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The external auditor's role in regulation

An insight into the advisory activity of the National Audit Office of the United Kingdom

TThere has been considerable growth in recent years of government regulations over a whole range of activities and businesses. Regulation is a product of the way in which society perceives and responds to risk. In devising regulations, there must be a proper consideration of where the risks lie and how to balance the need for protection against the need to foster a society where people accept and share responsibility for managing life's risks. Good, effective regulation requires proper risk analysis, a thorough assessment of cost versus benefits and an independent approach – all skills that can be well deployed by the external auditor. In the UK, the National

Audit Office has been working with the Better Regulation Commission to reduce regulatory burdens without endangering regulatory outcomes. The Better Regulation Commission (www.brc.gov.uk) is an independent body which is responsible for advising and challenging the Government on regulatory reform, and scrutinising the Government's plans for regulatory simplification. Its focus on reducing burdens has the benefit of releasing resources for higher value activities, increasing voluntary compliance and improving legitimacy. This paper concludes that regulatory reform is an important issue for Supreme Audit Institutions.

Supreme Audit Institutions (SAIs) have increasingly supplemented a core focus on the financial statements of government entities with an interest in auditing performance, value for money and policy effectiveness. Performance audit has a broader focus than the audit of financial statements, and can encompass not only the classic tax-and-spend role of the state, but also its regulatory functions. This paper sets out the background to the audit of regulation, and then describes the work of the UK's National Audit Office on what has come to be known as the Better Regulation agenda.

There has been a considerable growth in recent years of government over a whole range of activities and businesses. The main driver of this growth has been risk, since regulation is a product of the way in which society perceives and responds to risk. Three risks in particular have underlain the growth in regulation:

❶ **THE RISK OF MARKET ABUSE BY DOMINANT COMPANIES.** As countries have privatised formerly state-owned enterprises, they have often tended to transfer public monopolies to the private sector. Realising that private sector monopolies may have a greater incentive to charge

excessive prices, countries have sought to create independent regulators to constrain this form of abuse. In the UK, for example, the privatisation of water companies as a series of regional monopolies was accompanied by the creation of Ofwat¹ as water regulator, with responsibility for controlling the price and quality of service offered by private sector water companies. Auditing the work of such regulators has been the subject of discussion in, and Guidelines from, the International Organisation of Supreme Audit Institutions (INTOSAI) Working Group on the Audit of Privatisation.²

② **THE RISK OF WIDER MARKET FAILURE.**

Economists and policy makers have recognised that, while markets may be efficient in the technical sense of matching resources to demand, they may ignore or even create wider external problems (known as 'externalities'). Such externalities arise typically in the environmental sector (where an efficient market may nevertheless degrade some element of the environment, such as air quality) or the employment market (where an efficient market may not protect workers against some risks, such as discrimination on the basis of ethnicity or gender). The typical policy response is to create regulations and regulators designed to prevent and prohibit the market failure.

③ **THE RISK OF UNCOMPETITIVE BEHAVIOUR.**

Even competitive markets can from time to time suffer a tendency to relapse into anticompetitive arrangements. This can often manifest itself as the creation of cartels or other restrictions that harm consumers because they deny them the benefits of a choice between competing suppliers. In the UK, for example a recent case identified price-fixing between manufacturers and retailers of the England football shirt. After the UK's competition regulator, the Office of Fair Trading (OFT), intervened to break the price fixing agreement, prices of England shirts fell by around 35 per cent.³

While each individual regulatory response

may be justified in the light of some defined risk, the cumulative effect can be pernicious. This is because an overly protective regime, which seeks to minimise and remove any residual risk to consumers, employees and citizens, can reduce the incentive on individuals to manage their own interests. In devising regulations, therefore, there must be a proper consideration of where the risks lie; and of how to balance the need for protection against the need to foster a society where people accept and share responsibility for managing life's risks.

