



WALES AUDIT OFFICE
SWYDDFA ARCHWILIO CYMRU

Wales Audit Office / Swyddfa Archwilio Cymru

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Mr Jonathan Morgan AM
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Dear Chair

On 12 November 2010, I wrote to you setting out my intention to provide the Committee with three documents in advance of your 9 December meeting. These were:

- The report of the National Audit Office (NAO) of the results of their independent review of the Wales Audit Office accounts 2005-2010, which I commissioned from them shortly after I took up post as Auditor General on 1 October 2010;
- The report of my internal audit team on its review of the Wales Audit Office's financial accounting arrangements; and
- The report of my internal audit team on its review of the Wales Audit Office's work in progress recording arrangements.

I enclose with this letter the first two of these reports. My internal audit team expect shortly to conclude their work on the final report, and I will provide the Committee with a copy of that document as soon as it becomes available.

I thought that it would be helpful for me to briefly summarise within this letter the key messages of the enclosed reports, and also to outline the actions that I have already taken, and those I propose to take, to put the Wales Audit Office's governance and management arrangements on a sounder and more transparent basis.

Background

1. Since the sudden resignation of Jeremy Colman in February 2010, an internal Wales Audit Office 'due diligence' investigation has revealed matters of serious concern. It remains my intention to provide the Committee with a copy of the due diligence report at the earliest opportunity. However, I have been advised that it would be contrary to the principles of natural justice, as well as creating a potential risk of legal action for defamation, were I to publish that report without first taking all reasonable steps to agree the factual accuracy of its contents with Mr Colman.

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2. In particular, the terms of the former Chief Operating Officer's departure from the organisation proved to be far more generous than had been understood by other senior managers in the organisation. Most worryingly, whilst the retirement package was within legal limits, the forward provision for the settlement which amounted to £539,173 did not appear in the 2009/10 annual accounts of the Wales Audit Office. The interim Auditor General, Gillian Body, therefore commissioned the Wales Audit Office Internal Audit Team to review the circumstances of the matter.
3. Shortly after my appointment as Auditor General for Wales on 1 October 2010, I shared with the Public Accounts Committee my preliminary conclusion that the necessary corrective actions in relation to the accounting treatment would have a serious short-term impact on the financial position of the Wales Audit Office. Indeed, it would lead to the organisation potentially being in deficit for a period. I also shared with the Committee my early plans to strengthen governance and restore the Wales Audit Office to financial balance over a two-year period, ideally without recourse to requests for increased funding.
4. I also informed the Committee that I had invited the Comptroller and Auditor General, using staff of the NAO, to undertake a detailed and independent investigation into the Wales Audit Office's accounting policies and practice. The terms of reference for that review (which are appended to the NAO report) included an examination of the internal audit methods used in relation to accounting policies and practice and in relation to income recognition.
5. The matter of income recognition at the Wales Audit Office has also been the subject of allegations reported in the media in recent weeks. The allegations arose from anonymous and non-specific information reportedly supplied by four existing staff of the Wales Audit Office and a former member of staff. This prompted me to write to you on 12 November, and also to the Presiding Officer. I explained in that letter the extensive measures I had taken to encourage staff to approach me directly, or to approach the National Audit Office review team on a confidential basis, with any concerns they might have. Both trades unions made similar efforts with their respective members. And, as you will be aware, the Presiding Officer acceded to my request that he forward to the Comptroller and Auditor General, in confidence, the material with which he had been provided by the media.

6. This, then, is the background against which the NAO and internal audit reviews are set. I believe that these investigations have been both thorough and proportionate. As I have already shared with the Committee my intentions with regard to strengthening the governance of the Wales Audit Office, I will not repeat the details here. However, they will provide a strong foundation for delivering appropriate governance and robust external challenge, enabling me to be confident in the support of the Wales Audit Office in discharging my responsibilities as Auditor General for Wales.

