MEETING OF THE COMMISSION

Wednesday 19 September 2007

Session 3

£5.00

Produced and published in Scotland on behalf of the Scottish Parliamentary Corporate Body by RR Donnelley.

CONTENTS

Wednesday 19 September 2007

Col.

SCOTTISH COMMISSION FOR PUBLIC AUDIT
2nd Meeting 2007, Session 3

CONVENER

*Angela Constance (Livingston) (SNP)

COMMISSION MEMBERS

*Robert Brown (Glasgow) (LD)
*Derek Brownlee (South of Scotland) (Con)
*George Foulkes (Lothians) (Lab)
Charlie Gordon (Glasgow Cathcart) (Lab)

*attended

THE FOLLOWING GAVE EVIDENCE:

Mr Robert Black (Auditor General for Scotland)
Russell Frith (Audit Scotland)
Richard Gibson (HW Chartered Accountants)

SECRETARY TO THE COMMISSION

Mark Brough

LOCATION

Committee Room 3

Scottish Parliament

Meeting of the Commission

Wednesday 19 September 2007

[THE CONVENER *opened the meeting at 10:33*]

Decision on Taking Business in Private

The Convener (Angela Constance): Good morning, colleagues. I apologise for the delay in starting the meeting. I welcome members; I also welcome representatives from Audit Scotland and HW Chartered Accountants. I respectfully remind everyone to switch off their mobiles and other electronic devices.

Our first item is a decision on whether to take item 6 in private. Item 6 is an opportunity for the commission to discuss matters relating to the evidence that we will hear this morning. Do members agree to take item 6 in private?

Members *indicated agreement*.

Working Practices

10:34

The Convener: We move on swiftly to the paper that the secretary has prepared on the commission's working practices, which we discussed in detail at our recent away day. Derek Brownlee had the opportunity to find out about those matters only when the meeting papers were issued, so I ask whether he has any comments or questions, given that he was not party to the earlier discussions.

Derek Brownlee (South of Scotland) (Con): The proposals in the paper are perfectly sound. I particularly welcome the decision to publish the verbatim record, which is helpful progress.

The Convener: I do not intend to go through each item in the paper unless members wish to raise other points. I want to move on swiftly, so are members happy to agree the paper?

Members *indicated agreement*.

Annual Report and Accounts 2006-07

10:35

The Convener: The next item is evidence on Audit Scotland's annual report and accounts for the year that ended on 31 March 2007. I invite Mr Black and his colleague Mr Frith to the table. Good morning to you both—it is nice to see you again.

I have a housekeeping point. We intend to conclude the meeting by noon, because some members and other colleagues have trains to catch and so on. My view is that item 3 is the most substantive on the agenda. I hope that members agree and that we can spend a good 30 minutes or so on exploring issues that relate to the annual accounts.

Mr Black, I ask you to make a brief opening statement to highlight the salient points, after which members will have the opportunity to focus the remainder of the time on questioning and dialogue with you.

Mr Robert Black (Auditor General for Scotland): Thank you for the opportunity to offer one or two opening comments, which I will keep brief, as I am well aware of the time pressures on the commission and the Parliament generally.

There are two versions of the annual report—the published version, which was issued before the summer, and the annual report and accounts document. We tried to ensure that the narrative in the published version, which we hope is a reasonably attractive glossy document, and the narrative in the annual report and accounts were pretty well identical. They are not really different, although the published version might be slightly more user-friendly, not least because it contains pictures of Russell Frith and me.

In the annual report, we try to provide an insight into the full range of our work and into the breadth and depth of our activities throughout the public sector. As an organisation, we remain committed to delivering our twin aims of holding public bodies to account on behalf of and with the Parliament and of assisting the improvement process through the audit resource.

As the annual report says, we audit about 200 public bodies in Scotland. As members will be well aware, in the past year, that covered spending of £29 billion or so of the total managed expenditure that the Scottish Parliament oversees.

Audit Scotland is unique in the sense that it is the only independent body that examines the whole of government. We can consider complex cross-cutting issues such as the youth offending system or the operation of the community planning initiatives that resulted from legislation that the Parliament passed—we have examined both those subjects. We also have a distinctive capability that is not prevalent in England, for example, to follow public money from the centre—from the Government itself—through to the point of service delivery, such as a health board or local further education college. We sometimes use the phrase "following the public pound" to describe that activity.

As the annual report says, in the financial year 2006-07, we submitted to the Parliament 21 reports. They included four cross-cutting reports of the type that I mentioned, four reports on the national health service's performance and nine reports on individual public bodies' accounts. All those reports went to the Audit Committee in the first instance.

In addition, we produced nine reports on best value in local authorities and four local government performance reports, which examined local government services. Those 13 reports were considered by the Accounts Commission for Scotland, which made its findings public. By far the greatest number of reports go to the audited bodies throughout Scotland. In total, 195 reports were delivered last year to individual spending bodies such as councils and NHS boards. Those reports are delivered at the conclusion of the local audits. In appendix 3 of our annual report, from page 27 onwards, we highlight all the public performance reports that we made last year.

We are committed to ensuring that value for money is obtained in our own work. For example, in 2006-07, we contained the increase in audit charges for most audited bodies to 1.5 per cent or less, although our costs rose by significantly more than that. We have also delivered several efficiency savings, which are outlined in the annual report. As members will be aware, a study by our external auditors last year found that our fee levels compared favourably with the audit fees that are charged to authorities of a similar size in England, and our running costs have fallen as a proportion of the total fees charged since 2004-05. We benchmark rigorously with our sister bodies—Russell Frith is in charge of that. We cannot make the same economies of scale that they make, so our performance in that respect is reasonably good.

