



The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

MEETING OF THE COMMISSION

Thursday 10 December 2015

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MEETING OF THE COMMISSION

3rd Meeting 2015, Session 4

CONVENER

*Colin Beattie (Midlothian North and Musselburgh) (SNP)

DEPUTY CONVENER

*John Pentland (Motherwell and Wishaw) (Lab)

COMMITTEE MEMBERS

*Alex Johnstone (North East Scotland) (Con)

*Angus MacDonald (Falkirk East) (SNP)

Paul Martin (Glasgow Provan) (Lab)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Russell Frith (Audit Scotland)

Caroline Gardner (Auditor General for Scotland)

Ian Leitch (Audit Scotland)

Diane McGiffen (Audit Scotland)

CLERK TO THE COMMITTEE

Alison Wilson

LOCATION

The Robert Burns Room (CR1)

Scottish Parliament

Meeting of the Commission

Thursday 10 December 2015

[The Convener opened the meeting at 10:01]

Decision on Taking Business in Private

The Convener (Colin Beattie): Good morning everyone and welcome to the third meeting in 2015 of the Scottish Commission for Public Audit. I remind everybody to ensure that their mobile phones and electronic devices are switched off.

Agenda item 1 is for the commission to decide whether to take in private item 3 today and consideration at future meetings of our draft report on Audit Scotland's budget report. Are members content to do so?

Members *indicated agreement.*

Audit Scotland Budget Proposal 2016/17

10:01

The Convener: Item 2 is Audit's Scotland's budget proposal for 2016-17. I welcome to the meeting from Audit Scotland, Ian Leitch, the board chair; Caroline Gardner, Auditor General for Scotland; Russell Frith, assistant auditor general; and Diane McGiffen, chief operating officer. I am not sure whether Ian Leitch or Caroline Gardner would like to make an opening statement.

Ian Leitch (Audit Scotland): Thank you for the invitation to come along. This is the first time that I have appeared before the commission. I take the opportunity to thank my predecessor, John Maclean, for the sterling work that he did on the board of Audit Scotland, and I hope to follow his very good example.

You have our budget proposal for 2016-17 and you will see that we intend to deliver real cost reductions in audit fees while maintaining the quality of our work. We have frozen the 2015-16 audit fees in cash terms and we anticipate being able to achieve further average real-terms reductions for the 2016-17 audit year. That continues a period of fee and cost reductions of over 20 per cent in real terms over the past four financial years.

I turn briefly to the fee strategy, which is a matter in which the commission has taken a considerable interest, as has the Audit Scotland board. We have indicated in the fee strategy paper that you have before you today that the board has been considering various options in relation to Audit Scotland's review of fees. Over the past year, Audit Scotland has been reviewing its funding and fee arrangements to ensure that they are fit for purpose. We are going to do more work on that to refine it because there have been imbalances in the sectors. That is something that has been exercising the mind of the board, so we want to look at the issue and make further proposals, subject of course to consultation with our audit clients. Plainly, we will have to get their views on how matters should proceed. We hope that any changes would be implemented for the 2016-17 audit.

Before I ask Caroline Gardner in her capacity as the accountable officer to make an opening comment on the budget, I should say that, as you will see from our paper on the budget, we have now moved to new offices. We have closed two expensive and rather inefficiently operated offices in George Street and moved to West Port, and we anticipate savings of £2 million over 10 years as a result of the move. It has allowed us to be more

efficient in the use of technology and much more efficient in using the open plan areas in that office. It has created a cultural shift in the organisation and we intend to have a formal opening shortly—we do not have a date for that yet. We will extend an invitation to the convener and the commission members to come along and see the new method of operation in the new offices.

I will now invite the accountable officer to comment.

Caroline Gardner (Auditor General for Scotland): The budget for 2016-17 has been prepared in the context of some significant uncertainties, including the outcome of the United Kingdom spending review and its impact on the Scottish budget; the amount of work that we will need to do to provide support to Parliament in relation to the new financial powers that are coming into effect; and the outcome of the audit procurement exercise, which is under way.

We know that we are on the brink of further constitutional change in Scotland, which will involve the most significant change in the financial powers that are devolved to Scotland since the creation of the Parliament. Through our work, we are determined to support the Parliament in managing and making the best use of those new powers. The change to the volume of our audit work will be known once the wider framework for the new financial powers is established. However, this budget includes the starting point for us to resource that work in the longer term.

To allow us to plan for the audit implications of further devolution and new financial powers for the Scottish Parliament, we have added £100,000 to our resource request this time and we are happy to talk you through how we intend to use that money.

Even without those powers, significant shifts are under way within the bodies that we audit. For example, our budget already includes the impact of the new integrated health and social care authorities, which together will manage more than £8 billion when they come into full effect from 1 April next year.

As our board chair, Ian Leitch, has indicated, one of the areas that we are reviewing is our fee strategy. We recognise that there are some imbalances in the current system that we want to address. In addition, we are carrying out a procurement exercise that will set the prices that we pay for the next five years to the audit firms that carry out a significant part of the audit work for me and for the Accounts Commission. We do not yet know the size and distribution of any savings that that exercise may generate, but we will know that by spring 2016. We have therefore agreed to freeze audit fees for 2015-16 at 2014-15 levels. In

real terms, that represents a 1.6 per cent reduction. We will be able to model the impact of the procurement exercise on future fees in time for our budget submission to you next year.

Excluding the impact of new audit work, we have reduced the amount that we ask for from the Scottish consolidated fund by 2 per cent. In real terms, at 2015-16 prices, that represents a 3.6 per cent reduction.

Ian Leitch has talked about the further reduction that comes from our investment in property. We are pleased with the success of that project, which was delivered on time and under budget. We look forward to being able to roll those savings through in future years.

We are pleased to be able to build on our record of reducing the costs of audit in the past. We know that there will be new responsibilities for us in the future. We are on the cusp of significant change. We have tried to get the right balance between continuing to build on our record from the past and building capacity for the future. We look forward to answering your questions about the submission.

