MEETING OF THE COMMISSION

Thursday 10 October 2013

Session 4

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SCOTTISH COMMISSION FOR PUBLIC AUDIT
2nd Meeting 2013, Session 4

CONVENER

Colin Beattie (Midlothian North and Musselburgh) (SNP)

DEPUTY CONVENER

John Pentland (Motherwell and Wishaw) (Lab)

COMMISSION MEMBERS

Hugh Henry (Renfrewshire South) (Lab)
Alex Johnstone (North East Scotland) (Con)
Angus MacDonald (Falkirk East) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Ronnie Cleland (Audit Scotland)
Russell Frith (Audit Scotland)
Caroline Gardner (Auditor General for Scotland)
Diane McGiffen (Audit Scotland)

SECRETARY TO THE COMMISSION

Catherine Fergusson

LOCATION

Committee Room 5

Scottish Commission for Public Audit

Meeting of the Commission

Thursday 10 October 2013

[The Convener *opened the meeting at 09:47*]

Interests

The Convener (Colin Beattie): I welcome everyone to the second meeting in 2013 of the Scottish Commission for Public Audit. I remind everyone to ensure that their mobile phones and any other electronic devices are switched off. We have received no apologies.

For agenda item 1, I invite Hugh Henry to declare any relevant interests.

Hugh Henry (Renfrewshire South) (Lab): I have nothing to declare, convener.

The Convener: Thank you, and welcome back to the SCPA.

Hugh Henry: Thank you.

Decision on Taking Business in Private

09:48

The Convener: Agenda item 2 is a decision on taking business in private. Does the commission agree to take in private the items that are listed under agenda item 2?

Members *indicated agreement.*

Audit Scotland Autumn Budget Revision 2013-14

09:48

The Convener: Agenda item 3 is Audit Scotland's autumn budget revision for 2013-14. I welcome from Audit Scotland Caroline Gardner, Auditor General for Scotland; Ronnie Cleland, chair of Audit Scotland's board; Russell Frith, assistant auditor general; and Diane McGiffen, chief operating officer. I understand that the Auditor General must leave by 10.50 in order to catch a plane, and that Audit Scotland's other representatives will remain here, if necessary, to answer questions that we might still have. I invite the Auditor General to make an opening statement.

Caroline Gardner (Auditor General for Scotland): Thank you, convener, for your flexibility over timing. I will, of course, remain for as long as the commission requires me this morning. I had flagged up to the clerks that I had booked a flight for later but that it could be changed, if necessary.

Since we submitted our autumn budget revision, the Scottish Government's finance team has raised a timing issue with us about the submission itself. First, it has advised us that the pensions element of the submission can be treated as annually managed expenditure, or AME. Until now, all of Audit Scotland's budgets and budget revisions have been treated as falling within the departmental expenditure limits, or DEL. Treating that as AME has advantages for the overall Scottish budget position with Her Majesty's Treasury, but the level of AME cover for Scotland as a whole is redetermined only once a year in late autumn and agreed changes to the Scottish total are then included in the spring budget revision. The Government's finance team has therefore requested that we defer this element of our proposal until the spring budget revision, when the finance team will have received confirmation of the revised AME total from the Treasury. We are content to accept that, subject to the SCPA's agreement.

Secondly, the Government's finance team has asked whether we would defer the remaining proposal for £160,000 within our submission, which covers the contingent liability that is recognised in our 2012-13 accounts, in order to provide more time for the finance team to assess the emerging picture of prospective underspends and pressures. That element will likely remain a DEL requirement. Having had discussions with the Scottish Government's finance team, we are on this occasion prepared to defer our autumn budget revision proposals until the spring budget revision, on the clear understanding with the Government's finance team that this is entirely a timing issue for this year and that the proposal will be included in the SBR in full and be subject to the established arrangements for scrutiny by the SCPA. Our proposals and the reasons for them will remain unchanged.

The timing of the request from the Scottish Government means that we have not been able to reflect it in our submission to the commission. We have been in discussion with the Government finance team over the past few days, which led to my letter to the convener yesterday asking you not to consider our proposal at today's meeting but instead to note that the proposal will be resubmitted for the spring budget revision later this year, as our need for the resources will remain unchanged.

The Convener: Thank you. As you have stated, we received a request from you late yesterday afternoon to defer consideration of the matter. Obviously, it was too late to do that because it was already an agenda item that was in the public domain. However, the liabilities remain, even if they are deferred, so there is an opportunity for members to discuss that and to get a better understanding of it. When we move into private session, members can decide whether they are comfortable with deferring consideration, as you have requested.

My first question is this: can Audit Scotland explain why the £160,000 was not provided for in the 2012-13 balance sheet but was instead disclosed as a contingent liability, given that the amount was agreed, finalised and paid over—I think—to HM Revenue and Customs?

Caroline Gardner: Russell Frith will talk you through that. As you will know, it has been a long-standing matter of discussion with HMRC, and the accounting treatment was a matter of some discussion with our auditors.

Russel Frith (Audit Scotland): When the accounts are prepared, we and our external auditors have to take a view on the likelihood of particular items becoming actual liabilities. At the point at which we were forming those judgments, we made provision for an element of what we were discussing with HMRC, but we were still hopeful that we would be able to limit the liability to the amount that we had provided in the accounts, while recognising that there was a possibility that it could increase up to £160,000. It was a judgment call that we discussed extensively with the external auditors; we were both comfortable that we had got the right balance between provisions and contingent liabilities.

As it turns out, within a couple of months of the accounts being finalised we reached agreement with HMRC, and the liability was at the upper end, so the £160,000 stopped being a contingent liability and became an actual liability.