I thank the commission for giving me the opportunity to highlight those few points. We will do our best to answer any questions that members may have.

The Convener: Thank you for your opening statement, Mr Black. Without further ado, I open the discussion to questions from members.

Robert Brown (Glasgow) (LD): One aspect of Audit Scotland's approach is benchmarking and ensuring high standards in its own operation. Against that background, can you make any observations on the big change in the cash that was held at the end of the financial year, which increased from £454,000 in the previous year to £1,666,000? That is only one aspect of what appear to be substantial fluctuations in figures on debtors and creditors that are far beyond what I would expect of an organisation of your size.

Mr Black: That is largely a result of the fact that the audit business year does not coincide with the financial year for financial reporting, which ends on 31 March. For example, audit planning for public bodies in Scotland for the financial year 2008-09 will start pretty soon, in November. A lot of the work will be undertaken between November and the following spring. As you will gather, we receive fees from the audited bodies to provide us with the cash to pay for the audit. We also pay the auditors as the work is done, so the firms also receive cash. On 31 March, a snapshot is taken of a flow of work that is on-going. Over the years, we have found—and the SCPA has been made aware of this—that, at 31 March, our financial position and our cash can be affected by the state of play of the income that is coming in and the money that is going out on audits.

I ask Russell Frith, who is on top of such things, to explain more fully what happened at the last year end compared with the previous year end.

Russell Frith (Audit Scotland): The cash balance that is held at any one time is largely dependent on the phasing of the invoicing of audited bodies. We try to invoice most of the audited bodies at two or three points in the audit year. Whether we invoice them in March or April will have a significant impact on whether or not we have a high cash balance at 31 March. We could try to reduce that balance by, for example, invoicing only one of the sectors—say, health—in March and invoicing the rest in April. However, such an approach would be somewhat artificial, as the timing of our expenditure is based on the audit year. It depends on the timing of the invoicing, which is lumpy throughout the year, but such a balance is held for probably only a short time.

10:45

Robert Brown: I understand that to a certain extent, but I would expect a pattern to emerge from year to year. The approach makes things extraordinarily difficult to follow and also links into end-year flexibility issues, all of which, I would argue, makes the matter more complicated than it should be. Is there any more satisfactory way of dealing with the issue? It might not even need to take into account the difference between the audit year and the financial year, but might simply be a matter of finding a better invoicing mechanism.

Mr Black: I absolutely agree that this approach makes the picture both difficult to present and more complicated than is ideal for your purposes. The most radical option would be to make our financial year coincide with our business year. In that case, we would prefer a financial year that ended perhaps in October or November, as any picture taken then would show a complete business cycle.

However, this is not my area of expertise. Russell Frith might be able to suggest ways of simplifying the picture even more, but you have to appreciate that even if the cash balance was managed at 31 March it might well have gone up again in May. Of course, much of this is outside our control, as it depends on the flow of work that auditors undertake in audited bodies, which can fluctuate from year to year. For example, this past year was the first year of new audit appointments, which meant that, in the early months, there was a lot of activity around bedding in new audit arrangements. That affected the amount of cash that was going out at a certain point.

I ask Russell Frith to say whether there is anything more that we can do in this area.

Russell Frith: I should first say that if we had attempted to reduce the cash balance chances are that the debt would have gone up as we would not have invoiced yet.

If Audit Scotland were a commercial organisation, it would almost certainly choose 31 October as its year end, as that would fit with its business cycle. However, under the Public Finance and Accountability (Scotland) Act 2000, we have no choice but to make our year end coincide with the financial year.

The Convener: Since you are stuck with it, is there no other way of ensuring that your business year can coincide with the financial year?

Russell Frith: No, not as far as the biggest element of our business—the financial audit side—is concerned. The year end for the other public bodies whose accounts we audit is 31 March. A proportion of that work has to be carried out before and after that date, because, if we tried to delay it until after the year end, we would find it impossible to deliver the audited accounts within the increasingly tight timescales that the Government wants.

Derek Brownlee: In addition to benchmarking with comparable organisations, do you benchmark with private sector audit firms? Moreover, how does the skill mix of your staffing complement compare with that in similar bodies, including those in the private sector?

Mr Black: We monitor audit fees in the private sector. As the director of audit strategy, Russell Frith is responsible for overseeing that activity, so I am sure that he can give you more of an indication of what happens.

With regard to our staffing complement, 60 or so of our 290 members of staff work in public reporting, while the great majority—165—work in audit services. Of those 165, the great majority are financially qualified or are trainees who have to complete a large programme of professional development in order to become go-alone professional staff. The rest are in central support functions and corporate services.

I ask Russell Frith to talk about the benchmarking that is done. Perhaps he could cover our sister public audit agencies as well as firms.

Russell Frith: Yes. As members know, Haines Watts recently carried out a study on the public audit agencies, an element of which was benchmarking. We seem to compare favourably with unitary local authorities in England.

On benchmarking our costs, the public audit agencies together have recently produced a benchmarking guide for back-office services; it is intended to be used by the audited bodies themselves, but we are also starting to use it. As part of piloting that guide, we considered our information technology costs, which, given our size, appear to compare favourably with those of the other public audit agencies.

Derek Brownlee asked about the skill mix, on which we have done a little work recently. Over the past two to three years, we have introduced a modernised audit approach, which has involved a significant revision of the approach to basic financial audit and wider governance areas. We are finding that that requires a higher skill mix than would be required for a basic, minimum, defensible audit that was compliant with the Companies Act 1985, because it involves looking at risks, particularly the business risks that the audited bodies face.

This year, we are carrying out a review of the resourcing of the audit services group, now that the modernised audit approach has settled down, to see whether we need to make further changes.