The Convener: Thank you. As you correctly say, members have some questions and I would like to start with a question about fees because that has been a recurring theme for the commission over the past few years. Indeed, in October 2014, we were told that work on a revised fee strategy would be concluded in early 2015. On page 9 of the current fee strategy document, Audit Scotland states:

“Several papers and a presentation have been discussed by the Audit Scotland Board”.

We are obviously disappointed that that work is still on-going after all these years. We have had previous reassurances that the work would be concluded in the early part of 2015. Can you explain the delay in the review process and provide us with a firm date for its conclusion?

Ian Leitch: Some of us, when we joined the board, started asking a lot of questions. To some extent, that may have delayed matters, because we have been probing into the whole question of whether each sector has been paying its full costs and we have had a series of papers throughout the past year. That has allowed us to look at where the imbalances are occurring and determine where we are going to go with it. However, we need to bear in mind that we have to balance a number of issues. An important point is that the clients want to avoid an excess of volatility.

If we get sectoral balance, which is what we are aiming for, the next question is whether individual fees should be charged on a basis that means that there may be movement and volatility year on

year. However, as we indicated in the fee strategy paper, the informal soundings, particularly from the local government sector, are that people do not want that.

We must have openness and transparency in how we set our fees, and it is necessary that we consult. Therefore, although work is still on-going, the big thing that I am going for is consultation with our various audit clients, throughout the next few months, to see how they want it done. Do they just want sectoral balance? Do they want set pooling within that balance or do they want to ensure that individuals pay the full amount, meaning that some fees will go up and some will go down? Consultation will delay matters a bit—I apologise for that—but it is necessary to carry our client groups with us as far as we can.

The Convener: From what you are saying, I would deduce that we are at the start of a process rather than moving towards the end of it.

Ian Leitch: I do not agree with that; I think that we are fairly well through it. We have had working papers looking at how the sectoral imbalances have occurred historically and what remedies we should take. A few months ago, we had a discussion—it is reflected in our budget submission to you—about whether we should try to reduce some of those imbalances by increasing fees. However, taking account of the procurement exercise that is on-going and the fact that we are advised that further savings will come from that round, we decided on a freeze. We decided to hold things as they are, see what the procurement round shows and carry out that consultation.

It is a major exercise to consult our client groups on what should be done, but that is the openness and transparency that we are aiming for. The price may be a few extra months on the timetable for matters, but that is a price worth paying. If we tell people what we are proposing and show them how things are done, there will be more acceptance of and less complaint about—in so far as there is any complaint—fees being handed down from on high.

The Convener: You mention the possibility of sectoral balance and so on. We would welcome a move towards a closer balance of fees and the related expenditure in each sector, but to what extent will further work on the fee strategy seek to achieve that closer balance for the individual audited bodies both within and across sectors? For example, will audited bodies with strong track records of governance and control be subject to lower fees than bodies that have higher audit risks?

Ian Leitch: The accountable officer will answer that question.

Caroline Gardner: It might be helpful if I remind the commission of the framework that governs our overall funding and fee-setting process and of the work that has been done so far. There are a couple of areas outstanding that, because of the procurement exercise, it will not be possible to complete until 2016.

Under the legislation that set up Audit Scotland, we are entitled to impose charges for the work that we carry out on most of the bodies that we audit. Those charges are required to be set while having regard to the particular classes of bodies, or the individual bodies, that we audit. The aim is to break even, taking one year with another. The papers that the board has reviewed over the past year or so have explored what that means in practice and what issues need to be resolved as part of the review, as the chair of the board has said.

One issue that we have reviewed is whether it is appropriate to continue to raise three quarters of our funding through fees with, broadly, the other 25 per cent coming from the consolidated fund with the oversight of the SCPA. The board's decision was that it is appropriate to do that and that having that fee mechanism helps to ensure the accountability of auditors to the bodies that they audit while maintaining their independence.

The second big area of work that has been done is how the board gets oversight of the balance between the amount that is raised and the amount that is spent in each sector, particularly in local government and the bodies in my area of responsibility; and, within my area, in central Government, health, further education and so on. As the chair has said, there have been some imbalances that have tended to increase over the life of an audit appointment. The latest figures, which we reported back to you in June alongside the presentation of our annual report and accounts, showed that there was a broad balance between local government and the rest but that health was slightly over-recovering and that there were some imbalances between the chargeable and non-chargeable central Government work. The board has taken the decision that it makes sense to fix those imbalances when we make the new audit appointments from next October onwards.

10:15

As for individual bodies, that is one of the issues that the board is still considering. We know from previous consultations that the bodies that we audit value predictability in their audit fee and are not keen for significant year-on-year moves. To bring each body into balance in terms of the amount that its audit cost and the amount that we charged would, given the variances, also make it

difficult for us to manage our finances on a continuing basis. There is already some capacity in the system to reflect the quality of a body's internal controls and governance; you might recall that we set an indicative fee for each body and, in the current system, the auditor and the audited body are able to vary the fee up or down by 10 per cent. Any variation beyond that has to be approved by Audit Scotland. We know that there are some imbalances between larger and smaller bodies because of the fixed cost, if you like, of auditing a small body, and we want to review that when we set the indicative fees for the new audit appointments.

Over the past few months, we have also strengthened the governance of the balance between sectors, with the board agreeing a new policy that makes it very clear that the interpretation of taking one year with another should be that the figure is no more than 10 per cent up or down for each sector in a year, with the aim of its being resolved the following year. The board will formally review that annually to give itself an assurance about where it is going.

As the chair has said, a lot of work has been done, but we cannot resolve some parts of the equation finally until we know the costs of the audit procurement exercise and make the new audit appointments next autumn.

The Convener: Your papers refer to a historical decision made when Audit Scotland was set up that ensured that the costs of best-value audits were broadly met by central Government. In your opinion, does that approach remain valid?

Caroline Gardner: I will ask Russell Frith to give you more detail, if you will find it useful, but the historical picture is that when local authorities had a legal responsibility for best value imposed on them in 2003, local government received about £2.5 million from the local government settlement to cover the costs of best value and best-value audit. About £1.5 million was earmarked for audit, and the funding was distributed to local authorities on a per capita basis.