John Pentland (Motherwell and Wishaw) (Lab): In your letter of 13 September 2013 to the convener you highlight that interest and penalties might arise from backdated VAT, although that is still to be confirmed by HMRC. Can you provide an update on the position with regard to penalties and interest and can you offer us an assurance that those costs will be met from Audit Scotland's existing approved budget?

Caroline Gardner: Certainly. Again, Russell Frith will talk you through the detail.

Russell Frith: We have provided all the information to HMRC to allow it to come to a view on the amount of interest and penalties, but it has not yet come back to us with the amount that it will require. Our understanding of the various ranges of penalties that HMRC applies and the circumstances in which it applies them suggests that the penalties will not exceed about 15 per cent. We have covered that within the provisions that we have already made.

John Pentland: Are you telling the commission that you think that the £160,000 that has been set aside will, if necessary, cover any interest or penalties.

Russell Frith: That is what we expect.

The Convener: Alex Johnstone is next.

Alex Johnstone (North East Scotland) (Con): Have we covered question 8?

The Convener: Yes. No. I am sorry—it is me that is going adrift, here. Angus MacDonald is next.

Angus MacDonald (Falkirk East) (SNP): I will stick to the same theme. The commission is aware of the on-going negotiations between Audit Scotland and HMRC, as has been confirmed this morning. Can Audit Scotland provide the commission with an update on negotiations with HMRC, and with further information about the basis of HMRC's challenge? For example, is HMRC challenging the VAT status of the Accounts Commission?

Caroline Gardner: As the commission will be aware, there are two VAT issues under discussion between us and HMRC. The first is the issue that is related to registration of Audit Scotland for business activities, which has been a matter of discussion in relation to our annual accounts with the commission over the past couple of years, and for which a contingent liability was registered in our accounts and discussed with the commission earlier this year.

That contingent liability of £160,000 is now crystallising, although we are pleased to be able to say that that issue is now closed down and we are simply waiting for confirmation of the charges that HMRC will apply within the £160,000 that we have discussed. Unfortunately, however, HMRC has recently raised a new issue with us that relates, as you said, to the tax status of the Accounts Commission.

Audit Scotland was formed in 2000 by merging the former Accounts Commission for Scotland with the National Audit Office's activities in Scotland. The new body, Audit Scotland, covers all audits of public bodies in Scotland. Before the merger, the Accounts Commission had what is called section 33 status, which enabled it to reclaim input tax on the audit fees that were charged to local government for audit activity in that sector. We entered into discussions with HMRC's predecessor body about continuing that status since the Accounts Commission's responsibilities were unchanged under the new arrangements. The Accounts Commission continues to exist and Audit Scotland carries out activity on its behalf, but the statutory functions remain with the Accounts Commission.

We discussed the issue with HMRC over a long period and reached an agreement in 2006 that reflected the Accounts Commission's continuing status and activity and enabled us to reclaim input VAT on its behalf, which we have been doing since then.

HMRC has now raised a question about the standing of that agreement and we are in continuing discussions with it about its application over the past seven years and its application in the future. It is still a matter of very live discussion between us and HMRC. The commission will understand that the extent to which we can air that in public is limited. However, we would be very happy to give in private any extra information that the commission might find helpful.

Angus MacDonald: Thank you. Do you have any indication from HMRC on the timescale for further negotiation?

Caroline Gardner: It is very hard to predict that. We responded to HMRC's original raising of the issue very quickly and are waiting for a response. The timescale after that will depend on the response that we receive from HMRC and what further work it requires.

Hugh Henry: Can I follow up on that?

The Convener: Sure.

Hugh Henry: If HMRC does not change its view and there is future liability, are there any options for service delivery that would avoid that liability?

10:00

Caroline Gardner: The scale of the amount that we are talking about makes it very difficult to see how we would do that. The scale of the past liability, which is in question, is more than £4 million. The amount that we have reclaimed during that period has been between £400,000 and £500,000 a year. The commission is aware that we have just been through a four-year budget strategy under which we have reduced the cost of audit by more than 20 per cent. In doing that, we have been very conscious of the need to demonstrate that we are applying the same discipline to ourselves as we expect of the rest of the public sector and to ensure that we are not damaging our ability to carry out the range and quality of the audit work that is more than ever required in the current financial climate. I struggle to see how we could again reduce costs by anything approaching that amount. We will obviously continue to apply pressure, but the options that we would have would be to ask the SCPA for funding, or to look at recovering the money through local government fees, neither of which is palatable.

Hugh Henry: I was not so much asking how you could reduce your costs to cover liability as trying to establish whether there is another way of delivering the service that does not end up incurring that liability. Would the cost of services provided directly by Audit Scotland still be recoverable, and those of services provided by external auditors not be recoverable?

Caroline Gardner: If HMRC continues in its current direction of travel with this issue, we will have to look at other models of service delivery and consider their VAT and other implications; VAT implications are not the only aspect that we would need to explore.

At the moment we have a commitment to five-year audit appointments for the in-house teams and for the firms with which we work, and we would need to continue with that. I have, in any case, asked Russell Frith, as the assistant auditor general, to start looking at options for service delivery. We will play the VAT implications into that; those implications cannot be seen in isolation.

Alex Johnstone: Have you considered at this stage the potential costs and benefits of engaging specialist advice, including funding the fees of an adviser?

Caroline Gardner: Yes. We are trying to strike a balance. On the one hand are the interests of the bodies that we audit and the SCPA in ensuring that we get a good outcome to this particular VAT issue but, on the other hand, we are conscious that there is a potentially high cost for professional advice and that we are spending public money. So far, we have responded clearly to HMRC about the grounds on which we believe its challenge is wrong, but we have also made sure that we will be able to draw quickly on professional support if the need to do so becomes apparent. It is a fine balancing act for us; we are talking about public money, so we are looking to manage it as well as possible.