Derek Brownlee: I want to ask about staff costs. It strikes me that there is an increase in staff turnover. One of the crucial areas for us to consider is the level of staff remuneration and whether it is appropriate, given the market that you are in. I presume that you have to monitor remuneration in areas where your staff might go. What are the trends in marketplace, not just for the period that we are considering but more generally, in relation to salary inflation and the tightness of the labour market?

Mr Black: I will attempt to give a reasonably full answer to that question.

To understand where we are now, one needs to have an appreciation of where we came from. Audit Scotland was created from the National Audit Office's regional office in Scotland, which was comparatively small—it provided roughly 30 or 40 per cent of the staff of the new organisation—and the Accounts Commission, where the rest of the staff came from. When we merged into the new organisation, we found that the terms and conditions of the National Audit Office staff, for whatever reason—it might have been because the NAO was a United Kingdom organisation with a strong London presence—were somewhat more favourable than those of the staff of the Accounts Commission. There was clearly a possibility that the costs of the business after the merger would increase. However, I was determined that we should try to contain the costs. I am pleased to say that we succeeded in achieving a position in which the core terms and conditions of Audit Scotland staff are local government terms and conditions. In other words, the great majority of our staff are on terms and conditions that are pretty well identical to those of staff in local government. We have a small number of staff who have preserved terms and conditions as a result of their service with the NAO; the equivalent terms and conditions for them are those in the NAO.

That means that we have a small number of staff who enjoy the non-contributory civil service pension scheme, whereas the majority of the staff are members of the local government pension scheme—we are an admitted body of the Lothian pension fund—and they pay the usual percentage contribution from their salary into a fully funded scheme. That is the background.

Year on year, we monitor closely what is happening to the local government settlement and, once it has been agreed, we apply it. It tends to be retrospective but the staff are very good in accommodating that.

Remuneration issues are overseen by the remuneration committee of the Audit Scotland board, which is chaired by an independent non-executive member. The deputy chair of the Accounts Commission, which has an interest in minimising costs to local government, is also on the board. That is the degree of scrutiny. Obviously, I am not an employee of Audit Scotland, so I take a close interest in making sure that everything is carefully monitored.

The salaries of the fixed-point salary group, which is the top management of the organisation, were set as a result of an independent review that was undertaken about two years ago. Again, as a result of the merger of the two organisations, we had to operate for a period of time with salaries that were a bit out of alignment. One or two of the senior staff were on preserved salaries because of the NAO position. That was rationalised a couple of years ago, and by downsizing the management team we ensured that senior management costs were kept under control.

With the fixed-point salary group, we tend to look principally—although not exclusively—at what is happening in the local government salary field, and any increases reflect that.

George Foulkes (Lothians) (Lab): I want to follow up Derek Brownlee's question about skill mix, particularly in relation to the audit of best value.

Some of Audit Scotland's reports can be quite devastating to local authorities and individuals; indeed, they can be career-breaking. Page 24 of the annual report says of West Dunbartonshire Council:

> "Its leadership was not respected and there was a lack of transparency in decision-making. Staff morale was poor, and there were allegations of bullying."

That might well be the case, but how does the training that chartered accountants receive equip them to determine that?

Mr Black: It is the Accounts Commission rather than the SCPA that is engaged in that matter. As the Auditor General for Scotland, I do not have direct responsibility for the oversight of the audit of local authorities, although clearly as the accountable officer of Audit Scotland, I take an interest.

I suppose that the short answer to your question is to say that the best-value team contains a mix of staff from different backgrounds, including local government. Each of the best-value reports that we undertake is subject to an independent monitoring and review exercise by people who are expert in local government, such as former local authority chief executives. Russell Frith has been involved in some of the moderation activity.

The facts in the report are agreed with the audited body, the reports are made very carefully, and they are tested by the Accounts Commission.

George Foulkes: So the teams that produce reports on West Dunbartonshire Council, East Ayrshire Council and so on do not consist entirely of chartered accountants.

Mr Black: Absolutely not. In fact, I do not think it would be misleading to say that only a minority of the best-value staff are financially qualified. They come from a range of other disciplines, including local government.

11:00

George Foulkes: Is it right that the Accounts Commission and Audit Scotland should still be seen as accountancy and auditing bodies? Is there an argument that the bodies now have a wider responsibility and that we should try to find a better formulation to describe them?

Mr Black: That is an interesting question. It is certainly fair to say that the work that we undertake has developed enormously over the past five or six years. As I mentioned, we started up with the amalgamation of the National Audit Office and the former Accounts Commission. At that time, the core business was the financial audit of public bodies and a very limited programme of value-for-money studies that were perhaps much less ambitious than the ones that we undertake now. These days we are in the fortunate position of having an organisation with a lot of capacity to do high-quality work of the type that we have summarised in the annual report.

We like to present ourselves as a body that is concerned with holding people to account for their use of public resources, and as a body that is equally concerned with helping the improvement process in local government, as I think I mentioned in my opening remarks. We are now a radically different organisation from the one that existed before devolution.

George Foulkes: From our point of view, as the Scottish Commission for Public Audit, and from the point of view of the bodies that are subject to your reports and inquiries, it is important to know how you and the chairman of the Accounts Commission are appointed. Will you comment on your accountability and on that of the chairman of the Accounts Commission, in relation to your appointments?

Mr Black: My appointment reflects the statutory provisions in the Scotland Act 1998. The act was designed principally to establish the Scottish Parliament, but—significantly, from my point of view—it created the post of Auditor General and required the Parliament to make such an appointment. The more detailed terms and conditions attached to the appointment were then enshrined by the Scottish Parliament in the Public Finance and Accountability (Scotland) Act 2000.

