

Llyr Gruffydd AM
Chair
Finance Committee
National Assembly for Wales

22 May 2019

By email

Dear Llyr

Public Audit (Wales) Act 2013

Thank you for inviting me to provide written evidence to inform your post-legislative scrutiny of the Public Audit (Wales) Act. In relation to the issues set out in point 1 of your letter, I thought it would be helpful to provide some information on how funding and fee-setting for public audit operate in Scotland.

Fee income represents approximately 71% of Audit Scotland's total funding, with the remainder coming from the Scottish Consolidated Fund. Audit Scotland has a statutory duty under the Public Finance and Accountability (Scotland) Act 2000 to seek to broadly break even on audit work that is charged for, taking one year with another, either for each audit or for classes of audits. Audit Scotland treats each sector (e.g. local government, health) as a class of audits. Audit fees are set with the objective of recovering the full cost of audit work in each sector. I have attached a copy of our funding and fees strategy for information.

The principles of the funding and fee setting arrangements are designed to underpin the delivery of high quality, independent public audit in Scotland while demonstrating accountability for the public money involved. Enclosed is a copy of our Fees & Funding Strategy for reference.

The objectives are as follows:

- Comply with the Public Finance and Accountability Act
- Maintain the independence of auditors
- Reflect the way in which public services are organised and audited
- Minimise volatility from year to year without reason
- Transparent and easy to understand
- Simple to operate
- Sustainable

Audit Scotland is not able to hold reserves. Within this constraint, the flexibility provided by the legislation to broadly break even for classes of audit enables Audit Scotland to manage its business effectively by:

- Supporting differences between years in the overall amount of work performed in each sector
- Recognising the extent of cross sector joint working and the judgemental nature of allocating this between sectors
- Recognising the need to apportion overheads between sectors
- Smoothing changes in fee levels from year to year to reduce volatility and provide predictability
- Providing flexibility to manage the difference between the financial year and the audit year.

I hope that this information is helpful to your enquiry, and I look forward to meeting you and the Committee in June.

Yours sincerely

A handwritten signature in black ink that reads "Caroline Gardner". The script is cursive and fluid, with the first letters of each word being capitalized and prominent.

Caroline Gardner
Auditor General for Scotland

Fee Strategy

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Key messages

- We have completed a review of funding and fee setting arrangements.
- We carried out a successful audit procurement exercise leading to new audit appointments being made for the 2016/17 to 2020/21 audits.
- Our aim is to deliver independent, consistent, high quality, wider scope public audits whilst achieving best value in our use of resources.
- We will reduce average fee levels for the 2016/17 audits by 6.7% (8.6% in real terms).
- This is on top of a 24% reduction on average in real terms between 2010/11 and 2015/16 audits.
- We expect to make further real terms reductions in fee levels for 2017/18 and 2018/19 audits.
- Our 2017/18 budget proposal includes the transfer of funding for NHS performance audit from audit fees to the SCF. We will reduce audit fees to the NHS by the same amount.

Introduction

1. This fee strategy supports Audit Scotland's 2017/18 budget proposal, sets out our approach to setting fees and the fee levels for 2016/17 and future audits.
2. Audit Scotland's principal statutory function is to provide services to the Auditor General and the Accounts Commission. They appoint independent external auditors to most public bodies in Scotland and determine the scope of audit work through the Code of Audit Practice.
3. We are funded by a combination of fees to audited bodies and funding from the Scottish Consolidated Fund (SCF). Audit Scotland is responsible for setting audit fees, which make up around 75% of total income.
4. Fee income forms part of our annual budget submission to the Scottish Parliament. The budget proposal is subject to scrutiny by the Scottish Commission for Public Audit, a commission of the Scottish Parliament, and forms part of the annual Budget Act approved by the Parliament. Whilst the budget proposal is for financial years running from 1 April to 31 March the majority of annual audit work covers a period from November to October. We set fees for each audit and therefore each budget includes fees for parts of two annual audit cycles.
5. Annual audits are undertaken by Audit Scotland staff and private firms appointed by the Auditor General and the Accounts Commission. Performance audits are carried out by Audit Scotland staff with assistance from external specialists and appointed auditors where appropriate.
6. To support our vision of world class high quality audit and to maintain independence, auditors are rotated every five years. During 2015/16 we carried out an audit procurement exercise leading to appointments of in house teams and external firms being made to over 220 bodies for the 2016/17 to 2020/21 audits.
7. During 2016 we completed a review of funding and fee setting arrangements to ensure that our approach is appropriate for our current environment at the start of a new round of audit appointments. The review confirmed that many of the principles already in place remain appropriate but found that we could improve the transparency and understanding of the fee setting arrangements.
8. The overall aims of our Fee strategy are to:
 - enable Audit Scotland to meet its statutory and professional obligations as independent external auditors of public bodies in Scotland
 - support Audit Scotland in meeting its corporate vision of being a World Class audit organisation providing high quality public audit in Scotland, whilst keeping charges to the minimum necessary; and
 - establish a transparent framework for the setting of fees and charges in a stable and predictable way.