Alex Johnstone: I will ask you to speculate again, I suppose. What consideration have you given so far to how you might seek the resources that are necessary to deal with the situation if your challenge is unsuccessful?

Caroline Gardner: It is very hard to predict that, especially given how difficult it is to predict what direction the discussions with HMRC might take. We are comfortable that, within the current scale of the issue, we can absorb the cost using this year's resources, but we would need to come back to the commission if, during the next few months, it becomes a more significant issue than we hope.

Hugh Henry: I will come back to the issue that I raised earlier about other ways of ensuring that there is no future liability. One option might be to allow external firms directly to invoice local government. What would be the implications of external firms directly billing local authorities for audit work that they perform on behalf of the Accounts Commission?

Caroline Gardner: I am reluctant to speculate on that because we are discussing live issues. I ask Russell Frith to give you a high-level response to that.

Russell Frith: I will give a response that is entirely VAT-related rather than one that takes account of the wider implications of the suggestion.

When we discussed the potential agreement with HMRC back in the early 2000s, we raised that specific point. HMRC's view at the time was that if we were to switch the arrangement such that firms would bill audited bodies directly, it would not regard that differently in VAT terms from the arrangement that we have.

The Convener: I will ask a question about the pensions adjustment. Why does Audit Scotland have to rush to fill the pensions gap when there are many pensions deficits around the country as a result of, for instance, changes in accounting requirements and the reduced yield on bonds? I have not heard of other public bodies rushing to try to fill that gap, so why does Audit Scotland?

Caroline Gardner: That is because of a combination of unusual circumstances, which has led to the accounting adjustment having a different impact on us than on—[*Interruption*.]

The Convener: Somebody obviously has a mobile phone or something switched on. I ask everyone to check and make sure that their phones are dead, please.

I apologise.

Caroline Gardner: Not at all, convener. Thank you.

We have a particular combination of circumstances that mean that the technical accounting adjustment has a different impact on Audit Scotland than it does on most public bodies.

We are governed by the central Government Treasury public bodies accounting framework, which means that we are not able to carry forward surpluses or reserves from one year to another. The only way that we can access underspends is through requesting end-year flexibility through the auspices of the commission.

However, at the same time, most of our staff are members of the local government pension scheme, which, unlike the civil service pension scheme, is a funded scheme that contains significant assets that are invested to cover future pensions liabilities as they become due, and which is governed by the international financial reporting standards, which means that there must at each year end be an accounting adjustment to reflect the value of the liabilities within the scheme.

Most bodies in the local government scheme are faced with the same accounting adjustment and have access to reserves that they can build up and run to enable them to cover the implications of that adjustment on their accounts. Most bodies that are under the same accounting framework as we are have staff in the civil service pension scheme, which is unfunded and does not require that accounting adjustment. Our challenge is that we straddle both and have, therefore, to deal with the impact of the accounting adjustment, but lack the flexibility to run reserves to cover it.

In broad terms, that is the nub of why it is an issue for us in a way that it is not from most other bodies. It is also worth saying that it is hard to predict the scale of the adjustment. Our actuaries do not inform us of it until after the year end, as at 31 March each year, and small changes in the interest rates that are applied can have significant impacts on the size of the accounting adjustment that is needed.

The Convener: In the second-last paragraph on page 2 of the ABR, you say:

> "This bid seeks to access as an ABR the funds retained by the consolidated fund in respect of pension adjustments in the past seven years."

Is the consolidated fund a general pot or is there within it a special pot for Audit Scotland that you expect to tap into?

Caroline Gardner: It is very much a general pot.

I direct members' attention to the table on page 3 of the autumn budget revision, where they will see the adjustments that have been made since 2006-07 to our pensions accounting, which come out at a net £8.6 million favourable adjustment where we have not sought to access the funding when the accounting adjustment has moved in our favour. You will see that, on a couple of occasions, the adjustments have been significantly in our favour: £6.5 million in 2010-11 and £875,000 in 2006-07. Because it is purely an accounting adjustment, we have been content for that money simply to return to the pot and be used for other purposes. There is not a particular pot marked "Audit Scotland", like a savings account on which we would want to draw.

It is also important to say that we have flagged up the issue with previous commissions, in our submissions and at meetings, as something that we expected would come to pass at some point, depending on movements in the scale of the pensions liabilities and changes in the valuation arrangements. [*Interruption*.]

The Convener: I am just checking my phone—I am okay.

Has Audit Scotland had any preliminary discussions with the Scottish Government about availability of the resource?

Caroline Gardner: That has been the subject of the discussions that I referred to in my opening statement. Russell Frith will talk you through those discussions.

Russell Frith: Once the Scottish Government was aware of our autumn budget proposal, and in particular the pensions element of it—this is the first time we have looked for any form of budget revision for an unfavourable pensions movement—it identified that under the budgeting rules between Scotland as a whole and the Treasury, it would be able to classify the adjustment under the AME rules rather than the DEL rules. That is favourable for Scotland as a whole, because AME is the type of expenditure that the Treasury, at United Kingdom level, does not expect bodies to be able to predict as accurately as they would the fixed normal running costs of an organisation.

The Government as a whole therefore has the opportunity to redetermine AME with the Treasury later in the autumn—they do that only once a year. In effect, Scotland should therefore be able to obtain an addition to its overall resources to cover the adjustment. If the adjustment was treated as being within DEL, Scotland's limit would not be going up and the resources to meet it would have to be found somewhere else within the existing Scottish block, if you like. However, because the Scottish Government has identified that it can regard the adjustment as AME for budgeting purposes, it should be able to increase the overall amount of resource that is available to Scotland to cover the adjustment.