The post of Auditor General was advertised by the Scottish Parliament back in 1999. There was a reasonably rigorous and open selection process, if I may say so, including advertisement and interview. A recommendation was then made by the Presiding Officer and the Scottish Parliament Corporate Body to Parliament, after which I was nominated to Her Majesty for appointment. I therefore hold the royal warrant. That means that I have independence from both the Executive and the Parliament, to enable me to fulfil my functions.

The post of the chair of the Accounts Commission reflects the fact that the Accounts Commission was established under the Local Government (Scotland) Act 1973. Members of the Accounts Commission, including the chair, are appointed by Scottish ministers—that is the legal term that is used in the legislation. The terms of the appointment of the chair very much follow the modern practice in relation to non-departmental public bodies and other public bodies. The post was advertised not that long ago and the Scottish Government has been going through a selection process to find a successor to Alastair MacNish. The successor will be appointed soon, and I understand that the appointment will be for three years, renewable for one term.

The Convener: I notice that there has been an increase in training and recruitment costs, although you said in the body of the report that you had changed the way in which you recruited. Can you tell us a little more about that?

Mr Black: Russell Frith described earlier how we are moving into a modernised audit process. The change is relevant to the question that I was asked a moment ago about our staffing mix. We are moving quite quickly towards a system that takes account of the fact that modernised audit requires a much more risk-based assessment of public bodies across Scotland—the 195 bodies that we audit. We therefore need people in charge of those audits who understand the business of the body that they are auditing and who have skills that enable them to communicate well with senior management, boards and councils. That, in turn, has meant that we have had to put a lot of resources into staff development.

Our people development strategy has two parts. The first is to sustain and reinforce the staff's professional development; and the second is to give management development training to staff. Members will see in the final set of accounts the expenditure that was a consequence of a big up-front investment to put in place management development for our staff. That development is on-going and we have seen the benefits from it.

Russell Frith: The management development programme is the main reason for the increase in spend in the financial year 2006-07. The programme continues into this financial year. There will be a small fall in the training budget in the next financial year.

Robert Brown: I will ask about a different issue, if you have finished with that one: it goes back to fluctuations. The note on page 18 of the annual report indicates that only 56 per cent of fees, which seems quite low, were agreed within the specified period, which is down from 60 per cent for the previous year. What is the specified period? Can that figure be improved?

Mr Black: Russell Frith is very much the expert on that area, but I will explain a bit about the context. When Audit Scotland was established, there was a choice: we could simply have instituted a regime in which all the audit costs that were incurred across Scotland outside the local government sector could have been a charge on the central budget. However, after leaving my local government career, I had a few years' experience in managing the old Accounts Commission, where I was struck by the advantages of there being an incentive whereby an audited body had an input into the costs of an audit. We cannot have a regime in the public sector whereby a public body controls the total cost of an audit, because that would upset the governance balance. I was committed therefore to having the incentive type of audit regime.

The regime has proved its advantages. It has allowed us to engage with public bodies at senior level on the composition of an audit, through audit planning, and on their perception of the quality that they receive. Their money is involved in the audit, so they are clearly interested in quality. We have also tried to incentivise the system, as Russell Frith will describe.

Russell Frith: I will build on what the Auditor General has just said. My team sets what we call an indicative fee for each audit for each year, which essentially reflects the previous year's fee, plus or minus changes in the audit's scope that have come up during the year.

The auditor and the audited body are told what the fees are and what they cover. They can then negotiate and agree the final fee, which must be plus or minus 10 per cent of the indicative fee. However, with our agreement, the final fee can be wider. The agreement mechanism is intended to prevent either party from unduly exploiting the other.

We thereby build flexibility into the system, and into the incentive for the audited body to get involved. All things being equal, if an audited body has good systems—for example, a highly effective internal audit function—it ought to pay a lower audit fee than a body that has poor internal audits and fewer controls, or which prepares a poor set of draft accounts.

Mr Black: Can you explain a bit about the comparatively low percentage of fees that were agreed within specified timescales?

Russell Frith: Yes. The 2006-07 audits, which started during the latter part of the financial year that the committee is considering, were the first under the new five-year appointment cycle. That means that a different auditor was auditing many of the audited bodies for the first time.

Inevitably, it takes longer for a new auditor to understand fully the business and audit risks that attach to a client, so we were not too surprised by the small shift from the target date for agreeing fees. We set a target date largely to ensure that bodies and their auditors get on and agree fees rather than leave it until the audit is finished. At present, the target dates for most sectors are at the end of January. Many were not achieved by then last year, but virtually all the fees were agreed by the end of March, so we are reasonably comfortable that the regime is still working effectively.

Mr Black: That is for the forthcoming audit year.

Russell Frith: That is for the audit year that is just about finishing now.

Mr Black: All the fees have been agreed before the audit starts for this financial year.

Robert Brown: Should we expect a substantial improvement in the situation? Is it to do with predictability of cash flow?

Russell Frith: The impact on cash flows is marginal because, until such time as the fees are agreed, we use the indicative fees for the initial invoices to the audited bodies and for remuneration of the firms that carry out about a third of the audits. We then adjust the invoices to reflect the agreed fee.

Robert Brown: That is helpful. I have one final question on the issue, which may be partly linked to what we have been discussing. In 2005-06 and 2006-07, there was a gap of about £2 million between what was available in direct funding from Parliament—which I assume is the amount that is approved by the Scottish Parliamentary Corporate Body and the Finance Committee—and what was actually required. On any view, that contingency, whether compared to the parliamentary funding or the total funding, is higher than I imagine Audit Scotland would be happy with in another body. What are your observations on that?