The Wales Audit Office internal audit report 'Review of Auditor General's accounts'

7. The overall conclusion of the Internal Audit review was that there were a number of weaknesses in the process of compiling the Auditor General's 2009-10 accounts, which contributed to the misstatement of the Wales Audit Office's financial position as at 31 March 2010 and also to a number of presentational deficiencies.
8. The key internal audit conclusions were that:
- a. The Auditor General's 2009-10 accounts misstated the financial position of the Wales Audit Office, were deficient in aspects of presentation and showed weaknesses in related policy and practice;
 - b. The governance arrangements over the preparation of the Auditor General's accounts must be strengthened to ensure that potentially contentious matters are properly brought to attention;
 - c. The Wales Audit Office's management accounting arrangements do not effectively support the production of the Auditor General's accounts; and
 - d. The Wales Audit Office does not currently have a suitable level of reserves to provide it with sufficient flexibility in managing its business.

The National Audit Office report 'Review of the Wales Audit Office accounts 2005-10'

9. The National Audit Office report corroborated all the key findings of the internal audit review listed above. The key conclusions of the NAO report were that:
- a. The accounts of the Wales Audit Office have not been prepared in accordance with the applicable financial reporting framework since 2005-06;
 - b. The failure to recognise ongoing liabilities in full has impacted significantly on the supply position of the Wales Audit Office;

- c. Accounting policies and accounting treatments have not been applied consistently;
 - d. The governance arrangements for the review and approval of the accounts have not worked effectively;
 - e. The Financial Reporting Framework is out of date, and the financial responsibilities of the Auditor General need clarification.
10. As I noted in my letter of 12 November, as part of their review, the NAO have also examined the Wales Audit Office's processes for income recognition, and found that these comply with accounting standards and are fit for purpose. The NAO have noted that Internal Audit was conducting detailed work (including substantial sample testing) in response to the allegations that audited bodies had been billed for work not delivered. Whilst a detailed review of these issues lay outside their original terms of reference, nevertheless the NAO have discussed with Internal Audit their process for performing their work on income recognition, reviewed some of their initial work and consider their methodology to be sound.
11. The Comptroller and Auditor General informed me on 2 December that he has received no further evidence to corroborate or otherwise the allegations which cover ground that is included within his report. I am aware that the Comptroller and Auditor General has also written to the Presiding Officer along similar lines.
12. Even in the absence of any specific information on which to act, in parallel with the ongoing internal audit work I have commissioned an internal management review covering the entire programme of health and local government performance work since 1 April 2005. This work encompasses literally thousands of individual projects. I intend to discuss the progress and status of the work on income recognition with the Committee at its 9 December meeting, and of course I will also provide a copy of the final internal audit report to you when it becomes available.

Actions to address significant issues

13. As I have previously made clear to the Committee, the Wales Audit Office has a crucial role to play in supporting the delivery of public services in Wales. I am therefore determined to place the governance and management arrangements of the Wales Audit Office on a sound footing to deliver its vital work in a way that secures public confidence. I have accepted all of the recommendations made in both the National Audit Office and the Internal Audit reports.

14. My own overall conclusions and related actions are set out below:
- a. I am grateful to the Comptroller and Auditor General, and his staff at the National Audit Office for their independent, authoritative review of accounting policy and practice at the Wales Audit Office ever since its creation in 2005.
 - b. It is reassuring to me that the findings of the National Audit Office review have entirely corroborated the findings of the (more narrowly-focussed) internal audit review of the 2009-10 accounts. The Wales Audit Office must demonstrate the highest standards in public accounting, as set out in the Financial Reporting Manual, and accordingly I intend to ensure that all of the disclosure deficiencies identified in Appendix B of the NAO report are appropriately addressed in our 2010-11 accounts.
 - c. There were clearly weaknesses in the governance arrangements that were in place between 2005 and 2010. The creation of new Non-Executive led bodies for Remuneration and Resources, together with refocusing the terms of reference of the Audit and Risk Management Committee are in my view important first steps in addressing these issues. I also intend to strengthen policies and internal processes. However, there were also instances where the policies and processes that did exist were not applied as they should have been. Clear lapses in integrity at the very top of the organisation compounded the situation, including an instruction by Mr Colman that the Head of Finance should keep both the existence and contents of the retirement package agreed with the departing Chief Operating Officer entirely confidential from all other staff within the Wales Audit Office. I am therefore making it a priority to establish internal mechanisms that provide additional safeguards. They will ensure full and appropriate involvement of senior staff in financial management and accounting issues, together with a proper understanding of the financial implications of human resource management decisions. Taken together with the creation of new governance committees, these measures will provide a strong and coherent mesh of checks and balances. This will provide me with an appropriate framework to ensure clear accountability in our decisions, without compromising the proper and essential statutory independence of an Auditor General.
 - d. There has clearly been a perception by many staff within the Wales Audit Office since its creation that it was imperative to achieve absolute financial balance (neither calling on the Assembly for a supplementary estimate nor surrendering unspent funds to the Welsh Consolidated Fund) in the annual accounts. Such an expectation was unrealistic in light of the funding arrangements under which the Wales Audit Office operates, and has fostered inappropriate accounting practices. It is my view that the