Government have also found that it is generally easier to create regulations – in response to some newly perceived risk – than it is to remove them. There are several factors behind this inertia, or what is often called regulatory creep:

■ *Vested interests* – there is a complex and equivocal relationship between business/government and regulation. There are many who benefit from regulatory regimes. For example, in the UK, the Financial Services Authority (FSA)⁴ has been criticised for several years for imposing too-stringent requirements on investment banks operating in the City of London. When the FSA recently announced its plan to remove training requirements however, most banks complained that they in fact valued these requirements since the common basis they provided made it easier to recruit staff with well-understood credentials.

■ *Zero tolerance* – the desire for a proportionate and risk based approach to regulation runs up against the public demand for zero tolerance. To take another UK-based example: in 2004 a group of illegal immigrant workers drowned while collecting shellfish in coastal waters. The ensuing public concern about the protection of such workers led to the creation of a new agency, the Gangmaster Licensing Authority, which has issued new regulations about the supply of workers to agricultural enterprises.⁵

■ *Regulation as source of comfort* – there is an enjoyment of the reassurance that detailed reg-

ulation provides. This was described beautifully by the Chair of the UK's Better Regulation Commission, *Rick Haythornthwaite*, when he compared society's guilty attachment to regulation to an adult's continuing love for a teddy bear that he or she knows is a vestige of childhood.⁶ We do not want to admit our love for regulation, Mr Haythornthwaite argues, and we must first recognise it before we can start to wean ourselves off it.

THE ROLE OF THE AUDITOR

What then is the role of the Supreme Audit Institution in this regulatory debate? An SAI needs to evaluate the effectiveness of cross-cutting Government agendas, including Better Regulation and public sector reform. On reform, the auditor is well placed to provide independent challenge to government initiatives to improve efficiency. For example, the UK Government is aiming to secure £21.5 billion of ongoing efficiencies and headcount reductions of more than 80,000 by 2008. Each government department has been set a public target to deliver. Efficiencies are being targeted across a wide range of activities, from better procurement to more cost-effective funding and regulation of public bodies.

The UK National Audit Office is contributing to the efficiency programme in two ways. First, the NAO assesses the robustness of efficiency savings reported to date. In its February 2006 report, *Progress in improving government efficiency*⁷, the NAO outlined good practice principles departments should follow to demonstrate the validity of reported savings. Savings should only be claimed if they are supported by credible baseline data, methodologies which include monitoring of service quality, and adequate data assurance processes.

More widely, through its work on the value for money of the UK public sector, the NAO

provides guidance to departments on where efficiencies could be secured. NAO reports, on topics ranging from the operation of the criminal justice system to the running of major defence procurement projects, analyse performance of government departments and recommend where improvements could be made.

The benefits of the external auditor scrutinising existing operations can similarly be seen in the context of regulation. It is clear that good, effective regulation requires proper risk analysis, a thorough assessment of cost versus benefits and an independent approach. These are all skills that can be exemplified in, and well deployed by, the external auditor.

In the UK, the NAO has been working with the Better Regulation Commission.⁸ Better Regulation is concerned with improving the way government as a whole regulates business, voluntary organisations and the public sector itself. It sees poorly designed regulation as burdensome and costly, and aims to improve productivity by releasing resources from regulatory functions in companies, so that they can focus more on their core activities. The Better Regulation Task Force's report *Less is More* estimated that reducing unnecessary regulatory burdens could produce "potentially greater than a 1 per cent improvement in GDP".⁹

The main tools of Better Regulation have been:

- Regulatory Impact Assessments, which seek to ensure that the flow of new regulation is properly evaluated and assessed;
- Administrative Burden Reduction, which seeks to address the stock of existing regulation by reducing unnecessary information requests made on companies and voluntary organisations;
- A review of inspection and enforcement, known as the Hampton Review, leading to recommendations for consolidation of the existing "fragmented" regulatory structure into a more streamlined system of thematic bodies.¹⁰

In response to the challenges of our age, the UK National Audit Office (NAO), one of the world's leading financial audit organisations, contributes to the operational efficiency of the public sector not only through its regularity audits, but also through the provision of economic evaluations and advice. The strategy of the State Audit Office of Hungary (SAO) – presented below – reflects a similar approach and aims.

