were appointed to investigate the continued stability of the Northern Ireland motor company, De Lorean.

The value of a VFM audit over a management audit is twofold: (i) it is carried out on an annual basis, so that, over time, all aspects of the company are reviewed; and (ii) it is a more systematic and comprehensive approach that can easily be combined with the statutory audit.

This extended role really incorporates four aspects, which can be drawn together by the acronym CARE (first invented by the New Zealand Audit Office – it summarises the comprehensiveness of the audit function).

C: Control – the evaluation of management controls over the resources for which it is responsible.
A: Attest and Authority – the expression of an opinion on financial statements and the verification of the authority for material and financial transactions.
R: Reporting – to management and shareholders on matters arising from audits.
E: Effectiveness and Efficiency – the giving of an opinion on whether the audited entity has applied its resources in an effective and efficient manner consistent with the objectives of the company as defined in the memorandum.

This approach is comprehensive, comprising an annual examination of financial statements, together with an annual examination of some operational aspects of the company, with a view to giving an opinion on value for money and management controls generally. As previously suggested, the VFM audit team, though headed by an accountant, would be multidisciplinary.

### Time for action

Recent changes in legislation have provided the framework within which VFM auditing is to operate in the public sector, but similar legislation is long overdue for private sector companies. It is now 14 years since reforms were last proposed. The present statutory compliance audit does not adequately meet the needs of shareholders, who also need to know that managers perform their tasks efficiently on activities that contribute to the effective attainment of the company's objective(s).

Both management and shareholders will benefit if the auditor's responsibilities are extended, yet there are many practical problems which may well mean that at present the external auditor would be unwilling to undertake this work for private sector clients.

One such difficulty relates to fees. In the present economic climate, there are constant pressures from clients for the auditor to maintain the existing scale of charges, and in some cases even reduce charges. Management would therefore need to be persuaded of the longer-term benefits that might accrue from undertaking such exercises.

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