Hugh Henry: I have a more general question, although I do not know whether the witnesses are in a position to answer it. Given the debate about a switch to AME from DEL in this case, are other significant areas of expenditure being switched to AME from DEL?

Russell Frith: Other areas of expenditure are within AME and have been for some years. Indeed, the possibility of doing this if there was an unfavourable pensions movement has existed for a little while, but it is not a situation that anybody has had to deal with before now.

Hugh Henry: Yes, but given that you are saying that a number of areas of activity are already classified as AME, are there any areas that are currently being considered for switching from DEL to AME?

Russell Frith: I am not aware of any.

Hugh Henry: Okay.

The Convener: There are no more questions. I remind members that the letter from HMRC on the VAT issue is confidential and should remain so.

Audit Scotland Budget Proposal 2014-15

10:13

The Convener: Item 4 is Audit Scotland's budget proposal for 2014-15. I invite the Auditor General to make any comments that she might have. I would appreciate it if she could touch on the potential impact of the liabilities that we spoke about under the previous item.

Caroline Gardner: Thank you. As chair of Audit Scotland's board, Ronnie Cleland will kick off, and I will add a few sentences, if I may.

Ronnie Cleland (Audit Scotland): Thank you. I will say a couple of things to give you the context. I appreciate that some technical and procedural issues have been raised that are beyond your and our immediate control.

I will say three things about the budget proposal. I draw your attention to the successful progress that we have made on cost reduction in our four-year plan, which I think is very noteworthy. I reassure the commission of the rigour that the board has applied to reviewing the budget proposals. We met on a number of occasions to go through them and the other board members and I are all content with the document and the presentation that is before you. Equally, we can provide reassurance to the commission that, in our view, the on-going reduction in costs will have no effect on the quality of our work. I know that that is an issue that the commission has raised previously and which it is rightly concerned about, as, indeed, is the board. The quality of our work is paramount to us.

I just wanted to set the context in terms of the board's role in oversight of what is in the proposals and how we came to be satisfied with them. Caroline Gardner will now say a few words about the submission itself, in line with the information that the commission requires.

10:15

Caroline Gardner: Thank you.

The paper that is before the commission sets out our budget proposal for 2014-15, which, as Ronnie Cleland said, completes our four-year plan to reduce the costs of audit by at least 20 per cent. We are requesting a total resource requirement of £6.6 million, which represents an overall cash increase of just 0.1 per cent on the approved 2013-14 budget. It comprises a slight increase of £64,000, or 1 per cent, in revenue funding, which is partially offset by a £55,000, or 21.6 per cent, decrease in capital funding.

The distinction between those two is important. We are required to account for revenue and capital differently. The increase of £64,000 in revenue funding relates specifically to the shift of responsibility for police and fire bodies from local government. Previously, that money was collected by the central Government sector through fees to those bodies. The £64,000 represents the share that we would welcome from the SCPA in funding our new performance audit responsibilities there under the central Government block.

Over the four-year period of our budget strategy, our proposals will deliver a real-terms reduction in audit fees of 23.5 per cent. In addition, we will deliver gross administrative costs that have been held at 2013-14 levels, which, in real terms, represents a 1.9 per cent reduction; a fourth year of overall cost reductions; and a freeze of most planned audit fees for 2013-14 audits at the 2012-13 levels.

I am pleased to confirm that the submission demonstrates the successful completion of our four-year medium-term financial strategy. We are now starting to look ahead to the period to come. We have made significant savings over the past few years, which, together with those in our proposed project, represent the limit of what we believe can be achieved at the moment in demonstrating that we are applying to ourselves the same financial disciplines that we expect of other public bodies across Scotland, while maintaining the range and the quality of the work that we are required to deliver at a time of significant financial pressures on all public bodies. We will continue to apply real discipline and rigour to ourselves, but the four-year budget strategy is now complete. We will take a longer-term look, in which we expect to consolidate the changes that we have made and to focus on demonstrating the maximum benefits that we can for the Scottish Parliament and for the wider public sector as a whole.

The Convener: Thank you.

I am not clear where the liabilities that we have been looking at are reflected in the budget. You talk about delivering a four-year cut in fees and budget reductions, but how have you factored in the cost of those extra liabilities?

Caroline Gardner: There are two different liabilities, which it would be helpful for me to take in turn. The first is the VAT liability that relates to the issue of the Accounts Commission’s VAT status, which we discussed at the beginning. At the moment, it is too soon for us to be clear what the likely outcome of that issue is. We have flagged it up at the earliest opportunity with the SCPA, as we did with our board, to ensure transparency, but it is difficult for us to predict what the scale of the outcome might be or how the issue should best be dealt with in the event that we are unsuccessful in explaining to HMRC why we think that its interpretation might not be correct. We will certainly keep the SCPA fully briefed as that process develops.

The second significant issue that we have discussed with the SCPA is the pension accounting adjustment, which comes through at the end of each financial year. For a long period, our position has been that it does not make sense for us to try to build that into our base budget. We are in an unusual position in that there is an overlap between our central Government accounting status and our membership of the local government pension scheme. The liabilities are extremely difficult to predict, as you can see from our submissions. They change significantly year on year from favourable to unfavourable, and there are extremely large variations in the scale of the numbers. They are always retrospective, and very small changes in the interest rates that are applied have a significant impact.

For that reason, we do not think that it makes sense to try to build those amounts into our standing budget for you. We would run the risk of either windfalls that we had done nothing to deserve or costs that we were required to meet that would have a big impact on our ability to deliver our business. Instead, we would like to continue the process of using end-year flexibility to cover them with you. As Russell Frith has outlined, the Government suggests that, in the future, that should be done through the AME process for Scotland as a whole rather than through the autumn budget revision DEL process. I hope that that helps to explain why you are not seeing those figures in the budget submission.