The British partner institution supported the SAO's institution development project complying with the European standards within the framework of a twinning partnership program funded from EU sources. As a continuation of this program, a strategic partnership was launched between the two organisations pursuant to an agreement signed in 2001, which has since been renewed several times. This partnership primarily implies continuous professional and methodological cooperation, within the framework of which NAO will assist the SAO audits to be performed in relation to the modernisation of the Hungarian

public administration system, and will also be involved in the joint research project of Corvinus University of Budapest and the Institute of Development and Methodology at the State Audit Office on public finances as a specific factor of competitiveness. Furthermore, cooperation manifests itself in agreed actions at INTOSAI events, and in joint actions for the modernisation of other supreme audit institutions. *Sir John Bourn*, Comptroller and Auditor General of the United Kingdom and *Árpád Kovács*, president of the State Audit Office of Hungary have already agreed to renew the relevant agreement, which will expire in the middle of 2007.

The advisory activity to the National Assembly and Government of Hungary – which is lively described by the basic principle of NAO “helping the nation spend wisely” – corresponds to the INTOSAI recommendations just like the mission and vision of the State Audit Office of Hungary that serve as an arranging principle for the SAO's strategy.

The NAO has reported extensively on Regulatory Impact Assessments (RIAs).¹¹ RIAs are intended to consider the costs and benefits of new regulations and legislation. They include formal competition tests and are intended to assess whether the benefits of a proposed regulation outweigh the costs. The good RIA will challenge the case for command-and-control regulation and always consider alternatives, including voluntary codes and Doing Nothing – though our reports found that the consideration of costs and benefits rarely in practice undertake this analysis. In fact, the NAO has identified three types of approach to the RIA within government departments:

- Pro-Forma RIAs, which are started late, have little analysis and have little influence on regulation;

- Informative RIAs, which are technically competent and communicate the decisions well, but do not really influence them; and

- Integrated RIAs, which are started early, well-resourced, robust and influence decision making.

The NAO will also report on the UK government's Administrative Burden Reduction programme. This programme, which adopts the Standard Cost approach first introduced in the Netherlands, involves an extensive cross-Government measurement programme to establish a baseline estimate of the total cost of administrative obligations under UK law and regulations. Government departments will then be expected to deliver cuts against the baseline. While it is important that the NAO examines the content of the baseline and departmental

actions to reduce it, we will devote most of our efforts to evaluating the outcomes of this programme. We will consider whether it really is achieving the improved business environment that it is expected to deliver.

On the consolidation of the regulatory structure, the NAO is currently undertaking a study entitled “Improving Public Sector mergers”. The target audience for this report will be those responsible for designing and carrying out future mergers of regulators. By focusing on the experience of a largely successful and complete merger (the creation of the communications regulator, Ofcom, in 2003-04, from the combination of 5 separate broadcasting and telecoms regulators), the NAO will identify the key success factors in delivering this kind of change and how the cost-benefit framework underlying a merger decision can be tracked.

The aim of this work has been to identify ways of reducing regulatory burdens without endangering regulatory outcomes. By 'outcomes' we mean the array of benefits that individuals and society as a whole derive from regulations.

It is important to emphasise that this is not simply a crude “cutting red tape” objective. Indeed, less burdensome and detailed regulation may actually be “better” regulation. Why? Firstly, a lower level of administrative burden and inspection may well release resources to higher value activities. This is true not only for businesses, who can concentrate on more productive things, but also for regulators and government, who may need to spend less time processing information returns from, and undertaking routine inspections into, regulated industries. The experience of the UK's new Pension Regulator is perhaps starting to bear this out, with an approach far more focused on meaningful risks to pension scheme members and less on trivial breaches of pension legislation.¹²

Secondly, one of the big disincentives to individuals and businesses to complying is the

cost imposed; the burden taken on by complying. By lowering the burden, we may actually increase voluntary compliance – and hence secure better outcomes.

Thirdly, a less burdensome regulatory regime more focused on where the risks lie might in fact increase its legitimacy in the eyes of the regulated. The UK Maritime and Coastguard Agency, which inspects all UK-flagged ships, provides a fantastic example of this. Over the last 5 years, in response to an NAO report, the Agency has focused more of its work where there is the greatest risk.¹³ This more intelligent regulatory regime has made the Agency more business-like and helped to attract more merchant ships to the UK flag – the number of registered vessels has increased dramatically, from 379 in 1999 to 600 in 2005, reversing a long-term decline due to world-wide competition and the costs of meeting UK maritime legislation requirements.