Since then, the audit fee for best-value work has been recovered on a per capita basis added to the core audit fee for each local authority. The Accounts Commission has reviewed that as part of the fee strategy review that we have described and has taken the view that the approach remains valid, because the pattern of best-value audit is not smooth across the years and is, in fact, being reviewed just now. It is one of the reasons why, looking ahead, we think it appropriate to regularly review the fee strategy—circumstances do change.

John Pentland (Motherwell and Wishaw) (Lab): Like the convener, I am concerned that the

fee strategy review has not been completed by now; indeed, regardless of what Mr Leitch has said, it seems that we are just embarking on that review. For the commission's comfort, can you tell us for definite when it will be completed?

There might be very good reasons for it, but I note that we are starting to talk about imbalances and consultation. I find that very surprising, because I would have thought that that would have been part of the original review. For its own comfort, the commission probably needs a dateline for the review's completion.

Ian Leitch: It will be completed for the audit appointments next autumn. I cannot speak for the time before I joined the board, but when I looked at this issue with colleagues on the board, I wanted to know whether there were imbalances in the sectors; whether some were paying too much and others not enough; and if so, how that had come about. We need a sharper pencil for all of this. The work is substantially being done—indeed, some of it was reported to you in June, when the imbalances occurred—and we now have to go out to consultation. Theoretically, we could impose the fees, but that would be entirely the wrong approach.

We will go to our client groups, as well as take account of the Accounts Commission's view. As you know, that body has a statutory role, although the services are supplied by Audit Scotland.

Best value was mentioned. The farmers among us will have to forgive the expression, but is the sheep-dip approach—where everyone gets dipped—appropriate in a situation where a local authority, for example, has a bad best-value report and it must have recurring reports? Should it be the case that everyone pays the share of that cost or should it be the polluter-pays principle? We need to have dialogue with the Accounts Commission, as well as with the consumer groups, on those issues.

There are a whole variety of issues to be consulted on, so I am determined that we take that additional time. I assure you that we will tie up the matter this coming year.

Angus MacDonald (Falkirk East) (SNP): Good morning, panel. We are aware that the Wales Audit Office has recently reviewed its fee strategy. In its equivalent document, it has published the hourly rates, by staff grade, that are chargeable to audited bodies, thereby enhancing the transparency of fees to audited bodies. Does Audit Scotland envisage publishing similar cost information, so that audited bodies can clearly see the make-up of the fees that are billed? That might in turn provide them with an incentive to improve their governance and control arrangements, which could result in lower audit fees.

Ian Leitch: I do not see a reason in principle why that cannot be done after the procurement exercise, although, plainly, we would not want to disclose our hand until we get the prices in from the private sector firms. I may be in error, but that would be my approach to the issue.

Caroline Gardner: After the procurement exercise has been completed, we will need to finalise how we recover the direct costs of audit, which are the costs of the work that is done in an audit whether by one of the firms or by our in-house audit service, and how we recover the indirect costs, which are the costs of the performance audit work that is carried out across sectors, Audit Scotland's central costs and the costs of providing support to Parliament. We could take the indirect costs and allocate them across the direct costs to give such an hourly rate; an alternative would be the approach that we have taken in the past, which is to have a direct cost and an indirect cost, which comes into the pool to cover our central costs. The board will have to consider that issue during 2016. Again, we will be trying to get right the balance between an approach that is straightforward to manage both for us and for the bodies that we audit and an approach that is transparent to you and our wider stakeholders in demonstrating value for money.

As Ian Leitch said, we will certainly consider the matter during 2016, but the board has not yet taken a decision on it. We benchmark our audit costs with the Wales Audit Office and the other UK audit agencies, to ensure that we are providing value for money and can demonstrate that to you and to our wider stakeholders.

Diane McGiffen (Audit Scotland): I, too, would offer reassurance. As you know, our objective is to deliver public audit in Scotland that promotes transparency, accountability and best value. When considering the transparency question, as well as looking at how our sister organisations across the UK explain fees, costs and so on, we have been looking more widely at public audit agencies and organisations in New Zealand, Australia and across the globe to see how we can make the best of promoting world-class audit at a high level of transparency. Consideration of how we deliver more transparency on fees will be a key objective of our project in 2016.

Angus MacDonald: Thank you for that. I am pleased to hear that you are looking at good practice around the globe, and it is good to know that you accept the need for transparency in the compilation of fees.

I will move on. As we know, Audit Scotland provides services to both the Auditor General and the Accounts Commission, but the costs of providing the services to those two clients are not apportioned in Audit Scotland's fee strategy,

budget proposals or annual accounts. What is the volume of audit work undertaken for the Accounts Commission and the Auditor General, and what are the respective costs?

Caroline Gardner: I will ask Russell Frith to come in with the details on that, if I may. In broad terms, as we reported to the commission back in June in relation to our total costs for 2014-15, for local government our overall income was £11.5 million and our overall expenditure was £11.45 million. The remainder all related to my responsibilities as Auditor General. Therefore, the Accounts Commission figure was broadly £11.5 million and the remainder of our budget related to the Auditor General. Russell Frith can give more of a breakdown, including a breakdown for the years that we are looking to now.

Russell Frith (Audit Scotland): As part of our budget preparation, we do an allocation of budget costs across the sectors so that we can start to monitor the extent to which the projected income meets the projected costs. For the annual financial audit, that is relatively straightforward, as it is based on the costs of the individual audits in each sector. For performance audit and best-value work, the allocation is based on the expected programme, which will include pieces of work that are purely for the Accounts Commission, pieces of work that are purely for the Auditor General, and a quite significant number of pieces of joint work that cross over the remits of both bodies. We estimate that, for the 2016-17 financial year, 53 per cent of the performance audit and best-value work will be done for the Accounts Commission and 47 per cent will be done for the Auditor General—that includes apportioning the joint work between the two. That is how we go about assessing what we need to recover by way of fees.

Angus MacDonald: Okay. Are those percentages detailed anywhere in the report?

Russell Frith: They are not explicitly in the report, but they are in one of the working papers that underlie the budget.

Angus MacDonald: Okay. May I suggest that they are included in the report in future?

Russell Frith: Certainly.

The Convener: It would be useful if the figures that you have just now could be supplied.