The Convener: You have stated that you expect that those pension deficits will continue in the years to come. I realise that there is no certainty of that, but it is a strongly held opinion. Does that not indicate that you should at least be considering whether there is provision for that?

Caroline Gardner: We think that it is not sensible to try to build the amounts into our base budget for a couple of reasons. First, they are likely to continue to fluctuate significantly because of the scale of small changes in the interest rate that is applied on the accounting adjustment that is needed. Secondly, it is simply an accounting adjustment, and the AME process is designed to cover those sorts of issues that are outside the control of either individual bodies or the Scottish Government as a whole. Our view is that that continues to be the best treatment for them, as it has been in past years in which we have had significantly favourable adjustments from which we have not benefited.

Angus MacDonald: On page 6 of your budget proposal, you note:

"Continuing reform of the Further Education sector will also have an impact on audit work, as will the requirement to audit local authority charities."

Can you provide further information regarding those two issues and advise us of any impact on future resources?

Caroline Gardner: Certainly. I ask Russell Frith to pick that up.

Russell Frith: As you will be aware, as part of the further education reform, a significant number of colleges are involved in mergers—in fact, all the planned mergers will take place during 2013-14—so we will have a smaller number of larger FE college audits to do. At the moment, virtually all the FE college audits are carried out by firms; therefore, there is a reduction in our fee income and an offsetting reduction in the cost of using firms in that area.

On the local authority charities, we are still establishing with each council the precise number of charities that will require to be audited. If councils are able to complete their reorganisation processes before March next year, that will significantly reduce the number of those charities. A year ago, there were around 1,200 individual registered charities among the 32 local authorities, which at that point would all have been required to be audited. Many authorities have made significant progress in merging those charities and bringing their number down to something much smaller, and we anticipate being able to cover them. We are separately agreeing the costs with each local authority, depending on their circumstances, so it will be cost neutral for us.

Angus MacDonald: Thank you. I had not realised that there were 1,200 charities out there in schools. I presume that some of those will be new charities that have been formed through the non-profit-distributing organisation school building programmes.

Russell Frith: Actually, none of the 1,200 is. They are, in the main, very old legacy or endowment-type charities that were formed around the turn of the previous century when individuals left money in the care of the structure of local government at that time to—to use a frequent example—pay for school prizes.

John Pentland: The bulk of Audit Scotland's income comes from fees charged to public bodies. Table 3 on page 9 of your budget proposal shows that the budgeted income from charges to further education colleges has fallen from £512,000 to £408,000. Can Audit Scotland explain that change in forecast income in that sector? I ask the question particularly because you state on the same page:

"For Further Education colleges, charges will rise by 1% reflecting the terms of the competitive tender undertaken in 2010."

Russell Frith: The drop from £512,000 in 2013-14 to £408,000 in 2014-15 reflects the reduction in the volume of work as a result of the mergers, which is offset to some extent by a 1 per cent increase in the price of the work being done.

John Pentland: The same table shows that income from local authorities will fall by £295,000 at the same time as the income from Scottish Government departments and sponsored bodies will increase by £319,000. Can you provide an explanation for those year-on-year movements?

Russell Frith: Yes. The local authority decrease is entirely the result of the abolition of the individual police and fire joint boards, and the increase in central Government income is largely the cost of auditing the new single Scottish Police Authority and the Scottish Fire and Rescue Service.

Alex Johnstone: You have more or less answered the question that I was going to ask. Given the changes that are happening to the police and the fire and rescue services, do you anticipate further future efficiency savings over time, or are you accounting for all the efficiency savings that will be achieved by those changes?

Russell Frith: We envisage that, from an audit point of view, there will be more work to be done in the first year than when the new organisations have fully settled down. During the first year, in several cases, they will have numerous legacy systems in place. For example, there will be several payroll systems still in operation for at least part of the year.

Alex Johnstone: Do you see the changes contributing a major efficiency saving like the one that you have described in the colleges sector?

Russell Frith: In terms of audit fees, yes. In the information that we gave to the Scottish Government for the financial memorandum to the Police and Fire Reform (Scotland) Bill, we suggested that the total cost of audit would fall by about half once the new bodies had fully settled in.

The Convener: Over the years, we have recognised the efforts made by Audit Scotland to implement budget and fee reductions. Table 6 on page 14 highlights the progress that has been made over a number of years. Do those figures include any EYF that has been sought as a result of autumn budget revisions? What impact would they have had on the table?

Caroline Gardner: The high-level answer is that the reductions that are shown there are not related to EYF but are instead related to the progress that we have made in restructuring our workforce and reducing staff numbers, changing the way that we work to ensure that those reductions do not limit our ability to carry out our role; to the tendering exercise that was carried out in 2010 for the audit firms appointed by Audit Scotland on behalf of me and the Accounts Commission; and to the savings coming from our property strategy, which is reducing the number and cost of the properties that we have to accommodate our staff around Scotland. On top of those things, there are a range of smaller efficiencies that we will continue to bear down on. I ask Russell Frith to clarify the impact of EYF on the figures in the table to which you refer.

Russell Frith: Table 6 shows the total approved SCPA funding for the year. The figures in table 7, which shows the fee reductions, are independent of SCPA funding.

Caroline Gardner: In some cases, the fee reductions are affected by EYF where we have specifically sought EYF for smoothing funding movements between years.

The Convener: Are they already adjusted for that?

Caroline Gardner: Russell Frith is telling me that I am misleading you, so I will stop and let him give you the detail before I go any further.

10:30

Russell Frith: The fee reductions are the fee reductions that we have notified to each audited body for that audit year. In addition to those, we have given fee rebates when we have used money that you have previously approved under autumn budget revisions to provide a cash return, if you like, to the bodies concerned. The fee reductions are in addition to those.

