



# **Estimate of the income and expenses of the Wales Audit Office for the year ending 31 March 2006**

## **Background**

1. Under Section 93 of the Government of Wales Act 1998, the National Assembly for Wales is required to meet the expenses of the Auditor General for Wales in so far as they cannot be met from income from other sources. To support requests for resources the Auditor General is required to submit annual estimates of income and expenses for consideration by the Assembly's Audit Committee.
2. The Auditor General, supported by the National Audit Office Wales, currently audits the accounts of the Assembly and its sponsored and related public bodies, and has power to undertake economy, efficiency and effectiveness (value for money) examinations on all parts of the Welsh public sector with the exception of local government. In developing his forward value for money programme, the Auditor General is required to take account of the views of the Audit Committee.
3. The Auditor General is permitted to charge a fee for auditing accounts other than those prepared by the Assembly. The audit of Assembly accounts, value for money work and other activities, including support provided to the Audit Committee, is financed by Assembly grant. The estimates for previous years have been prepared on this basis, and were considered by the Committee alongside the Auditor General's draft forward value for money audit programmes.
4. The Public Audit (Wales) Act 2004 will result in major changes to the audit and inspection regime for the Welsh public sector. It transfers to the Auditor General the functions currently exercised by the Audit Commission in Wales in respect of health and local government. It also enables the creation of a Wales Audit Office, headed by the Auditor General, by transferring the staffs of the Audit Commission and the National Audit Office in Wales to the Auditor

General's employment. Subject to the making of the necessary secondary legislation, these changes are expected to come into effect on 1 April 2005. The Act also makes a number of enhancements to the audit and inspection regime in Wales. These include improved access rights for auditors to follow public money to end recipients and duties to co-operate and share information with other inspectorates operating in Wales (particularly the Healthcare Commission and the Health Inspection Unit for Wales). There is also an expectation that the Wales Audit Office will work in co-operation with other UK audit agencies – for example by sharing staff and producing cross-border reports.

5. The creation of a unified audit and inspection body for the public sector in Wales offers an outstanding opportunity to create a world class organisation, suitable for the 21<sup>st</sup> century and one capable of making a real difference to the people of Wales. The organisation will have the powers to follow public money vertically through the funding chain to ensure that it is spent properly and wisely, as well as the ability to undertake studies of a cross-cutting nature and report holistically on the delivery of public services. The work required of the new organisation is therefore likely to be much greater than that currently produced by the two existing audit bodies in Wales.
6. The remainder of this document sets out the main factors that I, as Auditor General for Wales, have had to take into account in creating the new organisation, the expenditure that the Wales Audit Office will incur in respect of the work that it will undertake, and the various sources of income. It also sets out the uncertainties involved in assessing the likely income and expenses at this stage. These uncertainties arise from the establishment of the Wales Audit Office, and the dynamics and timing of some of the work currently undertaken by the Audit Commission in Wales, particularly in local government. The estimate should be read in conjunction with the proposed forward work programme, which I will discuss with the Committee on 30 September 2004.

### **Factors affecting the creation of the Wales Audit Office**

7. The Wales Audit Office will aim to minimise the burden of audit and inspection on its client bodies. It will maximise the impact on improving public services

for the benefit of those who use them. It will ensure that those services are effectively managed and that they give value for money. It will challenge the bureaucracy that surrounds public services and it will scrutinise its own activities to ensure it delivers value for money by eliminating unnecessary activities.

8. The legislation provides for Audit Commission and National Audit Office staff based in Wales to be transferred into the Wales Audit Office with continuity of employment and on terms and conditions that are no less favourable than those in place immediately before the transfer. The Auditor General is therefore committed to ensuring that those staff are no worse off than if they were to remain with their existing employer. My estimate for 2005-06 makes no provision for any additional costs that may need to be incurred in future years to cover organisational and structural changes that may be required as the new organisation beds in. History suggests that such changes may well be necessary.
9. The precise arrangements for transferring property, rights and liabilities from the National Audit Office and the Audit Commission to the Wales Audit Office will be the subject of Transfer Schemes to be made by Order of the Secretary of State for Wales with the consent of the Assembly, following consultation with the transferors and transferee. Subject to the provisions of these Orders, the Wales Audit Office can expect to receive the benefit of furniture and other equipment (including IT) with a net book value of around £750,000. If these goods had remained with the existing organisations, the Wales Audit Office would have had to spend considerably more than that sum on new capital purchases and I would have needed to look to the National Assembly for Wales to fund such procurements. Other matters relating to the transfer of assets and liabilities from the parent organisations are also likely to feature in the Transfer Schemes. The potential value of these is as yet unknown.
10. The Transfer Orders will also provide for the leases on existing buildings occupied by the National Audit Office and the Audit Commission to be transferred to the Auditor General together with associated contractual commitments (e.g. facilities management arrangements). Over time, as existing leases expire there should be scope to rationalise the Wales Audit Office's