core financial objective of the Wales Audit Office should be to break-even, taking one year with another, whilst recognising that the complexity of our income streams, business activities and expenditure patterns all mean that precise financial balance in any single year of account is highly unlikely. However, the creation of an appropriate level of operating reserves for the Wales Audit Office will require an injection of additional funding which, under statute, can only flow from local government audit work or from an increased annual or supplementary Estimate. I will therefore want to give this further careful consideration.

- e. As regards the role of the external auditors of the Wales Audit Office, I note that they have issued unqualified audit opinions on the annual accounts every year, although the NAO review of those accounts has identified a range of significant deficiencies in their presentation. On the 2009-10 annual accounts, I am deeply concerned that they did not bring what must be considered as significant audit judgements to the attention of the interim Auditor General, to members of the Audit and Risk Management Committee, or indeed to the Chair of the Public Accounts Committee. These audit judgements supported the omission of any provision for the future pension costs arising from the departure of the former Chief Operating Officer. My internal auditors have noted in their report that the external auditors continue to assert that the accounting treatment was correct, and also to maintain that the inclusion of a provision might have led them to qualify their audit opinion – a view that runs completely counter to that of the National Audit Office. These are all matters that, no doubt, the Committee will wish to pursue with the external auditors.
- f. Staff morale has undoubtedly been affected by the events of this year, and by the often adverse media coverage that this has generated. The discovery of the failures of integrity at the very top of the organisation, and of the weaknesses in the governance and management arrangements of the Wales Audit Office has been a blow to the morale of hard-working and highly committed staff and has left a legacy of anxiety in the organisation. Perhaps even more damaging has been the impact of a sustained campaign by certain individuals to expose the organisation to unevidenced anonymous allegations. I have made it abundantly clear to all staff that if they have concerns then there are proper routes for them to raise them, and that I am always willing to listen and, if necessary, take appropriate action. However, I will not in perpetuity expend public money on responding to unevidenced allegations about historic actions (some of which relate to predecessor bodies), or about individuals who have long since departed the Wales Audit Office.

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- g. I firmly believe that more open decision-making, together with clearer accountability and better internal communications, will do much to restore staff morale over time. Together with my management team, I greatly value the support of the Public Accounts Committee, the Trades Unions and of many colleagues across the public sector, during this difficult period. For the immediate future, the greatest boost to staff morale will undoubtedly come from drawing a firm line under these unfortunate events. I know that my staff and both unions are keen that the Wales Audit Office should now concentrate on delivering quality work that is clearly founded in appropriate levels of accountability and openness, and which supports the public sector in Wales during a period of severe financial restraint.

I hope that this letter has given you and your fellow Committee members a helpful overview of the material to be considered at your 9 December meeting. I look forward to that session, and to further discussions with the Committee concerning the effective audit of public bodies in Wales in the months ahead.

Yours faithfully



HUW VAUGHAN THOMAS
AUDITOR GENERAL FOR WALES

Encs

cc Amyas Morse, Comptroller and Auditor General