Caroline Gardner: We can certainly do that. The nearest reference to them is in the submission to the commission, in table 2 on page 12, which breaks down the income from charges to audited bodies by sector. Obviously, there is a very close link to the expenditure analysis and build-up that Russell Frith referred to. We can very happily let the commission have that information.

The Convener: I think that the commission is keen to see how far the costs are covered for the proportion of work that is done for the Accounts Commission and the proportion of work that is done for the Auditor General.

Caroline Gardner: We understand that entirely, and there is no problem in letting the commission have the breakdown. We can certainly build that into our agreement with the secretary to the commission on what information the commission would like in future.

John Pentland: Obviously, the commission is keen to explore the potential impact on Audit Scotland of the proposals in the Smith commission agreement and to ensure that Audit Scotland is in a position to deliver on its responsibilities in relation to Revenue Scotland, Her Majesty's Revenue and Customs and the delivery of the Scottish rate of income tax. The commission appreciates the uncertainty in determining the full extent of the additional work that may be required following the passage of the current Scotland Bill, but can Audit Scotland provide some details on how the figure of £100,000 was arrived at and why, at this early stage of the process, you believe it to be necessary?

Ian Leitch: Caroline Gardner will deal with that.

Caroline Gardner: I can certainly do that, Mr Pentland. First of all, it is worth being clear with the commission that we are already doing a fair amount of work in relation to the new financial powers. For example, today we have published a report on the implementation of the Scotland Act 2012, which looks ahead to the extent to which the arrangements—the establishment of Revenue Scotland and the joint working with HMRC—are fit for purpose for the new powers that are coming to the Scottish Parliament under the current Scotland Bill. We are already building up our expertise and capacity on the issues.

There are some significant uncertainties that will not be known until the Scotland Bill is passed and the fiscal framework is in place, a lot of which relate to the tax-raising powers, the control over all income tax, the assignment of the first 10 points of VAT, and the arrangements that will be put in place for the new welfare powers that the Scottish Parliament will have. We simply will not know what audit work is needed for those things until we know what arrangements are in place, but we are confident that the arrangements that we already have in place for auditing Revenue Scotland, the Scottish Government's preparedness, and the arrangements for working with the National Audit Office on the audit of Her Majesty's Revenue and Customs will all provide a sound foundation for that.

10:30

We have put £100,000 into our budget proposal to build on our experience so far. One of the things that we would like to use it for is to appoint a project manager who will co-ordinate the work that is going on with the NAO, HMRC, the Scottish Government, Revenue Scotland, the Scottish Environment Protection Agency and Registers of Scotland, look at what more will be needed and continue our focus on building expertise and capacity in Audit Scotland.

We know that, for us as well as for the Government, one of the challenges from the new devolved powers is that currently there are no people with a great deal of experience of tax policy or social security policy in Scotland. Recruiting new staff is therefore not going to be a good way of building the experience that we need, so we have to think creatively about how we build our capacity through our training programme and professional development to ensure that we have the skills and experience to scope the work that is required and then decide how best to carry it out. The £100,000 is therefore specifically about project managing our response and starting to build that expertise and capacity across our staff more generally so that we are ready to deliver the audit work that we will need to deliver from 2017 onwards.

John Pentland: Okay. On your preparations for delivering your responsibilities in relation to Revenue Scotland, HMRC and the delivery of the Scottish rate of income tax, what assessment or assessments have you made to ensure that Audit Scotland's governance framework and management structure remain suitable in the face of those changes?

Caroline Gardner: We have been providing the board with regular updates on the progress of the Scotland Act 2012 and the Scotland Bill. So far, as a board, we do not see anything that suggests that Audit Scotland's structure and governance are not fit for purpose. We are seeing development of the structures that are already in place, more powers for the Scottish Government and a very clear requirement for the Scottish Parliament to be able to exercise oversight of all that. The board's view is that our structure is fit for purpose, but we clearly need to keep that under review. The need to work closely alongside the NAO to make sure that the UK Parliament and the Scottish Parliament get the assurance that they require is a key one for us as the provisions of the Scotland Bill come into place.

That is the position that we are in, but I am sure that Ian Leitch will want to add to that assurance to the commission.

Ian Leitch: Yes. The board is very keen to keep a close eye on the situation. We get regular reports, as the Auditor General indicated, and of course we look at and review our own governance arrangements. Openness and transparency are the buzz words, and we are looking for more of all of that. A comment was made earlier about the commission wanting additional papers. We are happy to liaise with your support staff—the secretary to the commission and your advisers—on what additional information you would find helpful, so that we can give it to you in advance of commission meetings.

It is a big challenge for all of us. We have to balance good governance and cost effectiveness, but I think that the board is achieving that and penetrating areas that are of interest and concern to the commission and, indeed, to our client groups.

John Pentland: Given that HMRC is currently subject to audit by the National Audit Office, does Audit Scotland envisage any scope to pursue a resource transfer from the National Audit Office to Audit Scotland? One might assume that the extent of the NAO's input might decrease for the taxes that will be raised and administered in Scotland in future.

Caroline Gardner: At the moment, we do not envisage any reduction in the audit work that the NAO needs to do in relation to HMRC. As you would expect, we have worked very closely with those bodies over the past two years as the Scotland Act 2012 has been implemented. The Scottish rate of income tax, which is due to come into effect next year on 1 April next year, will be collected by HMRC on behalf of the Scottish Government. The amount of work that the Comptroller and Auditor General in Westminster will need to carry out in order to provide his audit opinion on HMRC will not reduce. HMRC will still be doing that work, and the Comptroller and Auditor General will need to carry out the same amount of work. However, we know that the Scottish Parliament will have its own need for assurance about the Scottish income tax that is collected on its behalf by HMRC, which will be additional work.

The picture is complicated slightly by the fact that I do not—for good reasons—have legal powers of access to HMRC. We have discussed with the Public Audit Committee in this Parliament, and captured in a memorandum of understanding, a process by which my audit staff can work closely with National Audit Office audit staff to plan the scope of what they are doing in relation to the Scottish rate of income tax; to take on board assurance about the quality of the audit work that they are doing; and to identify issues that we think

should be drawn to the attention of the Scottish Parliament.