accommodation and, in so doing, drive out efficiency savings. Other ongoing liabilities and actions in force at the transfer date are also expected to be transferred.

11. The National Audit Office and the Audit Commission in Wales currently rely substantially on their respective headquarters for central services, including, for example:

- Finance - bill-paying, invoicing, the preparation of management accounts and year-end financial statements, the development and maintenance of sound financial controls, financial planning etc.
- Human resources - recruitment, training and development, payroll, performance appraisal, casework, policies and procedures on a wide range of matters (such as attendance and welfare, discipline and grievance, and pay and benefits) etc.
- Information technology - the provision and maintenance of a network, software applications, internet and intranet, remote access, helpdesk, support for other support service applications (such as finance and human resources) etc.
- Technical support - on financial and value for money audit (including the provision of technical training), and advice on legal, policy and statistical issues etc.

12. The Wales Audit Office will need to source its own such central services. It may well be possible for the two legacy organisations to provide some of this support (for a fee), either as a transitional or longer term arrangement. Overall, however, there is likely to be an increase in running costs compared with the existing regimes resulting from a loss of economies of scale, particularly while the new organisation beds down. An appropriate proportion of these and other cost changes will, of course, be reflected in the fees charged for audit and inspection services.

13. Despite these cost pressures, the Wales Audit Office will have a continuing focus on ensuring that its own operations represent value for money. In particular, the new organisation will look for efficiency savings in the early years of its existence - for example, from possible rationalisation of accommodation and supplies and services - and to deliver enhanced value for money through effective collaboration and joint working. This will support our aim of minimising the burden and maximising the impact of audit and inspection in Wales.
14. The Audit Commission has appointed private sector firms to audit a number of local government and NHS bodies in Wales (the remaining appointed auditors are Audit Commission employees). Most of these appointments last until 2007 and may be extended by agreement. Under the legislation, these appointments will transfer to the Auditor General who will be bound by their terms and conditions for their duration.
15. The one-off capital and revenue costs of establishing the Wales Audit Office (e.g. IT and telecommunications networking, hardware, software and project management) expected to be incurred in 2004-05 and 2005-06 were detailed in the set-up cost budget and approved by the Audit Committee on 6 May 2004 (for reference, the main expenditure items are included at Annex A to this memorandum). Special financial arrangements are in place to account separately for these transitional costs to avoid the possibility of double counting. They are therefore excluded from this estimate but the amount that falls to be met in 2005-06 will be included in requests for resources when drawing down Assembly grant.

### **Other financial matters affecting the Wales Audit Office budget**

#### ***a) Additional audit work***

16. **Restructuring** - in July 2004, the First Minister announced a radical restructuring involving the absorption of the functions of the Welsh Development Agency, Education and Learning Wales (ELWa) and the Wales Tourist Board into the Welsh Assembly Government. A further announcement that could affect a number of other Assembly-sponsored public bodies is

expected later this autumn. As with previous restructurings, audit staff will work closely with the management of the bodies concerned, providing advice and disseminating best practice whilst ensuring that audit independence and objectivity are not compromised. Nonetheless, our previous audit experience - from, for example, local government reorganisation in 1996, the creation of ELWa in 2001 and the replacement of health authorities by local health boards in 2003 - is that any major restructuring of the machinery of government results in significant increased risks to the ongoing financial management of the organisations concerned and to the continuity of public service delivery. In 2005-06, the Wales Audit Office will need to take account of this and perform appropriate additional audit work.