9. This document explains the objectives and principles adopted in setting fees and charges following the review and applies these to the setting of fees for 2016/17 and future audits.
10. The fee strategy is based on the public sector landscape in autumn 2016. There are likely to be changes to our workload in the medium term as a result of the new devolved taxation and social security powers, any change in the public sector landscape and the outcome of the referendum on EU membership. We continue to work with the relevant audited bodies and any implications for fee levels will be considered as details of their timing and impact become clearer.
11. We will review the operation of this fee strategy after two years and undertake a full review in advance of the next audit appointment round.

Review of fee setting arrangements

12. Audit Scotland's vision is to be a world class audit organisation that improves the use of public money.

In order to deliver our world class vision we have:



Consulted stakeholders about their Expectations of Audit



Published *Public Audit in Scotland* – a high level statement on the scope of Public audit by the Auditor General, the Accounts Commission and Audit Scotland



Revised the *Code of Audit Practice* to raise expectations of auditors in conducting wider scope public sector audits and increase the transparency of audit work



Carried out an audit procurement exercise to underpin new audit appointments by the Auditor General and the Accounts Commission for the period 2016/17 to 2020/21.

13. We have reviewed our approach to funding our work and the fee setting arrangements to improve transparency and make them easier to understand and operate. These new arrangements apply from the 2016/17 audits, the first year of new audit appointments.
14. The review work has taken account of a number of changes including:
- Revised and enhanced auditing standards which have increased the minimum amount of work required to conduct a fully standards compliant audit.
 - Developments in technology in both accounting and auditing which have streamlined audits of the largest bodies.
 - Increased expectations in auditing or reviewing governance statements, remuneration reports and strategic reports/management commentaries.
 - Changes in the structure and organisation of the public sector, such as the reform of police and fire services and the creation of Integration Joint Boards for the delivery of health and social care.

15. As part of the review process we consulted with audited bodies and other stakeholders on proposed principles for setting fees and received substantial support for the principles from those bodies that responded. The consultation responses:
 - Agreed that audit fees should be set with the objective of recovering the full cost of audit in each sector.
 - Supported the principle that an audited body should pay the same fee irrespective of who is appointed to deliver the audit.
 - Agreed that some costs therefore be pooled across each sector.
16. The review and consultation also found that, while the arrangements for most work were appropriate and well understood, there was scope to reconsider the funding of NHS performance audit work. Currently 60% of the cost of this work is funded from the Scottish Consolidated Fund (SCF) and 40% by NHS boards. This approach was put in place after the creation of the Scottish Parliament. Prior to this, NHS Boards paid for all NHS performance audit work. This arrangement is different from the other sectors within the remit of the Auditor General where all performance audit costs are met from SCF funding.
17. Audit Scotland's 2017/18 Budget paper proposes that all funding for this work should come from the SCF. This will bring the funding of NHS performance audit work into line with the other areas of the Auditor General's remit and increase transparency and simplicity. The overall impact on public finances and Audit Scotland's total income is neutral as the increase in SCF funding will be matched by a reduction in fees to NHS bodies. (If the proposal is not accepted then the reduction in NHS fees will be £495,000 less than shown in this paper and the 2017/18 Budget proposal).
18. In order to achieve the objectives of the fee setting arrangements a number of costs are pooled and shared between all audited bodies within a sector or across all sectors. The review considered the differences in approach to cost sharing that had built up incrementally over a number of years and this has resulted in simpler and more consistent approach to the charging of these costs.
19. We also reviewed and revised the costs of individual audits using information on the actual cost of delivering the audits in recent years. In most sectors this will result in increases for some smaller bodies and reductions for larger bodies.
20. We will revise the way in which audit fees are presented and explained to audited bodies and the mechanism for agreeing adjustments to fees to reflect local circumstances.
21. The outcome of our review is the revised approach to fee setting described in this paper which is more consistent across sectors, transparent and sustainable.

