



WALES **AUDIT** OFFICE

SWYDDFA **ARCHWILIO** CYMRU

Estimate of the income and expenditure for the year ending 31 March 2007

Submitted to the Audit Committee of the
National Assembly for Wales under Section
93(4) of the Government of Wales Act 1998

September 2005

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Estimate of the income and expenditure of the Wales Audit Office for the year ending 31 March 2007

Introduction

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 by 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 Wales Audit Office:
 - 2.1. audits the accounts of the Assembly, its sponsored and related public bodies and all NHS Wales bodies. He also appoints auditors to local government bodies (including fire, police, probation services and national parks); and
 - 2.2. has the power to undertake economy, efficiency and effectiveness (value for money) examinations on all parts of the Welsh public sector; and
 - 2.3. is required to undertake inspection on most local government bodies under the Wales Programme for Improvement.
3. In developing his forward value for money programme (on non-local government bodies), the Auditor General is required to take account of the views of the Audit Committee.
4. The Auditor General is permitted to charge a fee for audit and inspection work. In previous years, the audit of the accounts prepared by the Assembly was financed by Assembly grant. Under the provisions of the Public Audit (Wales) Act 2004, this work will be financed by fees to bring it into line with the audit of accounts of other public bodies. This change will take effect for the 2005-06 year of account (which will be collected in 2006-07). The Auditor General's forward value for money programme and other activities, including support provided to the Audit Committee, continues to be financed by Assembly grant.
5. On 1 April 2005, the Public Audit (Wales) Act 2004 introduced major changes to the audit and inspection regime for the Welsh public sector. It transferred to the Auditor General the functions exercised previously by the Audit Commission in Wales in respect of health and local government. It also brought into being the Wales Audit Office, headed by the Auditor General, by transferring the staffs of the Audit Commission and the National Audit Office Wales to the Auditor General's employment. The Act also enhanced the audit and inspection regime in Wales by:
 - 5.1. improving access rights for auditors to follow public money to its final recipients; and
 - 5.2. conferring duties to co-operate and share information with other inspectorates operating in Wales.

6. 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.
7. 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 21st century and one capable of making a real difference to the people of Wales. The organisation has the power 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 will therefore be much greater than that produced by its two legacy bodies in Wales.
8. On 30 September 2004, my predecessor presented to the Committee his assessment of the factors influencing the creation of the Wales Audit Office together with estimates of the new organisation's income and expenditure for 2005-06. He noted a number of uncertainties constraining that assessment which supported a request for resources of £4.2 million in the current financial year.
9. Since then:
 - 9.1. the Assembly Government has pursued its policy framework set out in Making the Connections¹, for maximising the benefits of its increasing investment in public services and generating efficiency gains through scale economies of more effective co-operation and co-ordination; and
 - 9.2. the UK Government has published the White Paper *Better Governance for Wales* which envisages significant changes to the constitution of the Assembly and the creation of a legally separate Executive.
10. These developments impact directly on the way in which the Wales Audit Office will conduct its business. They also affect the interface with our audited and inspected bodies who are themselves working to develop new methods of service delivery that generate the £600 million of efficiency gains as set out in Making the Connections.
11. The remainder of this document updates the Committee on the establishment of the Wales Audit Office and presents my estimate of its income and expenditure for 2006-07. Some of the uncertainties identified last year have been resolved but, as we are only six months into the first operational year, a number remain. This estimate paper should be read in conjunction with my proposed forward work programme submitted separately.

Factors affecting the creation of the Wales Audit Office

12. The Wales Audit Office aims to make public money count by promoting improvement, so that people in Wales benefit from accountable, well managed public services that offer the best possible value for money.

¹ Making the Connections: Delivering Better Services for Wales

We also subject our own activities to independent scrutiny to ensure we deliver value for money.

13. Last year's estimate outlined the critical issues impacting on the costs expected to be incurred by the new organisation. This section presents an updated picture of the position in respect of those cost pressures and highlights areas of ongoing uncertainty.