CLOSING REMARKS

This paper has set out some general analysis of the growth of regulation in modern, liberal societies. It has also explained the role taken by the UK's National Audit Office in helping the UK government improve the effectiveness of regulation in the UK. The NAO's work on regulation is not merely of local UK interest, but of general importance across the SAI community.

This is because there is a growing demand for regulation in many societies, on the one hand, and increasingly powerful critiques of regulation on the other. It is therefore an issue on which societies might legitimately expect an SAI to contribute; and one on which SAIs, with their independence, technical rigour, and risk-based approach, are perhaps uniquely qualified to comment.

NOTES

- ¹ Ofwat's full name is the Office of Water Services. It is responsible for ensuring that licensed water companies fulfil their duties and meet the needs of consumers of water. It sets both prices and quality of service targets for licensed water companies.
- ² The full title of these Guidelines is Guidelines on Best Practice for the Audit of Economic Regulation. They can be found at <http://www.nao.org.uk/intosai/wgap/ecregguidelines.htm>
- ³ This case, and the Office of Fair Trading's work enforcing the Competition Act more generally, has been covered more extensively by the National Audit Office's report *Enforcing Competition in Markets*, HC 593, 2005–06.
- ⁴ The Financial Services Authority regulates the financial services industry in the UK. It covers both wholesale and retail financial services and has a wide range of rule-making, investigatory and enforcement powers. Its overall aim is to promote efficient, orderly and fair markets and to help retail consumers achieve a fair deal.
- ⁵ The Gangmasters (Licensing) Act 2004 provided for the establishment of a licensing scheme and the creation of a register for gangmasters operating in agriculture, horticulture and shellfish gathering together with the initial processing and packing of agricultural and fish produce. The Act received Royal assent on 8 July 2004. The Gangmasters Licensing Authority (GLA) was established on 1 April 2005 and will introduce the detailed licensing arrangements. It is anticipated that the GLA will start issuing licenses in Spring 2006 with the principal offences established by the Act coming into force during in Autumn 2006.
- ⁶ Rick Haythornthwaite, Britain's secret shame: we just love red tape, *Financial Times*, 9 February 2006
- ⁷ The NAO's first report on the Government's efficiency programme, *Progress in improving govern-*
- ment efficiency*, can be found on the efficiency pages of the NAO website alongside other NAO material relevant to public sector efficiency. The pages can be found at www.nao.org.uk/efficiency
- ⁸ The Better Regulation Commission is an independent advisory body. It provides independent advice to government, from the perspective of business and other external stakeholders, about new regulatory proposals and about the Government's overall regulatory performance. The Commission continues the challenge role carried out by the Better Regulation Task Force, as well as taking on new responsibilities following the announcements in Budget 2005, including vetting departmental plans for simplification and administrative burden reduction. It replaced the Better Regulation Task Force which had a similar remit. Its reports are available on its website at www.brc.gov.uk.
- ⁹ Better Regulation Task Force, *Less is More, A BRTF Report to the Prime Minister*, page 3
- ¹⁰ *Reducing administrative burdens: effective inspection and enforcement*, Philip Hampton, March 2005. Philip Hampton is Chairman of Sainsbury's plc, the leading supermarket group.
- ¹¹ The NAO has published two annual evaluations of the quality of regulatory impact assessments, in 2004 and 2005. *Evaluation of Regulatory Impact Assessments Compendium Report 2004–05* (HC 341 2004–2005); and *Evaluation of Regulatory Impact Assessments Compendium Report 2003–04* (HC 358 2003–2004)
- ¹² The Pension Regulator was established by the Pension Act 2005, partly in response to the recommendations of an NAO report on its predecessor, the Occupational Pensions Regulatory Authority (*Opra: Tackling the risks to pension scheme members*, HC 1262 2001–2002).
- ¹³ *Dealing with pollution from ships*, HC 879 2001–2002