Russell Frith: The figure is higher than we would like it to be and we are taking steps to try to get it down, for example by lowering the fee increases for the next audit year. However, a significant element of the figure of just over £2 million this year relates to pensions adjustments that came in right at the year end. We will come on to that issue.

Mr Black: The adjustments were favourable.

Russell Frith: Yes—they were favourable.

Robert Brown: The gap has been £2-odd million for two years, so it is not just a one-year phenomenon.

Russell Frith: Yes, but if we had not had the large and unexpected favourable movement on pensions of £875,000 right at the year end, we would have started the trend that we are trying to establish.

Derek Brownlee: I will move on to pensions. The movement in pension liabilities is significant in the accounts. I appreciate some of the technical reasons why that has occurred but, in more general terms and building on what was said earlier about the various pensions schemes that are in operation, what precisely are you doing to manage the pension costs and the risks that relate to future costs of the pension schemes that are in operation? Have you given any consideration to changing the pensions that you provide?

Russell Frith: I will answer the first part and ask the Auditor General to comment on the last bit. We are members of a local government scheme for the majority of our staff—that is an integral part of their overall terms and conditions. We are small members of the Lothian pension fund, which includes all the former Lothian Regional Council bodies. Therefore, we have very little control over the contribution rates at any given time. We are guided by the scheme's actuary and have little choice but to follow.

Our current rates are very much lower than the Lothian scheme average, because of the number of members of staff who have been recruited recently—since devolution—and their relatively short service. At the most recent actuarial review, we had a 3 percentage point reduction in our contribution rate, which was significant.

Mr Black: I do not have much to add to that. The extent to which we as an organisation can influence and control pension costs is limited because we have to rely on the actuarial valuations of the fund and on externally determined policy on employers' contributions.

11:15

Derek Brownlee: I appreciate that that is the case because of the type of scheme that you are in, which is typical of the public sector, but is the fact that there is a lack of control and little opportunity for you to influence the costs to which you are liable one of the main reasons why there has been such a move elsewhere to defined benefit and contribution? Is that not at least worthy of review?

Mr Black: An important point to bear in mind is that because we took a policy decision to associate Audit Scotland with the local government pension scheme, we are part of a fully-funded pension scheme, funded by employers' contributions and employees' contributions. The alternative would have been to go with the National Audit Office terms and conditions, which would have meant being admitted to the civil service scheme, which is unfunded. Members might recall quite an interesting and significant piece of work from Audit Scotland last year about the unfunded pension liabilities in Scotland. If I recall correctly, the range was from about £43 billion to £52 billion, which does not appear on anyone's accounts. There is no obvious alternative route for us to improve on that situation. The only way in which that could be changed would be a fundamental change in policy at United Kingdom level.

The Convener: If there are no more questions, I thank Mr Black and Mr Frith, and ask them to sit back temporarily. I invite Mr Gibson from Haines Watts, the auditors, to come to the table.

Good morning, Mr Gibson, and welcome to the commission. Will you tell us whether you have received all the necessary information, explain what has informed the opinion in your report and provide a brief overview of your observations?

Richard Gibson (HW Chartered Accountants): By all means, and thank you for the opportunity to present to the commission. I am a director at HW Chartered Accountants, where I am responsible for the audit of Audit Scotland. In early 2006, we were appointed as external auditors to the body, following a competitive tender. This is the second year we have reported to the commission. I have a brief presentation.

There are two major outputs from my audit. First, there is my audit opinion, which is recorded on page 54 of the annual accounts document that members have in front of them. The second output is the report to management, to the commission and to Audit Scotland, which is in effect a document of my audit findings. I will run through its highlights.

We commenced our audit in about January 2007. We undertook a review of the systems and controls that were being operated by the organisation and prepared both an interim internal document and our audit planning for the year-end audit, which was undertaken in April and May 2007. We reported to Audit Scotland and its audit committee in June, and the accounts were signed, following Audit Scotland's approval, on 22 June 2007. I am pleased to report that we did not find anything throughout the process of that audit that would lead me to qualify in any way the audit report that members have in front of them. It is what you would probably call, in layman's terms, a clean audit report for the purposes of March 2007.

In addition, our management report to the commission, which is included in your papers as SCPA/S3/07/2/3b, summarises the findings of our work. Members raised some of the issues arising from that report in your questions to Mr Black and Mr Frith. I emphasise that we did not regard any of the matters that are covered in the report as being serious enough to bring to the commisison's attention during the audit, nor are they serious enough to lead you to think that there is anything of concern within the organisation.

I think that it is the commission's responsibility to accept Audit Scotland's annual report and accounts as laid before Parliament. As the external auditor of Audit Scotland, I confirm that I am not aware of any reason why you should not accept its accounts.

If you have any questions, I will be more than happy to answer them.

The Convener: Thank you for your reassuring comments.

George Foulkes: You said that the audit report is unqualified and "clean". In your report, you express a little concern about the transfer of pension liability and about invoice timing. Other than those two concerns, do you have any reservations about Audit Scotland's accounting procedures and the way in which it operates? Is there any aspect of its work that you want to draw to our attention?

Richard Gibson: First, I would not say that those are "concerns"—they are observations. That might be semantics, but I do not believe that the commission should take issue with anything in the report. The commentary is for information as much as anything else.

There is no doubt that changes in the accounting rules for pension funds, the significant movements in the pension fund deficit in both 2006 and 2007 and the incorporation of those into the 2007 accounts had a fairly significant impact on the balance sheet and the figures that Audit Scotland reported. The purpose of our having raised that in the management report is to inform the commission of its occurrence rather than to express concern about the level of the deficit or anything else.