When the Comptroller and Auditor General produces his report on the Scottish rate of income tax, which is required under the legislation, I will produce a parallel report that captures my conclusions in relation to that work. Both reports are laid in the Scottish Parliament at the same time. The first two were laid in Parliament only in the past three or four weeks, so it is very much an emerging field.

The short answer to your question is that we do not envisage any scope for a transfer of resources from the NAO to Audit Scotland to cover the SRIT. So far, we are managing to cover the work that is required from within our existing audit of the Scottish Government, but we are keeping that area very much under review as the situation develops. The volume of resource that we require under the Scotland Bill may change as the Scottish Parliament takes control of all the rates and bands of income tax as well as being assigned the proceeds from the first 10 points of VAT.

Significantly more money is involved, and potentially more audit work is involved. We are currently building on our experience of the first report to get a sense of what that work might look like and of the resources for which we may need to make a bid to the commission to ensure that we can carry out the work and provide Parliament with the support that it needs.

John Pentland: Do you think that Audit Scotland has a legitimate role in that process? Obviously, a lot of money will be collected through those different powers.

Caroline Gardner: We recognise absolutely that we have a legitimate role; that is recognised by this Parliament and by the National Audit Office and HMRC in the memorandum of understanding that we have signed. I am very confident that we have the groundwork in place. What we do not yet have, and will not have until we know more about the implementation of the Scotland Bill and the fiscal framework that surrounds it, is knowledge of what that means in terms of the amount of audit work that we do. That will become clear over the next 12 months, although the foundation is there. We will continue to keep the commission up to date with our thinking about how much audit work is needed and what that will mean for our budget bid to you next year.

Angus MacDonald: The Auditor General, in her opening remarks, mentioned the UK spending review, which was announced on 25 November. Audit Scotland has acknowledged that the 2016-17 budget has been prepared amid the uncertainty of the outcome of the UK spending review and its

impact on Scottish budgets. What adjustments, if any, will be required to the 2016-17 budget proposal following the UK spending review on 25 November?

Caroline Gardner: We are not expecting any adjustments to our 2016-17 budget submission. The 2016-17 submission covers two audit years. One is the audit year that is about to start: the 2014-15 audit year for the final accounts from 31 March next year. The other is the financial year that starts after that. All of that is already pretty clear.

Once we know about the impact of the UK spending review on the Scottish Government's budget in January 2016, and any policy changes that come from it, we will have a clearer view of the different audit work that may be needed in the years beyond that. We will be keeping under review any changes to the responsibilities of audited bodies and any reductions in areas of spending, and potentially any significant areas of risk that may require more audit work.

We are very conscious that the UK spending review is likely to mean something like a 4 per cent reduction in Scottish block expenditure by about 2020, and we are committed—as our board chair has said—to continue applying pressure to our own costs to ensure that we are doing our share to address that. Equally, we know that there are significant new responsibilities coming to the Parliament that we will have to support, and that will push our costs in the other direction.

The short answer is that we are not expecting changes to the submission that the commission has before it today, but what you describe will be part of our planning for budget submissions in future as we look at how best to respond to all the pressures in our current environment.

Alex Johnstone (North East Scotland) (Con): On page 4 of the fee strategy, you say:

“We expect to be able to further reduce average audit charges in real terms for the 2016/17 audits but the amount and distribution of it will depend inter alia on the outcome of the current audit procurement exercise.”

Then, on page 9 of the budget proposal for 2016-17, you say that you have assumed

“that the remuneration paid to external audit firms will on average remain at the levels included in the current contracts.”

Then, on page 15 of the budget proposal, you state:

“The budget assumes for planning purposes that payments to appointed auditors (firms) will increase at 1% per annum in line with our payroll assumption for our own staff salary scales.”

Those three statements differ slightly. Can you reconcile them for us?

Caroline Gardner: We can, Mr Johnstone. You are right that they are complex. The context is that we are conducting a procurement exercise that is due to close next week when we receive the bids from firms. Russell Frith will talk you through how those three statements interact with one another.

Russell Frith: For the purposes of our 2016-17 budget, we have to make an assumption about the outcome of the procurement exercise. For that purpose, we have assumed that the amounts that the firms bid will remain at the existing levels. We believe that that is a reasonably conservative assumption and we would expect to achieve at least that. I would be disappointed if we did not achieve at least that level, but we have to make an assumption for the purposes of producing the budget document.

The 1 per cent increase to which you referred is for future years because, once we have received the bids, they are bids as at a point in time for the first year of the new appointments. We expect that prices will go up over the course of the appointment in line with the increases in our staff salaries. That is the same assumption as we have in the current contracts. By doing that, we believe that we are being clear with the firms about how prices will be reviewed during the contract and that encourages them to bid as competitively as possible.

I hope that that explains the difference.

Angus MacDonald: On page 10 of the budget proposal, Audit Scotland states that it plans to increase its number of whole-time-equivalent staff by one in 2016-17. On page 16, it states that the additional member of staff represents

“an investment in our publication and design resources”.

Given that, does Audit Scotland expect to make future savings from outsourced publication and design costs?

Diane McGiffen: Thank you for the question. This is an area that is evolving and changing quite rapidly as the demand for online publication and accessibility and the design that is required to support that expand and we try to make our work more widely accessible and transparent. At the moment, we do not expect to deliver savings from this area because it will expand as we try to make our work more available and easier to access and understand, and as we support the new website that we launched recently to create more interactive and dynamic opportunities to look at our work. However, we will look across the business as a whole, as we always do, to see where we can reallocate resources or generate other efficiencies.

Angus MacDonald: When can you expect to see savings in that section?

Diane McGiffen: In the publications section?

Angus MacDonald: Yes.

Diane McGiffen: As I said, the work in this area is expanding to support making our work more accessible. We are looking across the business to see where we can make savings and efficiencies. When we enter 2016, we will start to look more closely at that and at how we can generate savings now that we are in our new office.

10:45

Caroline Gardner: Over the past two or three years, we have made significant savings in the overall publications and communications budget by making much less use of hard-copy, printed documents and much more use of the website. However, those savings are already captured in the baseline for this budget.

Angus MacDonald: Yes, we noticed that.

