



WALES AUDIT OFFICE  
SWYDDFA ARCHWILIO CYMRU

Wales Audit Office / Swyddfa Archwilio Cymru

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Mr Darren Millar AM  
Chair of the Public Accounts Committee  
National Assembly for Wales  
Cardiff Bay  
Cardiff CF99 1NA

Dear Darren

### **AUDITOR GENERAL'S 2011-12 ANNUAL REPORT AND ACCOUNTS**

I laid my Annual Report and Accounts for 2011-12 before the National Assembly for Wales on 27 July 2012.

Following discussions between our respective offices regarding these, I set out below further information which I hope will be useful to the Public Accounts Committee in considering these documents.

In particular, I provide further information regarding the following elements reported in my Annual Report and Accounts:

- Financial Outturn 2011-12;
- Annual Governance Statement;
- Note 15: HMRC provision (£2,605,000); and
- Cash management.

I hope this information is helpful and look forward to discussing my Annual Report and Accounts with the Committee on 2 October 2012.

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## Financial Outcome 2011-12

The Financial Review in my Annual Report and Accounts (supported by Note 2 to the accounts) provide a detailed breakdown of my income and expenditure in 2011-12. Total income and resource was £24,341,000 (£24,481,000 in 2010-11) and expenditure was £23,693,000 (£22,471,000 in 2010-11). This resulted in a surplus generated in year of £648,000 (£2,010,000 in 2010-11) before the cash repayment of £1,945,000.

In my commentary on the accounts, I state that a number of factors had allowed us to generate this level of surplus in 2011-12 including:

- increases to income streams of £1.4 million; and
- a reduction in normal annual operating expenditure of £1.0 million.

I thought it would be helpful to the Committee if I provided further information in respect of each of these factors.

### Additional income (£1.4 million)

The additional income disclosed in the accounts arose from a number of sources, including:

- £0.4 million - additional income on grants certification which arose from the clearance of a backlog of outstanding grant claims by some local authorities.
- £0.2 million - income is recognised as we charge time to an audit, which usually spans two financial years. As such, additional income can arise where we carry out more audit work than anticipated in the first of the two financial years (2011-12). There will be a consequent reduction in income in the following financial year (2012-13).
- £0.4 million - additional unplanned work which we were required or commissioned to undertake at audited bodies. Examples include the Pembrokeshire CBS Special Investigation, additional audit work at Neath Port Talbot County Borough Council, Blaenau Gwent County Borough Council additional Corporate Inspection, and the Caldicot and Wentlooge Special Investigation.
- £0.1 million - secondment income relating to WAO staff working with other public bodies.
- £0.1 million – only £0.1 million of the £0.55 million supplementary income approved by the National Assembly in 2011-12 for the Voluntary Exit scheme was needed. Although the total cost of the scheme was £346,000, we were able to fund £246,000 from the WAO's original 2011-12 budget.
- £0.2 million – arising from additional work carried out by the audit firms carrying out work on behalf of the Auditor General under Framework Contracts approved in 2007

This combination of additional income sources is unprecedented and is unlikely to be repeated in 2012-13 and future years. For example, additional unplanned audit work (third bullet point above) was £180,000 more than the average of the previous three years, and as far as we are aware, Local Authorities have now cleared their backlog of grant claims (first bullet point above).

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**Efficiency and savings (£1 million)**

The 2011-12 budget included an amount of £0.5 million for restructuring of the Performance Audit Group. However, the restructuring was delayed into 2012-13, with the consequent funding requirement impacting upon the 2012-13 budget. In addition, a further favourable variance of £0.55 million arose as a result of significant under spends by budget holders. An analysis of the under spend has identified that it arose for a variety of reasons including:

- budget holders actively trying to minimise costs and identify efficiencies, for example, by looking for lower cost service providers. One example of this is in Business Services where over £50,000 was saved on a range of office related contracts; and
- changes in WAO working practices which have given rise to reduced expenditure, for example reduced legal costs arising through central management of legal advice, and deferring non urgent expenditure, for example on training and IT equipment purchases.

