



WALES AUDIT OFFICE

SWYDDFA ARCHWILIO CYMRU

Internal Audit: 2010-11

November 2010

Author: Terry Jones

Ref: 576A2010

Internal Audit: Review of the Auditor General's Accounts

Wales Audit Office

We have concluded that there were a number of weaknesses in the process of compiling the Auditor General's 2009-10 accounts. These weaknesses contributed to the accounts misstating the financial position of the Wales Audit Office as at 31 March 2010, and to a number of presentational deficiencies in the accounts.

Contents

| | |
|---|----|
| Review of the Auditor General's Accounts | 3 |
| 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 | 4 |
| 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 | 6 |
| The Wales Audit Office's management accounting arrangements do not effectively support the production of the Auditor General's accounts | 8 |
| The Wales Audit Office does not currently have a suitable level of reserves to provide it with sufficient flexibility in managing its business | 9 |
| Appendices | |
| Action Plan | 10 |

Review of the Auditor General's Accounts

1. This Internal Audit is an additional review to those included in the 2010-11 audit plan. Having become aware of queries associated with the 2009-10 statement of accounts, the Managing Partner Planning and Resources requested Internal Audit to undertake a review. The review seeks to answer the question: **Do any policies and conventions, assertions and interpretations of accounting standards reflected in WAO's statements of accounts require any clarification and/or amendment?**
2. In order to respond to this question, a review of the preparation of the 2009-10 accounts was undertaken, which included:
 - review of the supporting working paper file and additional information provided by the Head of Finance and others;
 - interviews with the Head of Finance and others including the interim Auditor General, all other Executive Committee members, the Compliance Partner, the former Chief Operating Officer and the Internal Audit Manager;
 - reviewing and taking assurance from internal audit reports on the Wales Audit Office's financial systems;
 - comparison of the Auditor General's accounts for 2005-06 to 2009-10 to NAO disclosure checklists; and
 - review of correspondence between the Managing Partner Planning and Resources and the external auditor. We have not contacted the external auditor as part of this review.

Internal Audit has undertaken annual reviews of the WAO's financial systems. However, no previous internal audit reviews have been undertaken on the preparation and presentation of the accounts themselves.

3. We have concluded that there were a number of weaknesses in the process for compiling the Auditor General's 2009-10 accounts. These weaknesses contributed to the accounts misstating the financial position of the Wales Audit Office as at 31 March 2010, and to a number of presentational deficiencies in the accounts. We make a number of recommendations to address these matters. In clearing the drafts of this report the Head of Finance has indicated that while he accepts the recommendations, he does not consider that the evidence to support some of the conclusions is sufficiently robust, and that some of those conclusions are not presented in a sufficiently balanced way.
4. The Auditor General for Wales is required by the Government of Wales Act 2006 to prepare accounts each financial year, and to have those accounts audited by an external auditor appointed independently by the National Assembly for Wales. The external auditor is KTS Owens Thomas Ltd, who have been the incumbent auditor since the creation of the Wales Audit Office, and were reappointed in 2009 for a further four year period. Unqualified audit opinions have been provided on the Auditor General's accounts from 2005-06 to 2009-2010. It will be clear to the

reader from conclusions drawn in this report that some of our views on the correct application of accounting standards, and compliance with the FReM, are not consistent with the provision of unqualified audit opinions.