There are significant movements on the balance sheet in 2007—that was mentioned in questions earlier. My observation in the management report is simply that a significant proportion of those movements arose from the timing of invoicing. As I said, 2006 was our first year of auditing Audit Scotland and 2007 was our second. We noticed differences in the timing of billing, which brings us back to Mr Brown's question about the audit process. As an external auditor, I have no opinion on whether the differences are right or wrong.

They are properly reported and I am happy to report that the balance sheet is a fair reflection of what happened. Because of the impact and the change in the commission, it was appropriate to bring the matter to your attention as one of the reasons for movements on the balance sheet.

That apart, there are two small comments on the fixed asset register and another movement—those comments are made at the end of the report. However, neither is of significant concern and I am sure that the senior management of Audit Scotland have both matters well in hand. One of the comments is on a fixed asset register and the other is on the methodology of valuation of work in progress at the year end. Both matters were discussed at some length and I am entirely comfortable that we will, between us and Audit Scotland, not bring them to the commission's attention again next year. In effect, the comments are recommended improvements rather than areas of concern.

Robert Brown: I confess that I still have some difficulty with the invoice timing issue. In the latter part of the Auditor General's remarks, we heard that invoicing was done initially on the basis of indicative invoices based on the previous year's figures. Adjustments were then made. In your report, you make the point that the invoicing dates are driven by Audit Scotland's cash flow requirements rather than being fixed dates that are agreed in advance. To cut a long story short, the approach makes it difficult to follow the pattern of the accounts year by year, which seems, prima facie, a bad thing. How can things be improved so that the fluctuation is ironed out?

Richard Gibson: The timing is unfortunate. I do not think that the fluctuations that you see on the balance sheet of Audit Scotland for the year to 31 March 2007 are the result only of the timing of billings. That is one of several factors that has had an impact on the movements on the balance sheet.

It is beyond my scope to comment on the whys and wherefores of the timing of billings: as I said, it is my job to report on what Audit Scotland has done, not on how it has done it. However, I must say that I struggled conceptually with the reasons for such significant movements. I suspect that, because the turnover of the organisation is so substantial, if it has three billing points in the year, there will be certain points in the year when there are significant billings. You will appreciate that, in the private sector, cash-flow management requires a fairly constant stream of billing. In my audit services to Audit Scotland, you might see more regular billing if we were doing regular work for Audit Scotland throughout the year rather than working for the organisation one or two times a year.

I cannot comment on whether Audit Scotland has chosen the most appropriate way in which to manage the relationship with its customer base. However, from my perspective, that is one of the factors that has resulted in the fairly significant shifts on the balance sheet. Provided that there are no concerns over the ability of the organisation to continue trading or to meet its debts as they fall due—which there are not—I, as an auditor, have no concern or issue about that. That is an internal matter.

Robert Brown: In the private sector, billing is normally done throughout the year and, apart from downturns over the Christmas period and the summer holidays, one would expect a reasonably steady flow of invoices over the period, all other things being equal.

Richard Gibson: Yes. That is a reasonable comment. I do not have a feel for how Audit Scotland bills on an on-going basis. Coming in once a year and taking a photograph of where the organisation is at 31 March does not provide one with a particularly good feel for how the organisation has performed. It is the difference between looking at the mileometer of your car at the end of the year and seeing how you have driven. I am not looking at that. It is a matter that I would advise you to refer back to the management of Audit Scotland. From my perspective, there is absolutely no question but that Audit Scotland is properly accounting for what it does. How it does it is not a matter on which I feel competent to comment at this stage.

This probably goes beyond the question that you asked, but one of the reasons for the significant movement in the cash figure that has not yet been touched on is the fact that there was a significant VAT repayment, in the region of £845,000, immediately prior to the year end. That money was primarily paid out to local authorities shortly after the year end. So, there is another specific, one-off reason why the balance sheet looks slightly unusual in this financial year.

The Convener: There are no more questions for you, Mr Gibson. Thank you very much.

Richard Gibson: Not at all. Thank you.

Expenditure Proposals 2007-08 and Autumn Budget Revision

11:28

The Convener: We move to agenda item 4. Audit Scotland's budget for the current financial year was approved by the commission at the end of last year. Members will recall that, at the end of our first meeting, we agreed that we would take evidence on progress that had been made in the current year and any in-year budget revisions that Audit Scotland may propose. I welcome Mr Black and Mr Frith back to the table and invite them to make any brief opening statement that they may wish to make.

Mr Black: I am not sure that we have anything that we want to add to what is contained in the papers that members have before them.

The Convener: Okay. Do members wish to ask any questions?

Derek Brownlee: I want to stray a little wider than the paper that I have before me. My question relates to how your organisation is performing in relation to efficiency. I want to consider the issue in a broader context than the efficiency programme in Audit Scotland.

When we consider how Audit Scotland spends its money, we must also consider the impact of Audit Scotland's activities on how the rest of the public sector spends its money. Has any work been undertaken on the impact of additional spending—or, indeed, a reduction in spending—by Audit Scotland? I am thinking of the consequences of that for the number and scope of audits that you are able to conduct and the consequential impact on the change in efficiency in the parts of the public sector that are your auditees. In other words, is there an easy way in which we can identify whether an extra pound of spending for Audit Scotland can save more for the public purse elsewhere? To turn the question round, could spending less money on auditing lead, through inefficiencies, to greater spending in the public sector?

11:30

Mr Black: That is a wide-ranging question. When I last appeared before the commission, to give evidence on Audit Scotland's annual report and accounts, we discussed the way in which Audit Scotland's role has evolved and developed since devolution. It is undoubtedly true that our role has evolved. I apologise for the fact that there is no simple answer to the member's question.