The Convener: On that point, I end up with three copies of almost all of Audit Scotland's publications, from various sources. Perhaps the process has not been refined to the level that we it need to be.

Caroline Gardner: I will sort that out this morning, convener.

John Pentland: Appendix 1, which concerns operating cost trends, shows that Audit Scotland's expenditure on private firms has decreased marginally year on year from 2013-14's actual expenditure to 2016-17's proposed budget. In the same period, Audit Scotland's gross administrative costs have marginally increased. Can you explain the reasons behind those figures? How do they reflect the efficiency of the private firms compared with that of Audit Scotland's in-house teams?

Russell Frith: The small decreases in the appointed audit firm costs over that period represent a combination of the firms billing us slightly reduced travel costs and changes of the make-up of their portfolios. For example, their portfolios reduced slightly when the police and fire service reform took place. None of that reduction relates to the efficiency of the firms in carrying out individual audits; it simply reflects the volume changes in the work and the slightly reduced travel and subsistence costs.

John Pentland: So it is not down to audit work; it is down to efficiencies that have been achieved elsewhere, one of which you identify as travel.

Russell Frith: In the case of the firms, yes.

John Pentland: How does that balance with you sending people out to firms?

Russell Frith: Sorry?

John Pentland: Can you make any in-house savings by not travelling?

Russell Frith: Indeed. The audit teams constantly examine their travel approaches, and the travel plans for each of the audits try to minimise the costs.

John Pentland: The commission is aware that Audit Scotland pays private sector firms a set fee for an audit appointment, and it is for the firms to plan and deliver their work within that fee. That creates an incentive for those firms to be as efficient as possible in order to maximise their profit from that assignment. Can Audit Scotland explain what similar efficiency incentives are in place for in-house teams? For example, are local audit teams given a notional monetary budget with which to plan and deliver their audits, or are they just given a number of weeks?

Russell Frith: They are given budgets. The starting point for those budgets is essentially the same as would have been the case if a firm had been appointed to the same audit. The teams develop budgets for each audit, based on the risks, and we monitor the costs of the in-house teams delivering audits against what we would have paid a firm for the equivalent audit.

John Pentland: Although private firms might have that incentive to work to their fee, how is that efficiency delivered in-house?

Russell Frith: As I just said, we monitor the cost of the in-house teams delivering audits against what we would have paid a firm for the same audit. We have been doing that for a number of years. The cost of the in-house teams during the past three or four years has been on a constant downward trend, which is the result of us continually considering our methodologies and practices and monitoring them against what the firms are delivering. There is an incentive for the in-house teams to compare themselves with firms on quality and cost. It is a balance of the two.

John Pentland: By way of benchmarking it?

Russell Frith: Yes.

John Pentland: If a private firm is given a fee of £20,000, for example, and it is able to do that job in a week, there will be profit in that. If you are then giving the same sort of task to an in-house team, would you expect the team, given the £20,000, to do a comparable job? Would you expect the in-house team to do it in a week?

Russell Frith: We would expect the in-house team to do it for the same cost, yes.

John Pentland: No, I am asking whether the in-house team would do it in the same time that it took the private company—a week.

Russell Frith: Sorry—are you asking whether we would expect the in-house team to do it in the same way as a private firm?

John Pentland: Yes. We are talking about money and time. There is a £20,000 fee and the private firm is able to do the job in a week. If you get an in-house team to do the same job and you give the team £20,000 for that, will that team do the job within a week?

Russell Frith: How the team plans the audit depends on its assessment of that particular audit. We do not try to—

John Pentland: No, I am trying to say that it should be like for like. Do you have that comparability?

Russell Frith: Cost is what we concentrate on.

John Pentland: I am not talking about the cost; I am talking about the time that it takes. We have already gauged that £20,000 is set aside. It is the time that I am trying to establish. Would it take the in-house team a week to do the job for the same cost or would the in-house team take eight weeks to do the job for the same cost?

Russell Frith: Broadly, the team would take close to a week. I would expect the time taken to be similar but not necessarily identical.

John Pentland: Do you have any examples of that?

Caroline Gardner: I will briefly expand on Russell Frith's answer. As he said, our starting point is to monitor the cost of the audit across our different providers—the firms in each sector and the in-house team. Within that, we deliberately give them room to think about how they carry out the work, how they resource it, and the skills mix and the audit methodologies that they use.

As long as they are meeting the quality standards that all auditors are required to meet under the international standards on auditing and our own quality requirements in the appointments that we make, we think that there is a benefit in that approach. It means that we are clear about the cost but we are also getting access to the innovation, creativity and professional expertise of each of our providers—the firms and our own team—and there is scope for cross-learning between them.

If one firm or one of our in-house teams were to do the same work for the same cost but in a different way, we would be interested in how it was doing that and we would seek to learn from it to get the benefits in terms of both cost and quality. However, we do not measure in detail the time that goes into each input in the way that you are describing, because we feel that that is much less important than the cost and the quality outcomes.

John Pentland: Yes, but surely the private company is bound by the same criteria and has to deliver the same quality.

Caroline Gardner: Absolutely.

John Pentland: This is a point that we have emphasised on a number of occasions. If you are using a private company's work as a benchmark, are you able to achieve that benchmark in-house or are you taking longer to do the same job?

Caroline Gardner: The cost and the quality are our primary benchmarks. As you can imagine, the cost rolls up a lot of the time that is involved as well. Most of the cost of doing an audit is the cost of the people. That is broken down by how much they are paid and how much time they spend on the work. There are different ways of getting the skills mix in place to do the work. We focus primarily on the cost, but we are also interested in how the work is done because there is scope to limit.

We are absolutely not applying different benchmarks to the firms and to our in-house team. As Russell Frith said, the benchmark is the same, as is the fee that we charge. We compare that across the life of the audit. In fact, the Audit Scotland board received a report fairly recently that gave a picture of how the in-house audit services team compares across the different sectors with the firms that we use in each sector as part of that assurance process.