5. We acknowledge the full cooperation of the all those approached for information during the course of this review.

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

6. Other than in relation to the matters related in this report, the 2009-10 accounts, and those of earlier years, were well presented and understandable. There is clear evidence of control over their production by the Head of Finance and a solid audit trail to support the figures in the accounts. A review of the Auditor General's 2009-10 Estimates Paper did not highlight any issues of concern regarding the compilation of the 2009-10 accounts. The issues identified by this review relate to more technical aspects of the accounts production process and are the conclusions of the internal audit team.
7. The 2009-10 accounts omitted a material provision in respect of early retirement agreements entered into during 2009-10 and earlier financial years and were therefore misstated. It is currently estimated that a provision of £1.231 million will need to be included in the 2010-11 accounts for early retirements, including an estimate of £214,000 for an early retirement in 2010-11. The application of accounting policies had been applied consistently with those used in previous years. Previous years' accounts were also misstated in respect of early retirement agreements entered into during those years; the size of misstatement varies depending on the terms of the arrangements entered into during the relevant year.
8. The external auditor of the 2009-10 accounts is of the view that the early retirement accounting treatment in these and earlier accounts was correct, and they have written to the Managing Partner Planning and Resources to state that the inclusion of a provision might lead to qualification of, or an emphasis of matter paragraph on, the 2010-11 accounts. They have however suggested that they would reconsider the proposed treatment during an interim audit on the 2010-11 accounts. Appropriate adjustments will need to be agreed with the external auditor and reflected in the Auditor General's 2010-11 accounts.
9. A provision of £715,000 for early severance costs was included in the 2009-10 accounts in respect of a scheme announced to staff in March 2010 by the Managing Partner Planning and Resources. This provision was supported by a decision of the Executive Committee and an e-mail communication to all staff at the year-end requesting expressions of interest in the scheme. The provision was also underpinned by a confidential assessment that up to 20 posts might need to be made redundant following workforce planning if there was insufficient take up of the offer under the voluntary scheme. The inclusion of the provision is defensible under accounting standards and was accepted by the external auditor.

However, the robustness with which this provision was supported might have been strengthened had a 'technical accounting' review of the proposal been undertaken prior to its announcement. Such a review could have been undertaken by another audit agency or external firm if the matter was regarded as too confidential to obtain advice from within the Wales Audit Office.

10. The Auditor General is permitted to retain any net surplus arising from local government fees (other than grant certification work), but is required to pay any surplus on central government or NHS work back into the Welsh Consolidated Fund (WCF). The accounts contain a note that analyses the allocation of costs against income to demonstrate how this requirement is being satisfied. The applicable accounting policy note states that "... common expenditure has been attributed to each activity on an hours worked or other appropriate basis."
11. Certain of the costs of the Wales Audit Office are directly attributable to sector specific activities, but many overheads (e.g. business support) cannot be directly attributed to activities in particular sectors. Any allocation method is inevitably approximate and based on judgement. The approach used within the Wales Audit Office is not consistently and clearly applied and therefore does not represent transparently the cost base of the Wales Audit Office. A more effective system would recognise that all sources of funding should contribute to the running costs of the Wales Audit Office and would include appropriate checks such as an agreed reserves policy on the level of reserves that could be carried forward.
12. The accounts for 2009-10 were the first accounts required to be prepared under International Financial Reporting Standards (IFRS). As such, the accounts should have included two years of comparative figures in the balance sheet and supporting notes. This comparative information was provided in the balance sheet itself but not in the supporting notes. The Head of Finance has confirmed that he discussed and agreed this treatment with the external auditor.
13. Income and funding from the WCF were included in the 2009-10 Statement of Comprehensive Income; similar treatment was adopted in the accounts of earlier years. This treatment is inconsistent with provisions applicable to other bodies that compile their accounts in accordance with the Financial Reporting Manual (FRoM). Under the FRoM, funding from the WCF should be credited to Reserves rather than included in the Statement of Comprehensive Income. The Head of Finance adopted this approach as the 27 February 2006 HM Treasury accounts direction referred to income and expenditure and made no mention of how WCF funding should be treated. This accounts direction was issued for the 2005-06 accounts and later years, however, it has not been updated to reflect the introduction of IFRS, other developments in the FRoM or the Government of Wales Act 2006. Although the Wales Audit Office is not responsible for arranging for the accounts direction to be issued, requests should have been made for the direction to be updated periodically.
14. The Remuneration Report contains details of the Auditor General's salary and other remuneration information but excludes the cash equivalent transfer value of the Auditor General's accrued pension entitlement. The Head of Finance explained that this information was not available to him as the DWP would not provide it to the WAO. The Auditor General or the National Assembly for Wales Commission could have been asked to request the information directly. The

Auditor General's accounts should be exemplar and should contain all FReM disclosures applicable to other bodies.

15. A bad debt provision of £280,000 was included in the 2009-10 accounts, which was calculated in accordance with the accounting policy disclosed in the accounts and reflected some concerns on the part of the Head of Finance regarding debts due from bodies that were being abolished. There is little evidence to justify a provision of this size, which is an issue identified by the external auditor in its report on the 2009-10 accounts. The WAO already had plans in place to address this matter during 2010-11. Release of some of this provision might enable a contribution to be made to build up reserves, or other resources may need to be returned to the WCF.