We are attempting to evaluate the impact that we have on public bodies, using a number of different criteria. What is our impact on the strength of financial management and the value for money that audited bodies deliver? What contribution are we making to improving the accountability of public bodies? We will also look at the efficiency and effectiveness agenda, the quality of service delivery and the quality of planning and control. We would like in our next annual report to present as clearly as possible what our impact on that wider dimension has been.

Of course, the fundamental requirement is for us to provide Parliament and the Scottish Government with an assurance that public money is spent properly and wisely, to achieve value for money. We do that through the large number of reports that we make. It is impossible to unravel from many other factors our impact on the high standards of financial stewardship in Scotland. However, I would like to think that over the years we have made a significant contribution to improving the standards of financial management and governance across the Scottish public sector.

Robert Brown: I return to the issue of EYF and fluctuation in the figures. In your preliminary note on the autumn budget revision, you indicate:

> "Audit Scotland had the following amounts available to request as EYF:
>
> Revenue £2.416m
>
> Capital £1.043m".

The figure for capital is explained partly by the £200,000 or thereabouts that is estimated for landlord works on the offices. Are there other capital requirements for EYF that will influence the matter, or is £200,000 the total figure?

Mr Black: I invite Russell Frith to answer your questions on EYF matters.

Russell Frith: The completion of the refurbishment of the 18 George Street offices, which was spread over the year end, has the biggest impact on capital. Subsequent to the year end, we have spent £475,000 on completing that refurbishment. Of the £1.043 million that you mentioned, £475,000 has already been spent on completing the refurbishment that was started before the year end. A further amount—possibly £200,000—is to be spent at some stage on the common areas, when the landlord decides the precise scope of the work that he wishes to carry out. It will include the refurbishment or replacement of the lifts in the building.

Robert Brown: Perhaps it is not all landlord driven, but that seems a far cry from an initial estimate of around £200,000. We are now talking about total costs of £675,000.

Russell Frith: The landlord works are additional works that we did not know about when the refurbishment was initially planned. After seeing the work that we had done on our areas, the landlord decided that the common areas, too, should be upgraded.

Robert Brown: I might come back to that. On the revenue side, you talk about your fees strategy requiring £480,000 of revenue funding to be carried forward. That is linked to what we were talking about before, which you explained as partly to do with evening out fee increases and things of that sort. I do not follow that—it seems to me that the fee increases can be taken in the round, and that when the money is received, and not whether it will lead to fluctuations in fee increases, is the real issue. Can I have an explanation about that?

Russell Frith: I will try. The fee levels are set on a resource basis and not on a cash-flow basis, so the two need to be divorced. All audited bodies have given us the clear message that they would prefer us to give a smooth and steady flow of fee increases rather than significant ups and downs from year to year, if we can manage that. One of the ways in which we can do that is by using the end-year flexibility to smooth the matching of costs and revenues—that is what we planned to do at the previous year end, taking it over two years. Hence, we still have the bulk of the £480,000 to play out in that.

Robert Brown: I understand that you would not require it necessarily all in the one year, and that the ability to have flexibility over a couple of years is valid—but I cannot understand why funding that needs to be permanently down to you. That seems to be a slightly different proposition.

Russell Frith: One of the assumptions that we made in presenting the 2007-08 budget to the commission a year ago was that there would be a degree of smoothing still to take place in 2007-08. The only way in which our organisation can do that is through using end-year flexibility. Because of the structure of Audit Scotland, we are not allowed to hold reserves. A normal organisation would have used reserves to smooth out differences between its costs and its charging, but as a body that is directly funded from Parliament, we are not allowed to hold any reserves. In other organisations, the amount that we use for fees and charges—and developing the business—would be funded from reserves.

Robert Brown: I am sorry to press you on the fees strategy, but I would appreciate some clarity—is that just an approach you take, or is it a written document that we can access? What about the point regarding more regular billing throughout the year to even out some of the flows?

Russell Frith: More regular billing would have no impact on that at all—the figure is an accruals figure and not a cash figure. We could have more regular billing—for example, monthly billing—for at least the larger bodies, but there would be a significant additional administrative effort in doing so, both for us and for the audited bodies. To us, it seems more efficient and economic to do it two or three times a year, depending on the size of the organisations.

Mr Black: I can recall, from my local government days, favouring an arrangement in which the audit fee was paid for a few months at a time, rather than a monthly billing system. It is a more efficient way of doing business.

Russell Frith: Robert Brown might be reassured that, in constructing our proposals for the next year, we believe that we have ended the need to use end-year flexibility for fees and charges—at least for the foreseeable future. We have tried to address some of those issues and I think that we have succeeded.

Robert Brown: Rather than the committee dealing with the matter today, might the Auditor General be prepared to write to us in more detail on exactly what is being proposed and how that might work through? It is quite an important issue—although it does not fundamentally relate to the accounts, it provides us with difficulties in understanding the flow of accounts. If that could be resolved, it would be helpful to my understanding as a layman, and perhaps for others as well.

Russell Frith: Yes, we will do that.

Mr Black: We will be happy to send you a letter.

George Foulkes: I have just realised why Derek Brownlee is asking such clever questions—he is an accountant. Robert Brown is interrogating effectively because he is a lawyer. I want to ask a daft-guy question. Do all the bodies that you look into have internal auditors, external auditors or both?

Mr Black: Yes. Any body of a significant size will have a significant internal audit presence, although it might be fair to say that some of the smallest ones do not. Russell Frith might be able to help with that.

Russell Frith: Even the smallest ones tend to have a degree of internal audit capacity, which they might share with other small bodies.

Mr Black: Yes, the small bodies would have a shared rather than a dedicated audit facility.

George Foulkes: So all your expenditure is extra expenditure on top of those bodies' expenditure on audit. Do you ever assess your work to find out how much you have saved and whether it is more than you cost?