Ian Leitch: That document is called "Demonstrating Best Value in the Audit Services Group", which is the in-house team. Mr Pentland rightly probes the matter and asks a valid question that the board and I have been asking. The net effect of that is that we have a report, which is dated 29 October, that looks at the whole question. It is a fair point. If someone is allocated 14 days for a job and there is an incentive for the private firms to do it in 12, what is the incentive for Audit Scotland to do it in 12, if it gets 14 days for a similar task? There is a qualification to that, which is that we check that firms are not pricing for 14 days and then trying to get it done in 10 and pocketing the difference, if you will forgive that vulgar expression. We have to check that the quality of the work is of as high a standard. Equally, we insist that the in-house team does not just assert that it is cost effective; it has to justify that. That is why we commissioned a report to look at that.

There is a comparator. In one area, the cost is slightly higher and we are looking at that. We are conscious of the need to ensure that, in the mixed economy of an in-house team and external consultants, there is a benchmark, a balance, cost effectiveness and a qualitative threshold that we insist has to be maintained to satisfy the

commission and the wider Parliament on the discharge of the responsibilities. The board's job is to ensure that the resources and staff are made available to the Auditor General and the Accounts Commission, which as you know is a separate statutory body under the Local Government (Scotland) Act 1973. We have to ensure that we do that in an effective and efficient way.

The long and the short of the answer is that Mr Pentland is on the money in asking that question, and we have already looked at that issue and been supplied with information that gives us some assurance that there is balance over the piece, although some adjustments are still required to look at the question of cost effectiveness.

John Pentland: When you hire somebody from the private sector, how do you negotiate the contract? Do you say to the private sector firm, "Here is £20,000; now go away and do the job," or is the figure arrived at by negotiation?

Russell Frith: In the tender documents that are out at the moment, we specify the indicative fee for each audit that is out to tender. In effect, we specify what we think the fee should be for that audit. As we have explained in previous sessions, the auditor and the audited body can agree a slightly higher or lower figure, depending on the circumstances that they face in any given year. However, we set the expected fee for each audit in advance.

Caroline Gardner: As part of the competitive tendering exercise, the firms bid for the discount that they are prepared to offer against that indicative fee, and we use that to drive down the average cost of audit and then to benchmark against the in-house team. There is a competitive element to the process. We take as our starting point what the fee needs to be in a well-managed body that has good internal controls and then apply competitive pressure to that. We then use that to benchmark across the piece, over the life of the five-year audit appointments, to ensure that we are getting the right balance between cost and quality and that we have the ability to compare across the firms that are involved and our in-house team.

The Convener: Is it possible for commission members to receive a copy of the report from October that you mentioned?

Ian Leitch: Yes.

Alex Johnstone: Page 7 of the budget proposal says that, when projecting a budget, you make the assumption, as I suppose you must, that there will be "No volume changes" in the planned programme of national performance audits. However, should an urgent priority arise, are you able to postpone assignments to take on extra

work, or is there an alternative route by which you can fund unplanned work?

11:00

Caroline Gardner: The first of those alternatives is exactly how we do it. We start off with a plan for the work that we expect to carry out—most of those pieces of work will be things that we think are of significant public interest and that have real value-for-money or financial management implications. If something urgent comes along, we will look at the resources that we have and at how we can reschedule to respond to that quickly, as we need to.

In the programme, we also make an assumption that there will be three or four audits every year in my area of responsibility and three or four in the Accounts Commission's area of responsibility in which an issue will come out of the audit that requires us to respond to it. An example that will be very fresh in Mr Beattie's mind is Coatbridge College, where a significant governance failure in relation to severance payments was identified through the audit. We had to respond quickly to that to carry out more audit work to produce a section 22 report to lay before the Parliament and the Public Audit Committee. We assume that there will be a number of those each year. We do not know what they will relate to, but it is a pretty fair bet that there will be some, and we manage the programme dynamically to make sure that we focus on the most urgent things as well as the most important things.

The Convener: On page 13, Audit Scotland states that the 2016-17 budget has targeted a reduction of £79,000 in audit support external fees against the budget that was approved for 2015-16. However, the operating cost statement on page 19 shows that the budget line for audit support external fees has increased by £121,000 between 2015-16 and 2016-17.

How do you reconcile the targeted reduction of £79,000 with the increased year-on-year budget amounts that are shown in the operating cost statement?

Caroline Gardner: That relates to the challenge that we face in relation to the biennial national fraud initiative work. You will recall that that comes in every two years as a UK-wide initiative. Our contribution to the costs is £200,000 and 2016-17 is a year when that £200,000 is back in again. If you take that out, you will see the £79,000 reduction that we refer to in the budget submission, which you asked about.

The Convener: I recall that that has come up previously.

Caroline Gardner: I am sorry—it comes up every time.

The Convener: On page 19, the cost of Accounts Commission members is budgeted to increase marginally by £3,000. Perhaps this should have been a question about last year's budget proposal, but the cost of Accounts Commission members increased from £148,000 in 2014-15 to £158,000 in 2015-16. What was the reason for the £10,000 increase in the current financial year?

Russell Frith: There was a marginal increase in the number of days that Accounts Commission members were expected to spend on commission business, for which they were remunerated. That was agreed by the Scottish Government, which sets the remuneration for commission members.

The Convener: Can you remind me how many board members the commission has?

Russell Frith: Twelve.

The Convener: I have one or two minor questions, but before I ask them, do any other members have issues that they would like to raise?

John Pentland: I want to go back to the first question on the fee strategy. I think that there was an assumption that the review would have been completed and in our hands by now.

"Assume" and "assumption" are among the most common words in the budget proposal. We know that that means that something is supposed to be the case or that there is no proof. How much latitude is in your assumptions?

Ian Leitch: Do you mean in relation to what we assume we will get out of the procurement?

John Pentland: Just in general.

Ian Leitch: "Assumption" is an odd word, isn't it, convener? I think that assumptions are generally made by economists, but it is interesting for auditors to make them, especially given that we do not have cost accountants at our disposal.

There is no doubt that certain assumptions have to be made. On the intractable problem of how one's crystal ball gazing—"assumptions" is a nicer way of putting it—is carried out, I will defer to the man who knows the intricacies of this labyrinthine complexity, Russell Frith.

Russell Frith: Assumptions are inevitably made in any budget in which one is looking forward. We make assumptions about pay costs, about the outcome of the procurement exercise and about future pension costs. A lot of budgets and projections are based on assumptions so that is the word that we would use.