Terms and conditions

14. On 1 April 2005, Audit Commission and National Audit Office staff based in Wales transferred to the Auditor General's employment with continuity of employment. The Auditor General is statutorily obliged to employ such staff on terms and conditions that, taken as a whole, are no less favourable than those in place immediately before the transfer. Yet there were and continue to be large and numerous differences between the terms and conditions inherited from the two predecessor bodies. No fewer than 27 different grades are still in place for only 240 staff.
15. Clearly there is a need for rationalisation of this situation and there is also scope for improvements in efficiency as a result of the merger of the two predecessor bodies. The estimate for 2005-06 made no specific provision for any additional net costs of organisational and structural changes required as the new organisation beds in.
16. During the first seven months of the existence of the Wales Audit Office I have put a very high priority on continuity of service while developing a strategy within which to form an organisational structure for the Wales Audit Office. Within that context of form following function, I have engaged a professional firm of HR consultants to examine the options for, and the estimated costs of, harmonising terms and conditions. Following the completion of this work and subsequent consultation, I will be able to take a view on the way forward, including the scope for efficiency gains and the detailed financial implications for 2006-07 and beyond.
17. In line with my internal efficiency focus, I have assumed that any harmonisation costs will be contained within a 1.5% estimated uplift in total payroll costs which is well below the inflationary estimates for this budget.

Facilities

18. The Transfer Orders provided for the leases on buildings occupied by the National Audit Office and the Audit Commission to be transferred to the Auditor General together with associated contractual commitments (eg 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. I have already taken the opportunity to co-locate staff from the two legacy organisations who are working in broadly similar areas of activity, maximising the efficiencies that flow from more effective links.

Corporate services

19. The National Audit Office and the Audit Commission in Wales relied substantially on their respective headquarters for central services and we have implemented new arrangements to secure the necessary infrastructure for the new organisation. I am satisfied that the following arrangements are the most efficient and effective in providing appropriate corporate support:
- 19.1. arrangements are in place with the Audit Commission to provide an interim HR system and payroll service for at least two years;
 - 19.2. a new financial management system has been installed and the infrastructure is in place to support the new operational requirements;
 - 19.3. the Wales Audit Office ICT network is in place and ICT support services have been outsourced to a single supplier. I have retained a small internal IT team to drive and manage the strategy as well as controlling and monitoring the supplier contract; and
 - 19.4. arrangements for technical support are in place. These include provision for setting frameworks for audit fees, appointing auditors, managing suppliers, grant certification arrangements, quality control and the handling of correspondence.

Efficiency and effectiveness

20. In line with sound management practice, the principles established in Making the Connections, and with what could reasonably be expected of us, the Wales Audit Office is committed to ensuring that its own operations represent value for money. I have already implemented the first steps towards streamlining the senior management structure, which, whilst incurring some up-front costs, have already led to significant efficiency gains. My former deputy left the organisation without replacement at the end of May and I am in the process of finalising the longer-term structures for the senior management team and across the organisation as a whole.
21. We are actively pursuing other efficiency savings in the early years – for example, from improved working methods, possible rationalisation of supplies and services as well as accommodation (paragraph 18) – and to deliver enhanced value for money through effective collaboration and joint working.

Transitional costs

22. The one-off capital and revenue costs of establishing the Wales Audit Office (eg 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. Special financial arrangements are in

place to ring-fence these Wales Audit Office set up costs and the final outturn will be reported in the 2005-06 accounts.