The Convener: Where are they reflected in the figure?

Russell Frith: In effect, we are talking about timing differences. The overall reduction of 23.5 per cent, as shown in the bottom right-hand corner of table 7, is the correct overall figure. The meaning of the rebates is that, in effect, we have moved towards that total faster than we envisaged and so have been able to give money back in some of the intermediate years, but the overall figure of 23.5 per cent is the accurate total.

The Convener: So the rebates are reflected in the fee figures.

Caroline Gardner: No, convener. As page 14 says, the fee reductions are the average fee reductions that are baked into the fees charged. On top of that, as we say a couple of lines above, we have rebated fees totalling £2.5 million to audited bodies when our total expenditure in any given year was less than we expected. Because we are not able to carry that forward as reserves and use it to smooth, we have handled it through rebates, and that is accounted for you through our annual accounts, which you scrutinise, and through EYF when we have made use of it to carry cash forward for that purpose. The two together tie the 19.1 per cent to the 23.5 per cent, as Russell Frith said.

The Convener: So the percentage increase is correct.

Caroline Gardner: The percentage decrease is correct.

The Convener: The percentage decrease is correct at 23.5 per cent.

Caroline Gardner: That is right, yes.

Angus MacDonald: At the top of page 18 of the budget proposal, you indicate that you are likely to seek £1.280 million as part of your budget proposals for 2015-16 to fit out a new office. Can you offer assurances to the commission at this early stage that that potential request for capital resources will be supported by a business case that will clearly demonstrate the longer-term saving that will flow from the initial investment?

Caroline Gardner: The short answer is yes, we can certainly provide that assurance. I will ask Diane McGiffen to talk you through how we are planning for that at the moment.

Diane McGiffen (Audit Scotland): We have been working under our property strategy for some time to rationalise our offices. The plans that we are working with at the moment take advantage of the expiry of the leases on our two remaining Edinburgh properties. The leases expire at different points and we are looking at minimising the cost of transition to a new property. We are actively looking across the whole range of property that is available at the moment and taking account of our needs, our desire to reduce our overall footprint, and our wish to secure an efficient and easy-to-run office environment that meets our business need to bring our teams of colleagues together to work across different sectors.

We have been developing our own specification for that. We have already moved from having three properties in Edinburgh to having two, which has generated significant savings for us, and we hope that the move that we make, which we see as being a long-term investment, will deliver revenue savings and operational efficiencies. To achieve that will require up-front capital investment and, obviously, we will be looking to get best value in everything we do.

The projections in the budget proposal are based on our best estimates of our experience of moving recently from our East Kilbride office to our

Glasgow office, and we will refine and revise those projections as we approach the definite budget proposals that we will make to the commission.

Angus MacDonald: Just for information, the East Kilbride offices are now closed; is that right?

Diane McGiffen: Yes.

Hugh Henry: Successive administrations have encouraged the relocation of offices away from Edinburgh. Given that much of your work is done across Scotland, are you looking at relocating the Edinburgh office space to other parts of Scotland?

Diane McGiffen: We are looking at where our client base is for the staff who work in the Edinburgh office. Although there is a move to relocate away from Edinburgh, much of our audit work is located in Edinburgh—for example, the Scottish Government accounts, the local authorities and other services, the Scottish Parliament and so on—so we need to balance accessible transport links, the nature of the work that people do, the available property and so on. We take all of that into account. However, I must lodge with you that a significant amount of the work of our staff who are based here is Edinburgh based.

Caroline Gardner: It is also worth saying that, in addition to our Glasgow office, we have permanent office bases in Aberdeen and Inverness, as well as staff based in clients' premises around Scotland. Our Edinburgh base is a relatively small proportion of our total staffing, reflecting the distribution of work across Scotland.

Hugh Henry: But your headquarters function does not need to be in Edinburgh, because it does not directly serve the clients.

Caroline Gardner: As part of the business case process and the business strategy for property that Diane McGiffen described, we look at all our business needs. I think that we have two issues, one of which is that the size of our headquarters staff is relatively small in terms of people who are purely administrative, which is a small element of our work. Most of the staff who work in audit in Edinburgh audit bodies that are based in Edinburgh, such as the Scottish Government, other public bodies and the Scottish Parliament, or are performance audit staff who are currently mobile right across Scotland anyway. That is part of the reason why we think that we can reduce the footprint in Edinburgh. However, we think that we need to keep a base here in Edinburgh.

Hugh Henry: On page 19 of the budget proposal, you indicate that you will incur an additional 25 per cent on staff recruitment. Which posts are involved in that and why is there a need for an increase?

Caroline Gardner: I ask Diane McGiffen to pick up on that.

Diane McGiffen: We have been doing some restructuring and, at the end of quarter 2 this year, we were at about 94 per cent of our establishment, so we have some recruitment to carry out this year. We anticipate that, because our natural turnover rate has picked up and we have achieved our four-year plan, we will move into a scenario whereby we will need to replace many, if not most, of the staff who leave. We had a recruitment freeze for a period of time while we implemented the restructuring, and our recruitment costs went down. In addition, we annually recruit to our graduate training scheme, using assessment-centre methodology and other activities to attract the best-quality graduates that we can. The cost increases in the table on page 19 reflect our anticipation of the need to ensure that we replace any departures of staff and maintain a good recruitment strategy to continue our graduate recruitment scheme.

Hugh Henry: How many posts are involved in total?

Diane McGiffen: I do not have the exact figure, but it will be based on the projection of our turnover. We are at about 94 per cent of our establishment at the moment.

Hugh Henry: That seems quite a sum of money—£125,000—to spend on recruiting people. Indeed, in 2012-13, there was a spike of nearly 65 per cent in the cost compared with the cost for 2011-12. Why is it so expensive to recruit staff?