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

16. The Head of Finance leads a small team, who have limited collective capacity (rather than individual ability) to provide challenge on technical accounting aspects of the accounts or the judgements applied.
17. Historically, the Wales Audit Office has operated an informal peer review on the Auditor General's accounts. Under this system a number of senior members of staff were asked to comment on the accounts as presented (which excluded the remuneration report owing to delays in the availability of information needed to produce that report). They were not provided with any underpinning information and had minimal time or opportunity to properly scrutinise the accounts. Individuals have also commented that their observations were not always acted upon in areas such as the presentation of WCF funding. This may have arisen because of judgement based disagreement with the comments rather than them being simply ignored, but did not promote confidence in the accounts as the rationale for their rejection was not shared.
18. In 2009-10, the following arrangements operated to support the production of the accounts:
 - informal peer review of accounts (excluding remuneration report) by the Financial Audit Technical Partner, Compliance Partner and Managing Partner Financial Audit;
 - external audit of the accounts;
 - review of the accounts (including remuneration report) by the Managing Partner Planning and Resources and the Auditor General;
 - presentation of year-end financial information to the Executive Committee; and
 - presentation of the accounts to the Audit and Risk Management Committee (ARMC) and their scrutiny of them.
19. The Auditor General had controls in place to support the approval of the accounts, but in our view these controls did not operate effectively.

-
20. As noted above, the reviews of the accounts in 2009-10 were also time pressured and the peer reviewers did not have access to wider information to support them in undertaking their review.
 21. The subsequent stages of the review were largely built on reasonable trust that the information provided by the Head of Finance was complete and accurate, and that potentially contentious matters would be brought to attention. This has proved not to be the case over the accounting for severance costs, where information was not properly documented and restricted to the Head of Finance, the former Auditor General and in previous years, the Chief Operating Officer (the Head of Finance's line manager).
 22. We have been advised that the Head of Finance was instructed by the former Auditor General that the arrangement was to be kept confidential, that no-one was to be consulted within the WAO, and that none of the arrangements, and no communication relating to them, should be in writing (such an instruction is consistent with other information we have obtained about the former Auditor General's desire to keep the payment confidential). Following the departure of the former Auditor General, when questioned as part of the due diligence review, the Head of Finance confirmed the existence of a package, although according to the note of that meeting the extent of the package was not disclosed.
 23. The Head of Finance has acknowledged that the accounting treatment adopted for severance costs was in his view at the extreme end of what was acceptable, however, he did not alert anyone within the WAO to this position, even after the departure of the former Auditor General.
 24. The Head of Finance has, however, confirmed that he actively raised and discussed the accounting treatment with the external auditor, who provided an unqualified opinion on the accounts. As noted at paragraph 4 our views on the correct application of accounting standards, and compliance with the FReM, are that this treatment is not consistent with the provision of an unqualified audit opinion.
 25. Neither the Head of Finance nor the external auditor raised this matter with WAO management, the Auditor General or the ARMC. We note that the external auditor has written to the Managing Partner Planning and Resources maintaining the view that the early retirement accounting treatment in these and earlier accounts was correct, and that the inclusion of a provision might lead to qualification of, or an emphasis of matter paragraph on, the 2010-11 accounts.
 26. In our view, the Auditor General would be better served with more clearly defined, formal governance arrangements to support the approval of the accounts. This might include the following elements:
 - Formal 'peer Partner review' of the draft accounts, properly supported with relevant documentation and evidence, and with sufficient time to respond effectively.
 - Documented responses to points made by the peer Partner review to accompany further review stages.
 - An annual internal audit review on the compilation of the accounts and to report issues to the Managing Partner Planning and Resources when

-
- making recommendations on the approval of the accounts to the Executive Committee.
- Formal review by the Managing Partner Planning and Resources to include a 'completion checklist / assertions' by the Head of Finance.
 - Financial Audit Technical Partner (or other external agency support) advice to the Executive Committee when it is considering the accounts.
 - A formal presentation from the external auditor on their comprehensive findings from the audit, focusing in particular on contentious or sensitive issues or any issues requiring interpretation, to the Executive and Audit and Risk Management Committees.
 - Formally tabled questions on the accounts (to the external auditor and Head of Finance) by ARMC members prior to the meeting that reviews the draft accounts as well as ad hoc questioning on the day.
 - A full disclosure and matters arising checklist provided to the Auditor General by the Managing Partner Planning and Resources and Head of Finance prior to Auditor General signature of the accounts.
27. As highlighted above, our view is that decisions about severance costs did not adequately take account of the potential implication of those decisions on the Auditor General's accounts as the technical view provided by the Head of Finance was in our view incorrect, although supported by the external auditor.