17. The absorption of functions currently exercised by Assembly-sponsored public bodies into the Welsh Assembly Government will not significantly affect the level of audit scrutiny that needs to be given to those public services. This is because the reorganisation of functions should not result in any consequential reduction in the ability of the National Assembly for Wales to hold the executive to account.
18. **2004 Spending Review** - under the terms of the review, announced in July this year, Wales will benefit from an increase in the resources made available to the National Assembly of £841 million, or eight per cent, in 2005-06. The total Exchequer funding for that year is expected to be £11.8 billion. Further increases, of a broadly similar size, are planned for the following two years. The resulting additional expenditure - and any increased income to Welsh public bodies - will, of course, need to be audited and will unavoidably give rise to additional costs compared with those incurred in 2004-05.
19. **Stronger corporate governance** - a number of recent high profile corporate collapses, such as Enron, have led to a renewed awareness of the importance of governance arrangements within organisations. For example, in July 2003 the Financial Reporting Council issued a revised Combined Code on Corporate Governance, reflecting the findings of earlier reports, such as Derek Higgs'. There is much in these reports that reads across to public sector bodies and I am committed to applying the highest standards of audit and to helping audited

bodies achieve the highest standards of financial reporting and corporate governance. For example, auditors are becoming more involved in ensuring that organisations' audit committees and non-executive members are as effective as possible. This gives rise to additional work, such as training, as well as the increased audit activity in order to provide the necessary assurances in relation to corporate governance.

20. These three aspects of additional work and other changes such as the expansion of whole of government accounts to include the wider public sector (including local government and NHS trusts) are expected to give rise to increased audit costs in 2005-06 of some £300,000. These additional costs would have arisen even if the Public Audit (Wales) Act 2004 had not been passed and no changes had been made to the existing audit and inspection framework.

***b) Staff pension costs***

21. Wales Audit Office staff will not be civil servants but will, like a number of other public sector bodies not staffed by civil servants, be eligible for membership of the Principal Civil Service Pension Scheme (PCSPS). The Scheme's managers plan to increase the contributions payable by all employers of PCSPS members from 1 April 2005. The cost of this increase to the Wales Audit Office included in the 2005-06 estimate is around £600,000.

***c) Value Added Tax***

22. The Audit Commission currently adds VAT to its audit and inspection fees chargeable to local government and NHS bodies. This VAT receivable is offset against the VAT payable on supplies and services, including the cost of audit work carried out by appointed or contracted private sector firms. The justification for adding VAT to certain fees has been queried by HM Customs and Excise although the practice continues pending a final ruling. A similar issue exists with Audit Scotland.
23. Given these developments, the ability of the Wales Audit Office - once the functions of the Audit Commission in Wales transfer to the Auditor General for Wales - to continue levying VAT on charges for some or all of its audit and



inspection services is open to question and has yet to be clarified. Any reduction in the VAT that is capable of being levied will effectively increase the cost to the Wales Audit Office of procuring supplies and services.

24. This is a very complex issue that needs to be addressed as a direct consequence of the Public Audit (Wales) Act 2004. The Welsh Assembly Government is therefore currently attempting to clarify the VAT status of the Wales Audit Office with both the Treasury and Customs and Excise. Different rulings could be made for the various sources of income depending on the underlying statutory provisions. The potential additional cost to the Wales Audit Office, depending on the precise outcome of these discussions, could be as high as £1.3 million a year.
25. Pending resolution of these issues, I have assumed that the existing arrangements will continue unchanged for the purpose of compiling the 2005-06 estimate and have not included any provision for additional unrecoverable VAT. Should any changes be necessary, the Wales Audit Office will need to discuss with the Welsh Assembly Government whether the increased costs should be financed through additional fees to former Audit Commission clients, Assembly grant or a combination of both. In addition to the normal consultation with fee-paying clients, we would, of course, consult the Audit Committee if significant changes to this estimate prove necessary.