Other financial matters affecting the Wales Audit Office budget

Additional audit work

Restructuring

23. In July 2004, the First Minister announced a radical restructuring involving the absorption of the Welsh Development Agency, the National Council for Education and Training for Wales (ELWa) and the Wales Tourist Board into the Welsh Assembly Government from 1 April 2006. These three bodies employ some 1,600 staff and have a gross annual expenditure in excess of £900 million.
24. In November 2004, the First Minister announced further changes, redefining the Assembly Government's relationship with some of its sponsored bodies but also merging the Welsh Language Board and the Qualifications, Curriculum and Assessment Authority for Wales (ACCAC) into the Assembly Government.
25. The proposals outlined in the *Better Governance for Wales* White Paper will create an executive government for Wales that is accountable to but legally separate from the Assembly. This separation of the Assembly's executive and legislative/scrutiny arms provides a strong basis for even more effective scrutiny of the executive but in the short term it will be a significant restructuring posing a range of risks that will need to be properly managed.
26. As with previous restructurings, audit staff are working closely with the management of the bodies concerned, providing such advice as may properly be given whilst preserving due independence. 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 significantly increased risks to the ongoing financial management of the organisations concerned and to the continuity of public service delivery. The Wales Audit Office is taking account of this in 2005-06 and will continue to do so as the mergers proceed. In addition, and in line with previous re-organisations, I intend to place a report on the final accounts of each of the merging bodies.
27. The mere fact that functions currently exercised by Assembly-sponsored public bodies are being merged into the Welsh Assembly Government does not of itself reduce the requirement that those public services should be subject to audit scrutiny. Yet, aside from the merger process, which while it is in progress actually increases the need for such scrutiny, the merger has the potential to reduce audit scrutiny. I have, therefore,

put in hand measures to ensure that the proper degree of audit scrutiny is applied in these areas during and after the merger process.

28. In his November statement, the First Minister also invited proposals for integration between NHS Trust and Local Health Boards where there is coterminosity and where integration will benefit patients. I do not expect any such changes to be implemented until the 2007-08 financial year. Consequently, I have made no adjustments to the 2006-07 estimates in this regard.

2004 Spending Review

29. Under the terms of the review, announced in July last year, Wales will receive an additional £900 million in 2006-07, taking the total Exchequer funding to over £13 billion. A broadly similar increase is planned in 2007-08. The resulting additional expenditure – and any increased income to Welsh public bodies, if accompanied by increased risk, could give rise to additional costs compared with those incurred in previous years.

Stronger corporate governance

30. A number of high profile corporate collapses, such as Enron, 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 that from Sir 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.
31. 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.

Implications

32. 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) and the need to comply with new international accounting and auditing standards are expected to give rise to increased audit costs in 2005-06 of approximately £300,000 which will be recharged across the various income heads (Table 2, page 10). I have assumed the same level of cost in 2006-07. 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.

Staff pension costs

33. Wales Audit Office staff are not civil servants but, like a number of other public sector bodies not staffed by civil servants, are eligible for membership of the Principal Civil Service Pension Scheme (PCSPS). The Scheme's managers increased – on an incremental basis - the contributions payable by all employers of PCSPS members from 1 April 2005. This will give rise to an increased requirement of £75,000 in 2006-07. I have not included any provision for one-off costs that may arise from the transfer of staff from the Audit Commission pension scheme to the PCSPS, as the transfer valuation exercise has yet to be finalised.

Value Added Tax

34. In his submission to the Committee last year, my predecessor signalled that HM Revenue & Customs had yet to rule on the Audit Commission's practice of adding VAT to its audit and inspection fees chargeable to local government and NHS bodies, and off-setting this against VAT payable on supplies and services.
35. As an interim measure, HM Revenue & Customs has agreed that the existing arrangements can continue pending review. I have assumed that the existing arrangements will continue unchanged for the purpose of compiling the 2006-07 estimate and have not included any provision for additional irrecoverable VAT.

How the work of the Wales Audit Office is funded

36. The Wales Audit Office undertakes a wide variety of audit and inspection work on Welsh public sector organisations. The main elements, together with the sources of funding for 2006-07 work, are set out in Table 1.

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

Activity	Scale	How funded
Value for money/performance audit work on the Assembly, its sponsored and related public bodies, NHS Wales and the further and higher education sectors.	Total expenditure subject to value for money/performance audit over £13 billion.	Assembly grant.
Audit of accounts prepared by the Assembly, its sponsored and related public bodies, local health boards and NHS trusts.	9 accounts prepared by the Assembly. 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 £6 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.