Fee setting arrangements

Objectives of the fee setting arrangements

22. The overall aim of the fee setting arrangements is to support Audit Scotland in providing high quality independent public audit in Scotland whilst keeping charges to the minimum necessary. The objectives for the arrangements are that they:
 - comply with statute
 - maintain the independence of auditors
 - reflect the way in which public services are organised and audited
 - are transparent and easy to understand
 - are simple to operate
 - are sustainable
 - minimise the volatility of fee changes between years.
23. Audit Scotland is required to aim to broadly break even on audit work that is charged for taking one year with another either for each audit or for classes of audits. We have determined each sector as being a class of audits.
24. Audit Scotland considers that audit fees should be set with the objective of recovering the full cost of audit work in each sector. Within sectors there may be a degree of cross sharing, for example where the costs of travel and subsistence are pooled across a sector.
25. Audit appointments are made by the Auditor General or the Accounts Commission rather than by audited bodies themselves thereby enhancing the independence of external audit. The identity or location of the appointed auditor could affect the total cost of undertaking the audit if we did not take steps to ensure that, as far as possible, bodies pay the same audit fee irrespective of who carries out the audit by pooling some costs.

Audit work that is subject to fees

26. The fee setting arrangements cover all local government audit work and the costs of annual audit work in the NHS, central government, Scottish Water and further education colleges. The same principles are used to calculate notional fees for the central government audits that we cannot charge for.
27. Parliamentary funding pays for all performance audit work in central government, further education and Scottish Water, and, subject to approval of our 2017/18 Budget proposal, the cost of NHS performance audit work. It also pays for the costs of Audit Scotland's work to support parliament and its committees, the annual audits of the central government audits (that we cannot charge for), the National Fraud Initiative and the costs of the Auditor General, Accounts Commission and Audit Scotland Board.

28. Local government is a separate tier of government and the Accounts Commission appoints auditors and oversees performance and best value audit arrangements. Local government funding includes an amount for scrutiny costs such as audit and therefore local government bodies pay for all audit work across the sector. For more information see paras 36-38 below.

Fee setting process and governance

29. Fee setting is one part of the annual budget process. The legislative provisions relating to charging are set out in Annex 1.
30. Budget proposals, including levels of charges, are presented to the Audit Scotland Board for discussion and approval, normally in mid-September, before being submitted to the SCPA for consideration as part of the Budget Bill process.
31. Because charges are set for audit years that run from approximately November to October, the fee setting process for each financial year covers two audit years. Therefore in September 2016, Audit Scotland confirmed the levels of charges for the 2016/17 audits which were provisionally set as part of the 2016/17 financial year budget in September 2015. We also indicate our plans for charges over the next two audit years.

Calculating audit fees

32. Audited bodies will receive a breakdown of the total audit fee from 2016/17 audits as shown below:

£	Current year	Prior year
Auditor remuneration	--,---	--,---
Pooled costs	-,---	-,---
Performance audit & best value (where relevant)	-,---	-,---
Audit support costs	-,---	-,---
Total Expected fee	--,---	--,---

Auditor remuneration

33. The auditor remuneration element for an individual body is based on our assessment of the audit input likely to be required to deliver an audit that complies with the Code of Audit Practice for a body of that size facing the normal risks in that part of the public sector. The fee takes account of actual recent costs of carrying out the audit and assumes that the body:
- is well governed
 - has effective internal controls; and
 - prepares complete draft accounts in accordance with the agreed timetable.

34. Auditors and audited bodies can agree remuneration up to 10% above the level set, either where local circumstances mean that the implicit assumptions are not being met, or where significant local issues require additional work to be undertaken, for example a new and complex accounting issue or a history of accounting errors. In exceptional circumstances fees can be agreed above the 10% limit with the prior agreement of Audit Scotland.
35. If the auditor and audited body agree that a permanent reduction in remuneration is appropriate then Audit Scotland will consider the proposal, taking account of any potential impact on audit quality.