***d) Professional indemnity and employers' liability insurance***

26. The Audit Commission takes out professional indemnity insurance to cover potential claims arising from the actions or negligence on the part of its staff or appointed auditors. The Commission is also required by law to insure against "liability for bodily injury or disease sustained by its employees arising out of and in the course of their employment" (employers' liability insurance). The National Audit Office, on the other hand, has no need to take out professional indemnity or employers' liability insurance: as a body funded primarily by Parliamentary Supply, it "self insures" under provisions permitted by Government Accounting which sets out the general rule that Government does not purchase commercial insurance for the risks it faces. The key principle here

is that, taken as a whole, the cost of claims against public sector bodies funded by Parliamentary Supply over time could be expected to be significantly less than the cost of premiums that would otherwise have been paid to private sector insurance companies.

27. Section 93 of the Government of Wales Act 1998 requires the Assembly to meet the expenses of the Auditor General in so far as they cannot be met by other sources of income. Those expenses include sums payable in consequence of a breach of any contractual or other duty. These provisions were drafted so as to place the Auditor General for Wales on a par with the Comptroller and Auditor General, given their similarity of status and functions.
28. Given the imminent expansion of the Auditor General's functions and the creation of the Wales Audit Office, I have sought legal advice which confirmed that the Assembly would ultimately be responsible for meeting claims made against the Auditor General and the costs of any indemnities given to appointed auditors. It would be possible for the Auditor General to take out insurance cover to mitigate the potential cost of such claims, but the annual premiums for such cover, which would have to be met from the public purse, would be considerable.
29. Given this advice, the Assembly Government's Finance Group is minded strongly, subject to the views of the Audit Committee and the Assembly Government, that the Auditor General should not be required to take out professional indemnity or employers' liability insurance cover, and the Assembly would extend its existing practice of covering the cost if and when any such major valid claims arose. Other key factors that support this course of action are:
  - the Auditor General's primary responsibility for non-local government work is to the Assembly. The Auditor General is also the Accounting Officer of the Wales Audit Office and is accountable to the Audit Committee for its financial management. Given these provisions, it is difficult to envisage the situation where the Assembly would wish to claim against the Auditor General;

- any insurance policy taken out with a private sector insurer would be subject to a minimum excess and a maximum liability; and
- neither the National Audit Office nor the Audit Commission in Wales has ever been the subject of a successful claim for professional negligence, and costs in respect of claims brought by employees have been minimal.

### **How the work of the Wales Audit Office will be funded**

30. The Wales Audit Office, headed by the Auditor General, will undertake a wide variety of audit and inspection work on Welsh public sector organisations. The main elements, together with the sources of funding for 2005-06 work, are set out in Table 1 below.

**Table 1: Main activities of the Wales Audit Office and sources of funding**

<i>Activity</i>	<i>Scale</i>	<i>How funded</i>
Value for money/performance audit work on the Assembly, its sponsored and related public bodies, NHS Wales and the further and higher education sectors. Audit of accounts prepared by the Assembly	Total expenditure subject to vfm/performance audit over £12 billion. 9 accounts prepared by the Assembly	Assembly grant
Audit of accounts prepared by Assembly sponsored and related public bodies, local health boards and NHS trusts	Over 60 accounts	Fees charged to audited bodies
Financial, value for money/performance audit and inspection (Wales Programme for Improvement) work on local government bodies	22 unitary authorities; 4 police, 3 fire and 4 probation bodies Combined spend over £5 billion	Fees charged to audited and inspected bodies. The Welsh Assembly Government part funds Wales Programme for Improvement work.
Grant certification work and other work undertaken by agreement	Work undertaken at 22 unitary authorities and several Assembly-sponsored bodies	Fully funded by fees
Other work, such as support for the work of the Audit Committee and dealing with correspondence	Briefing the Committee in advance of its 9-10 annual meetings; advising on its draft reports, Government responses and other ad hoc matters	Assembly grant

*Note.* Work of a cross cutting nature, such as a study covering the Welsh Assembly Government and local government, could fall under more than one of the above activities and therefore funded by both Assembly grant and fees in appropriate proportions.

31. The majority of the work undertaken by the Wales Audit Office or by firms under appointment or contract will be funded by fees invoiced to audited and inspected bodies. This contrasts with the existing work of the Auditor General

which is predominantly funded by Assembly grant. The majority of fees will be set so as to cover the full cost of the work involved.

### **Analysis of estimated income and expenditure for 2005-06**

32. Table 2 provides a forecast of the Wales Audit Office's income and expenditure for 2005-06, including a breakdown of the main areas of expenditure.