Mr Black: Perhaps I misunderstood the premise behind your question. Each body in Scotland has an internal audit capacity of some sort. The external auditor is the auditor who is appointed by Audit Scotland. We are not an overhead in addition to that of the external auditor; we provide the external audit on behalf of the Parliament.

George Foulkes: So all the bodies that you scrutinise have internal auditors. I repeat my question: are the savings that are achieved as a result of your work compared with the cost of ensuring that those savings are achieved?

Russell Frith: The direct answer is no. The primary purpose of a significant proportion of our work, particularly the annual audits of the financial statements, is to provide assurance to the stakeholders—who are the equivalent of the shareholders in a company—that the accounts truly reflect the business over the preceding 12 months. In other words, a significant proportion of our work is not primarily designed to look for savings.

The performance audit programme—the programme of studies that come to the Audit Committee—has a mixture of objectives, one of which will sometimes be to identify what savings and efficiencies might be available. Performance and governance issues will be considered, too. One of the slides in the presentation that we gave at the away day illustrated some of the financial savings that we have helped to achieve over the past few years. For example, we recommended greater use of generic drugs, which led to savings in general practitioner prescribing costs. We helped to make benefit savings through the national fraud initiative and to improve in-year council tax collection rates. Those are examples of financial impacts that our work has had, but we do not design our study programme explicitly to save specific amounts of money. The aim of saving money is just one of a balanced series of objectives.

George Foulkes: Forgetting about your ordinary external auditing work, is it true that the amount of money that has been saved over the years would be substantially greater than the cost of the work that you do to find savings?

Mr Black: Yes. You might be reassured to learn that our costs are about £25 million to £26 million, which is less than 0.1 per cent of audited expenditure. Russell Frith mentioned some savings that we have helped to achieve. As regards identifiable savings—which are often for other bodies to deliver—we have estimated that £27 million was saved through the national fraud initiative, so one could say rather tritely that in one year alone our costs were met by the amount of fraud that was uncovered just by that exercise. However, I would not make such a claim. In addition, £14 million was saved on GP prescribing and more than £100 million was generated by improvements in in-year council tax collection rates. In respect of the management of housing voids and rent arrears, £33 million and £8 million, respectively, were gained, so we are talking about significant sums of money. However, I emphasise what Russell Frith said—the achievement of savings is no more than one part of our programme.

Budget Estimate 2008-09

11:45

The Convener: Finally, we will look at the outline budget plans for the next financial year, 2008-09. The SCPA would usually consider the budget in spring, but that was delayed this year as a result of the election. The purpose of the item today is to have a brief initial discussion. We will examine the matter in more detail at our next meeting.

Mr Black, would you like to add anything to the information that is in the letter before us today?

Mr Black: Only to say that, as I think you have implied, work is on-going on the matter as we speak. We are working on the detail of our budget submission, which will go to the Audit Scotland board before it comes to the SCPA by the end of the month. We are confident that the figures outlined in my letter to you will not move significantly between now and the end of the month.

The Convener: Are there any questions?

Robert Brown: I have one question. Can you confirm that whatever may come out of end-year flexibility is on top of the £7.249 million that is mentioned in your letter?

Mr Black: That is correct. We require end-year flexibility in order to manage the fee regime, as outlined in the letter.

The Convener: Does Derek Brownlee or George Foulkes have any questions? Speak now or forever hold your peace.

George Foulkes: We have another meeting to look at the matter.

The Convener: I thank Mr Black, Mr Frith and Mr Gibson.

The commission will now go into private to deliberate on the evidence that has helpfully been laid before us this morning.

11:46

Meeting continued in private until 12:03.

Members who would like a printed copy of the *Official Report* to be forwarded to them should give notice at the Document Supply Centre.

No proofs of the *Official Report* can be supplied. Members who want to suggest corrections for the archive edition should mark them clearly in the daily edition, and send it to the Official Report, Scottish Parliament, Edinburgh EH99 1SP. Suggested corrections in any other form cannot be accepted.

The deadline for corrections to this edition is:

Monday 1 October 2007

PRICES AND SUBSCRIPTION RATES

OFFICIAL REPORT daily editions

Single copies: £5.00
Meetings of the Parliament annual subscriptions: £350.00

The archive edition of the *Official Report* of meetings of the Parliament, written answers and public meetings of committees will be published on CD-ROM.

WRITTEN ANSWERS TO PARLIAMENTARY QUESTIONS weekly compilation

Single copies: £3.75
Annual subscriptions: £150.00

Standing orders will be accepted at Document Supply.

Published in Edinburgh by RR Donnelley and available from:

Blackwell's Bookshop

53 South Bridge
Edinburgh EH1 1YS
0131 622 8222

Blackwell's Bookshops:
243-244 High Holborn
London WC1 7DZ
Tel 020 7831 9501

All trade orders for Scottish Parliament documents should be placed through Blackwell's Edinburgh.

Blackwell's Scottish Parliament Documentation Helpline may be able to assist with additional information on publications of or about the Scottish Parliament, their availability and cost:

Telephone orders and inquiries
0131 622 8283 or
0131 622 8258

Fax orders
0131 557 8149

E-mail orders
business.edinburgh@blackwell.co.uk

Subscriptions & Standing Orders
business.edinburgh@blackwell.co.uk

Scottish Parliament

RNID Typetalk calls welcome on
18001 0131 348 5000
Textphone 0845 270 0152

sp.info@scottish.parliament.uk

All documents are available on the Scottish Parliament website at:

www.scottish.parliament.uk

Accredited Agents
(see Yellow Pages)

and through good booksellers

Printed in Scotland by RR Donnelley