Pooled costs

36. To achieve the aim that as far as possible an audited body should pay the same fee irrespective of whether the auditor is an Audit Scotland team or any of the appointed private firms we pool certain costs which would otherwise lead to different fees being charged depending on the identity or location of the appointed auditor. These pooled costs are apportioned across the audited bodies in each sector in proportion to the expected level of auditor remuneration. The pooled costs include:
 - Travel and subsistence costs.
 - Procurement savings.
 - Any difference between the costs of Audit Scotland teams and the auditor remuneration for their audits.
 - Recoverable input VAT (local government only).

Local government performance audit and best value audit costs

37. Local government bodies pay for the cost of all audit work carried out in the sector including national performance audits, best value audits and housing benefit audits. All councils carry out a similar range of services and therefore can benefit from the recommendations for improvement and good practices identified in performance audits and best value reports at other councils.
38. For performance audit work, including the costs of responding to correspondence from elected representatives and members of the public about issues in local government bodies, the budgeted costs are apportioned between significant local government bodies (councils, Integration Joint Boards and Strathclyde Passenger Transport) in proportion to the level of auditor remuneration.
39. For Best Value audit and housing benefit audit the amount of money received by councils towards the cost of this work is apportioned between the 32 councils only on the basis of relative populations in June 2015, being a proxy for the distribution of the funding through the local government settlement. We fully recognise that this approach to charging for best value does not reflect the actual costs incurred in relation to each council but believe that it is fair when considering the way in which councils were funded for it.

Audit support costs

40. Audit Scotland incurs costs in making audit appointments, providing assurance on audit quality, providing technical guidance and support to all appointed auditors and contributing to the development of auditing and accounting guidance within Scotland and across the UK. These costs are apportioned across all audits relative to the level of auditor remuneration.

Audit fees for 2016/17 audits

Fee levels

41. We are reducing the average audit fees for 2016/17 audits by 6.7% building on real terms reductions of 24% since 2010/11 through a combination of the review of fees and funding, recent audit procurement exercise and further Audit Scotland Budget savings.
42. As shown in Table 1 there is variation around this average between sectors. These differences arise from the varying prices bid for audit work in different sectors and the application of revised cost apportionment methods across all sectors as a result of the funding and fees review. For the NHS, the reduction includes the transfer of performance audit costs to the Scottish Consolidated Fund.

Table 1

	Average change on 2015/16 charges	Real terms
Local government	-4.5	-6.4%
NHS	-20.5	-22.4%
Central government - chargeable audits	+3.3%	1.4%
Further education	+2.0	+0.1%
Overall weighted average	-6.7%	-8.6%

43. The fee movements shown in Table 1 are based on achieving a break even position for the 2017/18 financial year in all sectors.
44. The effect of the above proposals and actual changes since 2010/11 on the average level of charges for each sector is shown in Table 2:

Table 2

Audit Years	Local Gov.	NHS	FE	Central Gov.
2010/11 to 2015/16	-10.4%	-13.3%	+2.0%	-8.9%
2016/17	-4.5%	-20.5%	+2.0%	+3.3%

45. Within sectors there will be a range of decreases or increases to better reflect the actual costs of undertaking each audit and the consequences of implementing the simpler and more transparent apportionment of pooled costs across and within sectors.

- Local government - for councils reductions will range from 0% to 11% with larger councils generally receiving larger reductions. Fees for Integration Joint Boards will rise as a result of the Boards all assuming their full functions in 2016/17. Other local government bodies will see fees remain at 2015/16 levels.
- NHS - mainland health boards will see significant reductions of 26-30% including the proposed transfer of funding for performance audit to the SCF. Island health boards will see an increase of around £2,500 to £7,500 (4-12 %) each to better reflect the actual cost of auditing these bodies. Almost all Special health boards will see fees remain at 2015/16 levels.
- Central government chargeable bodies will generally see increases of 1-6% to better reflect the actual costs of undertaking each audit and the review of the apportionment of pooled costs.
- Further education - colleges that have recently merged will see reductions of 4%. Colleges that have not merged will see increases of £1,600 - £2,200 (14%) to better reflect the actual cost of delivering audits in compliance with the Code of Audit Practice at these audits.