**Table 2: Wales Audit Office revenue forecast income and expenditure 2005-06**

<i>Income</i>	<i>£m</i>	<i>£m</i>	<i>Note</i>
Audit and inspection of local government bodies		7.6	
Wales Programme for Improvement grant		1.5	
Certification of grant claims		1.3	
Audit of Assembly sponsored and related public bodies		0.6	
Audit of NHS Wales bodies		4.9	
Other		1.1	
<b>Total income</b>		<b>17.0</b>	
<i>Expenditure</i>			
Staff costs and related costs		12.8	i
Fees payable to appointed auditors, contractors and consultants		4.1	ii
Accommodation and related costs	0.9		iii
Supplies and services	1.0		iv
Corporate services	2.2		v
Capital charges (non-cash)	0.2	4.3	vi
<b>Total Revenue expenditure</b>		<b>21.2</b>	
<b>Net request for resources</b>		<b>4.2</b>	
Purchase of fixed assets		0.2	vii
Net cash requirement		<b>4.2</b>	

#### *Notes*

- i. Staff will be transferred to the Wales Audit Office from two legacy bodies on protected terms and conditions. The Wales Audit Office needs to employ first class professionals with the creativity, innovation and impact to meet the challenges it faces.
- ii. The local government and NHS audit appointments made to accountancy firms by the Commission will transfer to the Auditor General for their duration.
- iii. The leases on accommodation currently used by the National Audit Office and the Audit Commission in Wales will transfer to the Auditor General. The Wales Audit Office will consider the scope for rationalisation once the new organisation has bedded down.
- iv. Includes expenditure on telephones, stationery, printing and publication.
- v. Covers ICT services, Human Resources, Payroll, Communications. ICT support services account for up to £0.75m of this revenue statement.
- vi. Includes estimated depreciation and notional interest charge.
- vii. Furniture and equipment currently used by the two organisations in Wales will be transferred to the Wales Audit Office so this line covers only the cost or new items to be purchased in year.

33. Following the creation of the Wales Audit Office, there may be some scope for limited rationalisation of audit work particularly in the health sector. However, the scope for early efficiency savings will be limited because, as explained in

paragraphs 11 and 12, the Wales Audit Office will not be in a position to benefit from the considerable economies of scale enjoyed by the two parent organisations, particularly in its early years.

34. In addition to the issues yet to be resolved concerning transfer orders and VAT (paragraphs 9 and 25 respectively), at this stage of the budgeting process there remain two areas where I face considerable uncertainties in forecasting income and expenses for 2005-06:

- not all of the costs of creating the Wales Audit Office, a new organisation, are yet clear. It would not have been appropriate for detailed work on the process to start in advance of the Public Audit (Wales) Bill's safe legislative progress and therefore not all the many contracts needed to ensure that the Office works smoothly from its inception have yet been negotiated; and
- the fees receivable - particularly from current Audit Commission clients - are dependent on a number of factors, such as detailed risk assessment. They are subject to thorough consultation and will not be finalised until November for local authorities. As Table 2 shows, these fees make up a sizeable proportion of total income and any variation from the levels currently forecast would have a significant impact on operations.

In each case, I have taken a prudent stance in forecasting the 2005-06 resource requirements.

35. We shall also need to discuss with the Welsh Assembly Government the extent to which it is appropriate to pass on to audited and inspected bodies through fees those cost increases which the new organisation will incur as a direct consequence of the merger and those resulting from increased employers' pension contributions (paragraph 21). Depending on the ruling from HM Customs and Excise, we may need to ask the Welsh Assembly Government, who promoted the Public Audit (Wales) Bill in Parliament, to take a view as to the extent to whether the resultant increase in costs should be met through higher base fees for former Audit Commission clients, an increase in Assembly grant or a combination of the two. For the purposes of this estimate, I have

assumed that fees to clients in the local government sector will reflect only those cost increases which would have been incurred irrespective of the creation of the Wales Audit Office. On this basis, other cost increases would be met by Assembly grant.