The setting of fees is influenced not only by those macro-level assumptions, but allocations, if I can distinguish the word, in terms of how we allocate central costs between the different audits. That is as much an art as it is a science.

I will take property costs as a basic example. We carry out a number of different audits and different types of audit, but we all sit on one floor in one office. We have to make an assumption—an allocation—of the cost of the different lines of activity. In our case, we do most of that on the basis of staff numbers. Other organisations might do it by estimating the square footage that is occupied by different groups. Because our groups all work together, that is probably not appropriate for us; staff numbers is more appropriate. There are many examples of that as we build up the budget and the fee strategy.

The Convener: As no members seem to have anything further to ask, I have one or two fairly trivial questions to clear things up in my own mind.

On page 4 of the budget proposal, in the paragraph headed "New work", you talk about Revenue Scotland and Food Standards Scotland and you say:

"Legislation does not allow us to charge a fee for these audits".

Is that legislation the Public Bodies (Joint Working) (Scotland) Act 2014?

Russell Frith: It is under the Public Finance and Accountability (Scotland) Act 2000.

The Convener: Will you audit all 30 new integrated joint boards?

Russell Frith: Between ourselves and the in-house teams and firms, yes.

The Convener: You will not be able to charge a fee for those.

Russell Frith: We will be able to charge a fee.

The Convener: You will, so we are just talking about those two bodies.

Russell Frith: It is Revenue Scotland and Food Standards Scotland because they have been set up as non-ministerial bodies within the Scottish Administration.

Caroline Gardner: The broad principle is that we cannot charge bodies that are funded directly from the Scottish consolidated fund. It is to save there being a circular flow of money for audit fees. Beyond that, we are able to and we do charge for all the audits that we carry out.

The Convener: On page 6 of the budget proposals, I see that we have pensions again. It is a perennial problem and you, Auditor General, have been turning up in reports on various public

bodies questioning the public pension deficit. For 2015-16, it is £2 million.

Ian Leitch: It is one of the mysteries of life, convener. You are looking for £2 million, which is not actual cash and it does not affect the amount of cash in your pocket. It is an adjustment that is made between the Treasury and the Scottish Office that does not affect their overall allocation. As a humble solicitor, I understand that to be the case.

Again, I said before we came here that if I was sitting on your side of the table, convener, I would ask that question because it is one of the great mysteries. When is money not money? When is cash not cash? When is £2 million just something that floats in the ether? If Russell Frith can disentangle that particular Gordian knot in 30 seconds, he will get a prize.

Russell Frith: In hard cash, Audit Scotland pays contributions to Lothian Pension Fund for its staff, based on what the actuary assesses as being the necessary contributions. The actuary makes that assessment based on long-term assumptions about what it will cost to provide pensions.

Unfortunately, accountants do not allow the same assumptions to be used for the purposes of producing accounts. Rather than the long-term assumptions that the actuary uses, international financial reporting standards require spot assumptions to be used, such as the market rates that apply as at the balance sheet date, on 31 March. Because, in particular, interest rates are pretty much at an all-time low, and the actuary assumes that interest rates investment performance will be better over the longer term than spot rates are now, there is a difference. For us, that difference in 2015-16 will be about £2 million.

The Convener: Yes, I am afraid that your body and other bodies are faced with that situation.

On page 8 of your budget proposals, under the section on pay, you say that pay scales increased by 1 per cent—presumably that excluded incremental increases. Have any staff received a pay rise in excess of that 1 per cent?

Diane McGiffen: No. That is our proposal, which contains a budget assumption. Our two-year pay deal ends on 31 March 2016. The increase, which was a flat rate on inflation, applied to all staff, including the management team and the assistant directors.

The Convener: Okay. I am curious about the corporation tax figures on page 16. Where do they come from?

Russell Frith: We have a small amount of bank interest. Under tax law, it does not matter that we are a public body—we must still pay that tax.

The Convener: The figure for next year is £5,000, which means that you earn bank interest of about £20,000 to £25,000.

Russell Frith: Yes, that is exactly what the budget says.

The Convener: For these days, that is a lot of money in the bank. Presumably that relates to your premises.

Russell Frith: No, it relates to the timing differences between our receiving the instalments of charges from audited bodies and our making payments to firms and staff.

The Convener: Okay. We are almost finished. I was also curious about the miscellaneous income budget line on page 19. In 2012-13, the amount was £164,000, but it has dropped to zero in the current financial year. Has the money been reallocated or has something ended?

Caroline Gardner: That is generally secondment income, convener—where we have seconded staff to other bodies and received the costs of their salary back in again. The amount varies from year to year. It is fair to say that we have recently found it harder to second staff out and in, as the financial pressures are affecting bodies. The figures account for the bulk of that budget line, I think.

The Convener: I have one last question. Annex 2, on page 16 says:

“Auditors have discretion to agree fees within a range of + or - 10%”—

and—

“20% for very small audits”.

First, what is a small audit? Secondly, why have 10 per cent and 20 per cent been chosen? Is that simply a notional amount or does it relate to anything?

Russell Frith: A small audit is one with a fee of, I think, less than £25,000. We have the figures in there in order to strike a balance between the auditor and the audited body agreeing the appropriate audit fee and either party putting undue pressure on the other. The range allows us to intervene on or at least review the agreement if the cost looks to be well outside the expected fee. There may well be a good reason for that, but we would want to have some involvement and say if auditors and audited bodies are agreeing fees outside a parameter. We have always had 10 per cent and 20 per cent. I think that, originally, when we brought them in, they were based on similar figures being used by other audit agencies.

The Convener: How often is that discretion used?

Russell Frith: A fee below 10 per cent is used very rarely; a fee above 10 per cent happens. It happens where a body has specific problems that require an auditor to do more work. A recent example is the audit of the police authority.

The Convener: Thank you. As no other member has any other issue to raise, that concludes the public part of our meeting. Thank you for attending.

Ian Leitch: We will liaise with the secretary and your advisers on the information that you have requested and on any further papers that you may require. We will try and make sure that you have them in plenty of time to inform your discussions.

The Convener: Thank you.

11:15

Meeting continued in private until 11:28.

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