Future years

46. For 2017/18 and 2018/19 audits, at this stage we expect to continue to make real terms reductions in fees across all sectors.

Hourly rates

47. Hourly rates are calculated for each grade of staff. The rates are based on the average direct costs of the role (such as salaries, national insurance and pension contributions) and indirect costs (such as property costs, and corporate support costs including IT, finance and human resources).
48. For the 2016/17 financial year the hourly rates used to cost audit work are:

£/hour	2015/16	2016/17
Trainees	47	46
Business support specialist	22	22
Audit/support officer	38	37
Auditor	42	41
Senior auditor	59	58
Manager	70	68
Senior manager	88	86

Directors & Assistant	149	145
Directors		

49. The rates for the 2017/18 financial year will be calculated once the budget has been finalised and the pay and grading structure review has been completed as this may change the grade structure used from 1 April 2017.

Annex 1

Legislative provisions relating to Audit Scotland charges

50. Audit Scotland is subject to several statutory provisions in the setting of charges which are set out in the Public Finance and Accountability (Scotland) Act 2000. Specifically, section 11 of the Act states that “Audit Scotland may impose reasonable charges in respect of the exercise of its functions in connection with” certain of its functions.
51. Further provisions specify that charges may be determined by reference to particular cases or classes of case and that in determining the amounts of those charges Audit Scotland must seek to ensure that the total sum received in respect of the charges is, taking one year with another, broadly equivalent to its expenditure in connection with the matters for which charges are made. Where an examination or study covers more than one body each body is to pay such proportion of the charge as is determined by Audit Scotland.
52. Sums received by Audit Scotland in respect of charges are to be retained by it and applied to meet the related expenditure. Other sums received are to be paid into the Scottish Consolidated Fund subject to any provision for them to be applied for any other purpose eg through the Budget Acts.
53. Any expenditure of Audit Scotland, so far as not met out of sums received and applied from charges is payable out of the Scottish Consolidated Fund.
54. The full text of section 11 of the PFA Act is:

Extract from the Public Finance and Accountability (Scotland) Act 2000

11 Audit Scotland: financial provisions

(1) Audit Scotland may impose reasonable charges in respect of the exercise of its functions in connection with:

- (a) the provision of services under arrangements made in pursuance of section 10(5)
- (b) the audit under sections 21 and 22 of an account, other than one prepared in pursuance of section 19(1) to (3) or 20(1)
- (c) the carrying out under section 23 of an examination, other than one in respect of an office-holder in the Scottish Administration or a body or other office-holder to whom sums are paid out of the Fund
- (d) the audit of an account in pursuance of Part VII of the Local Government (Scotland) Act 1973 (c. 65)
- (e) the undertaking or promotion of any study under section 97A or 105A of that Act
- (f) giving of directions under section 1 of the Local Government Act 1992 (c. 19).

(2) Charges under subsection (1) may be determined by reference to particular cases or classes of case.

- (3) In determining the amounts of those charges Audit Scotland must seek to ensure that the total sum received in respect of the charges is, taking one year with another, broadly equivalent to its expenditure in connection with the matters mentioned in subsection (1)(a) to (f).
- (4) Charges under subsection (1) (b) to (f) are payable by the body or office-holder whose account is audited or, as the case may be, in respect of whom the examination is carried out, the study undertaken or promoted or the direction given.
- (5) Where a charge under subsection (1)(c), (e) or (f) relates to an examination, study or direction in respect of more than one body or office-holder, each body or office-holder is to pay such proportion of the charge as is determined by Audit Scotland.
- (6) Sums received by Audit Scotland in respect of charges under subsection (1) are to be retained by it and applied to meet the expenditure mentioned in subsection (3).
- (7) Any other sums received by Audit Scotland are to be paid into the Fund, subject to any provision made by any enactment for such sums to be applied for any purpose instead of being paid into the Fund.
- (8) Any expenditure of Audit Scotland, so far as not met out of sums received and applied in accordance with subsection (6), is payable out of the Fund.
- (9) Audit Scotland must, for each financial year, prepare proposals for its use of resources and expenditure and send the proposals to the Scottish Commission for Public Audit (constituted under section 12), which is to examine the proposals and report to the Parliament on them.