### **Request for Resources**

36. Assuming that the Committee is content with the approach I intend to adopt with regard to insurance (paragraphs 26 to 29 above), I am seeking a request for resources for 2005-06 of £4.2 million. The net cash equivalent (after adjusting for capital expenditure and non-cash charges) is also £4.2 million. Because of the considerable uncertainties set out above, my resource requirements may vary from this amount, but I shall do everything I can to ensure that the Wales Audit Office is able to operate with this level of grant. Conversely, of course, I shall only draw down funding from the Assembly to the extent that it is needed. Against this background and to provide it with additional assurance, the Committee may find it helpful to ask my external auditors, as part of their routine work, to verify that in 2005-06 the Wales Audit Office has not drawn down more funding from the Assembly than is necessary.
37. The estimate for 2005-06 includes the income and expenses for all the work that is expected to be undertaken or overseen by the Wales Audit Office in its first year of existence, and is therefore fundamentally different from the estimates considered by the Committee in previous years. It would not be appropriate to compare directly the expenses of the Auditor General for Wales in 2004-05 with the Wales Audit Office estimate for 2005-06. Notwithstanding this observation, I have attempted to analyse the increase in my request for resources in Table 3 below.

**Table 3: Increase in request for resources**

<i>Explanation</i>	<i>Total increase £m</i>	<i>Paragraph reference</i>
Additional audit work, arising from restructuring of Welsh public bodies, additional corporate governance work and 2004 Spending Review funding settlement	0.30	16 to 20
Increased PCSPS contributions	0.60	21
Infrastructure support and central service costs of the new WAO arising from diseconomies of scale compared with parent body operations	0.35	11 to 12
Inflationary increase in salaries and other costs	0.10	
<b>Total increase</b>	<b>1.35</b>	

38. The increase in resources required (each element of which is recurring, rather than one-off) should properly be seen in the context of the overall Wales Audit Office budget of over £21 million. To compare like with like, only £0.59 million of the £1.35 increase that I am seeking for next year is relevant to the total resources of £2.85 million that I requested from the Assembly for the current year; the remainder of the increase, £0.76 million, is attributable to work for which the Wales Audit Office may charge a fee. Depending on how the Assembly Government decide to fund this element of the increase in my costs (paragraph 35 above), the £4.2 million that I am requesting represents my maximum resource need from the Assembly.
39. Notwithstanding and subject to these uncertainties, the Committee is invited to endorse this, the first estimate of the new Wales Audit Office, to help ensure that its work is a success for the benefit of the people of Wales.

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17 September 2004

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**Forecast of the one-off set up costs of the Wales Audit Office (approved by the Committee in May 2004)**

<i>Element</i>	<i>Total forecast cost £000</i>	<i>Note ref.</i>
Legal	10	i
Finance	100	ii
Communication	80	iii
Accommodation	25	iv
Information and Communications Technology	350	v
Support Services	20	vi
Human Resources	80	vii
Audit Methodology	55	viii
Project Management	120	ix
SUB-TOTAL	840	
VAT	147	x
<b>TOTAL</b>	<b>987</b>	

*Note: Many of these costs will fall due in the current year, 2004-05*

**Explanatory notes**

- i. **Legal** costs include those relating to the Public Audit (Wales) Bill and its related transfer orders.
- ii. **Finance** costs include the acquisition and implementation of essential finance (accounting), payroll and timesheet recording systems.
- iii. **Communication** costs include new stationery, signage and the establishment of an internet website and intranet.
- iv. **Accommodation** costs relate to the need to make some minor alterations to existing buildings to cater for the integration of the staffs of the two existing organisations.
- v. **Information and Communications Technology** costs cover the purchase and installation of new IT infrastructure, networking and telecommunications for the new organisation.



- vi. **Support Services** costs cover specialist support and set-up costs associated with the provision of services such as facilities management, health and safety and business processing.
- vii. **Human Resources** costs include the acquisition and implementation of an HR system, specialist support in the development of integrated terms and conditions for the staff who will be merging to form the new organisation, and the outsourcing of pensions administration.
- viii. **Audit Methodology** costs cover the preparation of a unified Audit Manual, and the development costs of audit support software.
- ix. **Project management** costs are those of the specialist project manager to oversee the process to ensure a smooth transition to the new organisation.
- x. **VAT** is payable by the Auditor General on the above expenses and is not recoverable.