37. The majority of the work undertaken by the Wales Audit Office or by firms under appointment or contract is funded by fees invoiced to audited and inspected bodies. These fees are set so as to cover the full cost of the work involved.

Analysis of estimated income and expenditure for 2006-07

38. Table 2 provides a forecast of the Wales Audit Office's income and expenditure for 2006-07 compared with estimated figures for 2005-06, including a breakdown of the main areas of expenditure. Despite the cost pressures detailed above, I have been able to reduce the total projected expenditure by £500,000.

Table 2: Forecast of Wales Audit Office income and expenditure 2006-07

	2005-06		2006-07		Note
	£m	£m	£m	£m	
Income					
Audit and inspection of local government bodies		7.6		8.0	i
Wales Programme for Improvement grant		1.5		1.5	ii
Certification of grant claims		1.3		1.6	iii
Audit of the Assembly, its sponsored and related public bodies		0.6		0.9	iv
Audit of NHS Wales bodies		4.9		4.6	v
Other		1.1		0.3	vi
Total income		17.0		16.9	
Expenditure					
Staff costs and related costs		12.8		13.2	vii
Fees payable to appointed auditors, contractors and consultants		4.1		4.2	viii
Accommodation and related costs	0.9		0.9		ix
Supplies and services	1.0		1.0		x
Corporate services	2.2		1.2		xi
Capital charges (non-cash)	0.2		0.2		xii
Sub-total		4.3		3.3	
Total revenue expenditure		21.2		20.7	xiii
Net request for resources		4.2		3.8	xiv

Notes

- i. Audit and inspection fees have increased by £400,000 reflecting inflation and increased scrutiny work.
- ii. Wales Programme for Improvement grant has remained constant from one year to the next. However, it has effectively decreased after inflation is taken into account.
- iii. Grant claim fee income has increased by £300,000. This includes an increase in ASPB European Union grant claims of approximately £100,000, and inflation.
- iv. The merger of several sponsored bodies with the Assembly Government from 2006-07 can be expected to lead to economies of scale but will not necessarily reduce the level of audit scrutiny required. The financial audit is now funded by fee rather by grant which amounts to £200,000.
- v. Audit of NHS Wales bodies have decreased by £300,000 reflecting a re-alignment of work programmes for 2006/07.
- vi. Other income reduced by £0.8 million as project work that was expected to be commissioned has not yet materialised.
- vii. Staff transferred to the Wales Audit Office from two legacy bodies on protected terms and conditions. Work is underway to standardise these and to ensure that the organisational structure develops such that it continues to deliver an effective and efficient service. Staff costs have increased by £400,000 but with the inclusion of increased pension costs of £70,000 there is a below inflation increase of £330,000.
- viii. Fees payable to appointed auditors and contractors has increased by £100,000 but, after inflation is taken into account, remains roughly the same as last year.

- ix. Accommodation and related costs remain as 2005-06. The leases on accommodation previously used by the National Audit Office and the Audit Commission in Wales transferred to the Auditor General.
- x. Supplies and services costs remain the same as 2005-06.
- xi. Includes ICT services, Human Resources, Payroll and Communications. Original 2005-06 estimate included payments to the Audit Commission and National Audit Office for some services which are now provided/purchased directly. A significant saving is projected for 2006-07, which, after inflation, has demonstrated efficiency savings.
- xii. Comprises estimated depreciation and notional interest charge.
- xiii. Total revenue expenditure has reduced by £0.5 million.
- xiv. The above estimate does not include the salary and related costs of the Auditor General which are payable separately by the Assembly under Section 91 of the Government of Wales Act 1998.

N.B. 2006-07 estimates take into account inflation and a reduction of 1% of gross expenditure to reflect the 1% efficiency gains target set out in *Making the Connections*.

- 39. There may well be some scope for limited rationalisation of audit work particularly in the health sector. However, the scope for making those efficiency savings early in the life of the new organisation will be limited because the Wales Audit Office will not be in a position to benefit from the economies of scale enjoyed by the two parent organisations.
- 40. I 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. 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.

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28 September 2005

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