Diane McGiffen: We now extensively use online recruitment methods to reduce costs. Some of the previous costs that are reflected in our budget included the relatively expensive cost of widespread print advertising. However, we now use a smaller amount of print advertising alongside online resourcing and recruitment. We need to continue to advertise widely enough to attract the best-quality candidates into the mix that we have, which has some costs. The fluctuation in recruitment costs just reflects different points in the restructuring of the business.

Hugh Henry: Over the three-year period from 2011-12 to the proposed budget for 2014-15, there is an 80 per cent increase in the line for "Audit support—external fees". Given the state of external markets and that many financial, accounting and legal firms have been laying off staff and struggling, why has there been such a spike in fees?

Caroline Gardner: I ask Russell Frith to pick up that question.

Russell Frith: In previous years, the lines that are now shown as "Audit support" and "Legal &

other professional fees" have been shown as one. This year, we tried to break that out and be clear by distinguishing the two very different sets of professional support that we engage.

It is probably fair to say that the actual figure for 2011-12 of £390,000 was very much a low point. I seem to remember being questioned at the time by the SCPA on why we had not spent the budget for that year. In recent years, we have got better at planning when we are going to use the resource and which audits we will need it on, and we have got closer to the budget. As you can see, we envisage £731,000 in 2013-14, and the figure of £705,000 in 2014-15 will be a little bit down on that. That reflects a long-term process. The £390,000 figure was artificially low and the figures for 2013-14 and 2014-15 are a more realistic long-term trend.

Hugh Henry: I understand that the 2011-12 figure might have been unrealistically low, but between 2012-13 and 2013-14 there was an increase of almost 30 per cent, albeit that the figure is coming down for 2014-15. There was a significant increase in inflation, but it was nowhere near that figure, so why was there that increase and what was it for?

Russell Frith: The 2012-13 figure was part of the journey to improve our planning and use of the resource. I do not have the budget figure for 2012-13 with me, but it would have been at least the same as that for 2013-14 and probably higher, so at that point we were still on a journey of improving our planning and budget management in the area.

The reason that it is volatile from year to year reflects the nature of the work for which we use the support. We do not have a particular level of support that we constantly use. We look for specific specialist help for the performance audits that we do in any given year.

Caroline Gardner: It is also worth noting that within those figures is the cost of the national fraud initiative, which is carried out every other year and which builds in volatility. That is a UK-wide exercise, which in the past has been administered across the UK by the Audit Commission in England and Wales, and we buy into it. In future, it will be run by the Cabinet Office. Because it is a biennial exercise, volatility is built in by its nature.

That is in addition to our taking a much more business-focused approach, as Russell Frith said, to setting the budget for the other work in which we buy in specialist expertise to support our audit work, particularly the performance audit programme.

Hugh Henry: Notwithstanding that, I am not sure that I understand Mr Frith's explanation. If improving budget management performance means a significant increase in costs, surely the logic would be that the more that you improve, the more expensive it becomes. Should improvement in managing performance and costs not mean stability or reductions, rather than significant increases?

Russell Frith: Not necessarily, no. What I mean by improving planning and management is that, when we look at how much we will need in the next year and provisionally identify where we are going to use it, we follow that through and use it where we have planned to use it. In some earlier years, we planned to use external support and did not move sufficiently quickly to use it during the year. In some cases, it slipped over into future years.

10:45

Hugh Henry: So does the increase in the budget line during the period since 2011-12 reflect higher activity or higher charges by the external providers?

Russell Frith: It is higher activity.

Hugh Henry: Okay.

John Pentland: I have a supplementary question. Diane McGiffen identified the anticipated spend on training. How much does Audit Scotland set aside for absences from its total budget?

Diane McGiffen: Our absence figures for last year were about five days per person per year, which is very good when compared with wider absence figures. We presented those in our annual report and accounts, along with previous years' figures. We do not set aside a provision for absence, but we actively manage absence and support colleagues to return to work.

John Pentland: How much then does absence cost in your budget?

Diane McGiffen: You are asking me to do some hard maths when I am loaded with the cold. I would have to multiply the absence figures by the average daily rate which, if you give me a few minutes, I could seek some help to do.

John Pentland: Have the absence levels improved over the years, or are you still setting aside the same 3, 4 or 5 per cent of your overall budget?

Diane McGiffen: In the past five years, our absence level has improved, although last year there was a slight increase because of a few cases of long-term sickness absence that we actively manage and support. Because our absence figures are relatively low, a small number of long-term sickness absence cases will impact significantly on the overall figure. We discussed that with our audit committee and board in our quarterly monitoring reporting, and we will report on the underlying trends and reasons for that at the end of the year. The figure was looked at closely during this year's discussions because of that slight increase.

John Pentland: It would be good to get a figure for the past two or three years.

Diane McGiffen: Certainly, Mr Pentland.

John Pentland: My other question is about the budget lines. My understanding is that you cannot carry over a surplus to the following year. I think that Hugh Henry touched on this. For example, the budget for training has increased to £405,000 for 2014-15. Am I to assume that, for the previous years, the total figure that was allocated was spent on training?

Caroline Gardner: First of all, you are absolutely right that we cannot carry forward an overall surplus year on year. We can ask the commission to allow us to carry forward any underspend against our budget through EYF under the autumn and spring budget revisions. Any overspend against our budget is extremely bad news for me as Auditor General, because it means that our accounts get qualified and we go to great lengths to make sure that that never happens. Within individual budget lines, we obviously have overspends and underspends for a range of reasons. We manage them actively and they are subject to continual review by my management team and the board in their quarterly financial monitoring.

I ask Diane McGiffen to pick up the specific question about the training budget and the way in which it has developed over the years.