The Wales Audit Office's management accounting arrangements do not effectively support the production of the Auditor General's accounts

28. Management accounts should provide managers with the information they need to discharge their responsibilities, to support transparent decision making and should also provide a clear link to information contained in the final annual accounts. Responsibility for defining the form of this information rests with both the Head of Finance and with the users of that information, including members of the Executive Committee.
29. The management accounting information provided to relevant parts of the Wales Audit Office has varied in terms of the amount of detail provided. The Performance and Financial Audit Partners' Committees for example received very limited analysis of the information presented to them. This has led to a situation where those recipients of management accounting information are not able to identify clearly the link between the management information they have received and the Auditor General's accounts. This has tended to undermine confidence in management accounting and the final accounts. The Head of Finance contends that this view has not been fed back to him previously.

The Wales Audit Office does not currently have a suitable level of reserves to provide it with flexibility in managing its business

- 30.** Adequate reserves need to be built up to provide a degree of financial robustness for the Wales Audit Office. An appropriate model might include a reserves policy that is actively applied in the Auditor General's estimates paper, that provides the Wales Audit Office with some degree of flexibility in managing its business, but which would require major additional resource requests to be specifically considered by the PAC. Items that might fall into this latter category include potential crystallisation of the VAT contingent liability on inspection work or significant personal injury claims by former employees.
- 31.** The 2009-10 accounts include year-end reserves of £117,000. As has been illustrated by recent events, this allows little flexibility when unforeseen events arise. Although the Wales Audit Office currently has a policy to build reserves this has not been possible in practice. The extent to which reserves are needed is dependent on the willingness of the National Assembly's Public Accounts Committee to approve supplementary budget requests.

Appendix 1

Action Plan

| Recommendation | Responsibility | Agreed | Comments | Date |
|---|---|--------|----------|----------------|
| R1 HM Treasury should be asked to issue an updated accounts direction to clarify the basis on which the accounts should be prepared and to reflect the Government of Wales Act 2006. | Managing Partner Planning and Resources | Yes | | December 2010 |
| R2 The Auditor General's estimates paper should identify how surpluses from activities are used to fund the general overheads of the Wales Audit Office which are not directly attributable to those activities. | Managing Partner Planning and Resources | Yes | | September 2011 |
| R3 Arrangements should be put in place to ensure that information on the cash equivalent transfer value of the Auditor General's accrued pension entitlement is available to support the production of full information in the Remuneration Report. | Managing Partner Planning and Resources | Yes | | April 2011 |

| Recommendation | Responsibility | Agreed | Comments | Date |
|--|---|--------|----------|---------------|
| R4 The provision for bad debts policy should be reviewed to reflect historical experience and any known factors affecting debt recovery. | Managing Partner Planning and Resources | Yes | | December 2010 |
| R5 More clearly defined and formal governance arrangements should be established to support the Auditor General in the approval of the accounts. | Managing Partner Planning and Resources | Yes | | April 2011 |
| R6 Business decision making processes should take account of any implications those decisions might have on the Auditor General's accounts and the need for a technical second opinion should be considered in critical cases. | Managing Partner Planning and Resources and Executive Committee | Yes | | December 2010 |
| R7 A review should be undertaken to develop the form of management accounting information provided to users, which should also support the production of the annual accounts. | Managing Partner Planning and Resources and Executive Committee | Yes | | January 2011 |
| R8 A revised reserves policy should be developed and implemented. | Managing Partner Planning and Resources | Yes | | April 2011 |

| Recommendation | Responsibility | Agreed | Comments | Date |
|---|---|--------|----------|------------|
| R9 The extent of the misstatement in the 2009-10 accounts should be confirmed and rectified in future accounts. | Managing Partner Planning and Resources | Yes | | April 2011 |



Wales Audit Office
24 Cathedral Road
Cardiff CF11 9LJ
Tel: 029 2032 0500
Fax: 029 2032 0600
Textphone: 029 2032 0660
E-mail: info@wao.gov.uk
Website: www.wao.gov.uk