Diane McGiffen: We have a series of detailed training plans with each business group and we have our annual performance appraisal and development process. We take a strategic look at our workforce and what we need to do and we have a workforce plan that informs the investment in training that we want to make because we are looking at our capacity and the shift in skills requirements. An example of that would be that we are keen to look at the ways in which we can enhance a more diverse range of data analysis skills that are available to support audit work and use through audit work.

Through the individual performance development programme, each member of staff sits down with their manager twice a year to discuss training, and to look at their development needs in their role and how they anticipate their role changing. We plan a programme of activities based on that. Some activities are tailored to meet individual needs and some of them look across the business at all the requirements. It means that we can achieve economies of scale and put on training programmes that meet the needs of a range of staff at the same time.

We have been active in training in the current financial year and we have offered a broad range of training and development opportunities for staff. Some of the training and development that we do has multiple benefits. This year, we have introduced a mentoring scheme. We have 25 pairs of mentors in the organisation, who are helping to look at development needs and other things in the organisation.

There is a rich mix of things going on. Not all of them have a financial cost that is met in the training heading in the budget. For example, the mentoring scheme is more of a time issue, which is reflected in our time budgets and so on. There is a range of ways in which we plan and manage learning and development. We then look at the flow of work and how we can organise to ensure that training and development happens. We review that at the end of every year and look at what people said they needed to support them in doing their job and whether it actually happened, and the extent of that gap. We then explore that with managers and staff.

John Pentland: I do not doubt for a minute that training is made available, but I am asking whether the budget request is solely spent on training. I would not like to think that some of the £405,000 that is earmarked for training next year will be spent somewhere else.

Diane McGiffen: It is primarily spent on training. In previous years, we sometimes supplemented internally the training budget with other budgets rather than an outflow the other way round, as you are suggesting.

John Pentland: It would be good if you could provide the commission with a couple of examples of how the training budget is spent.

Diane McGiffen: Certainly. I would be delighted to do that.

The Convener: Auditor General, I am well aware of your time constraints, which have now been reached. There are a few more questions left. If you feel that you need to leave at this point, that is fine.

Caroline Gardner: The commission is my first priority, convener. Thank you.

The Convener: We will move on to Audit Scotland's fee strategy, although Hugh Henry has already touched on the first question.

Hugh Henry: Yes, to an extent. Page 8 of the fee strategy indicates that there is a requirement for external firms to perform 37 per cent of annual audit work, but the figures show that external firms are paid 20.6 per cent of Audit Scotland's budget.

Can you explain the difference between the proportion of work that is performed by those firms and the resources that are paid over to them?

Caroline Gardner: I will kick off and I suspect that Russell Frith will want to give you more detail. The 37 per cent relates to the annual audit work for the 200 or so public bodies for which I and the Accounts Commission are responsible. In terms of volume, 30 per cent of that work is carried out by firms and 63 per cent by in-house teams. We think that a mixed market is important, both for the ability to challenge the cost and quality between the different providers that we have, and because it allows us to learn from each other right across the sector.

The difference that you are referring to in the overall budget reflects that the annual audit work is not the only work that we do. We also have a programme of performance audit work that is carried out right across the public sector. There are audits of best value and community planning, primarily for the Accounts Commission, and there is also a significant and growing volume of work in investigating issues of public concern that are drawn to our attention by MSPs or members of the public. The balance there is closer to 20 per cent, as you said.

The Convener: On page 14 of the fee strategy document, Audit Scotland advises:

> "Total audit charges for a body comprise two elements ... the amount paid to the appointed auditor for the annual audit work ... and a fixed charge which covers the cost of performance audits, best value audits, National Fraud Initiative",

et cetera, and

> "a contribution to the central costs of running Audit Scotland."

Can Audit Scotland give an estimate of the relative proportions of the annual audit costs versus the fixed charges?

Caroline Gardner: It will vary between sectors, but I ask Russell Frith to give you an indication of that.

Russell Frith: As Caroline Gardner said, it varies significantly between sectors according to whether the sector pays for all of the audit work. In the example of local government, if I remember correctly, the part for local government that is not paid directly to the auditor is now up at around 25 or 28 per cent, but that covers the local government element of performance audit work and all the best value audit work. So we recover fees from a local authority for a significant chunk of audit work, but that is not paid over to the individual appointed auditor because the work is done by the central Audit Scotland teams. The fees come down to below 10 per cent for areas such as further education or the bulk of central Government, where the performance audit work is paid for through the funding from the consolidated fund rather than being charged to audited bodies.

The Convener: Thank you. I have a couple of other questions. On page 7 of the budget proposal under the heading "Pensions", you state:

> "Our proposals continue to include pension costs of £25k for the previous Auditor General".

How long does that continue?

Caroline Gardner: I will ask Russell Frith to keep me straight on the arrangement for the pension for the previous Auditor General. I preface my answer by saying that the arrangement is unusual. When the first Auditor General was appointed, it was not possible for him to be admitted to either the local government pension scheme or the civil service pension scheme for his period of service as Auditor General. He therefore has a specific arrangement that was put in place by the Scottish Parliament but administered and paid for by Audit Scotland. That arrangement does not apply to me or to future Auditor Generals, because the technical difficulties have now been resolved. I think that Russell Frith knows the background to the arrangement very well.

Russell Frith: Yes. Under the arrangement agreed with the Parliament for the previous Auditor General, we pay the pension that he earned from his time as Auditor General, which is currently £25,000 a year. That will continue for as long as he lives.

The Convener: As you said, the arrangement is unusual.

Caroline Gardner: Very much so.

The Convener: Members have no further questions, so I thank all the witnesses for their attendance. We now move into private session.

10:58

Meeting continued in private until 11:14.

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