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## **Annual Governance Statement**

The Annual Governance Statement included in my Annual Report and Accounts, stated that, as set out in the Statement on Internal Control in previous years, the Head of Internal Audit had concluded that the Wales Audit Office's systems are capable of delivering effective internal control and risk management. However, the Head of Internal Audit had noted specific and significant deficiencies in the operation of internal controls which showed that systems were not operating effectively. He concluded that these deficiencies needed to be addressed quickly and effectively by management. In particular, the Statement noted that:

- further development and improvement of financial management and management accounts is essential;
- the Wales Audit Office is at risk of incurring financial penalties for non-compliance with employment tax regulations;
- policies, procedures and guidance for staff need to be refreshed and generally updated in line with new governance and management structures; and
- there is scope to improve the system of compliance with procedures governing contracts and procurement.

Management has accepted the recommendations made by the Head of Internal Audit and work is ongoing to address each of them. The progress being made is reported to the WAO's Audit and Risk Management Committee on a quarterly basis. However I thought it might be helpful to the Committee if I were to provide additional information on the background to, and the work being carried out to, address each issue.

### **Further development and improvement of financial management and management accounts**

During 2012-13, we have continued to improve our financial management procedures and our financial reporting mechanisms. Following the restructuring of the Performance Audit Group in April 2012, staff have now been allocated to work in smaller teams which are responsible for estimating the amount of chargeable work that can be delivered in any given period. This has led to more accurate profiling of audit work, which is now incorporated in the monthly reports that are considered by the Executive Committee, on a monthly basis. This information is also reported to the Shadow Board.

We have also created an additional temporary post in the Finance Department to further improve the quality of our financial management information. In order to ensure greater consistency between project delivery details which are derived from our time recording system, and our monthly management accounts which are produced by Finance, we have transferred responsibility for the production of the monthly Corporate Performance Management Framework (CPMF) reports from the operational parts of the business to the Finance team.

### **The Wales Audit Office is at risk of incurring financial penalties for non-compliance with employment tax regulations**

I explain in further detail below, the current situation regarding employment tax issues.

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**Policies, procedures and guidance for staff need to be refreshed and generally updated in line with new governance and management structures**

An Internal Audit review of the Wales Audit Office's financial procedures in January 2012 concluded that a number of improvements can be made to those procedures to ensure that all of the principles of Managing Welsh Public Money (MWPM) and good practice are followed. Specifically, the report recommended that there was a need to:

- clarify the roles and responsibilities of WAO staff with financial management responsibilities; and
- update and approve WAO's Financial Policies as Standing Financial Instructions.

We are reviewing and updating various of our policies, corporate notices and codes and updating as Standing Financial Instructions as required. This work is taking longer than anticipated due to the uncertainty surrounding the proposed new legislation and will need to be reviewed in the light of the draft Public Audit (Wales) Bill, when enacted.

**There is scope to improve the system of compliance with procedures governing contracts and procurement**

In January 2012, the Head of Internal Audit identified a need to improve our procurement procedures in order to minimize the risk of non-compliance with internal and EU procurement processes. This issue has now been addressed.

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### Note 15: HMRC provision (£2,605,000)

The HMRC provision contained in Note 15 to my accounts is made up as follows:

	£'000
VAT	2,392
Employment status	165
PAYE re two AAGs	<u>48</u>
	<u>2,605</u>

As I outline below, we are faced with a number of tax uncertainties arising from historical practices, all of which date from the creation of the Wales Audit Office in 2005 and to arrangements inherited from our predecessor organisations. In deciding whether to include a provision in the accounts for each of these issues, and if so at what level, my staff took the following approach:

- They formally sought views from our professional advisers as to whether in their view (on the facts as they were known at that time) it was appropriate to include provisions in the accounts and if so at what level.
- That advice was reviewed by my staff, who concurred with the professional advice received, and prepared a briefing paper for my Executive Committee recommending that the accounts contain provisions at the level recommended in the professional advice. My Executive Committee considered and accepted this advice.
- My Financial Audit Technical Group Director undertook a review of the process followed and prepared a report for my Audit and Risk Management Committee, which supported the conclusions reached by my staff in preparing the accounts.
- My Audit and Risk Management Committee was presented with a briefing outlining the above process and it in turn recommended to me approval of the accounts with provisions as set out above.
- In signing the accounts, I accepted the advice of my professional advisers, staff, Executive Committee and Audit and Risk Management Committee that taxation provisions of £2,605,000 should be recognised.
- My external auditor also agreed with the approach taken, as evidenced through their management letter and unqualified audit opinion.

I set out below an explanation of the background to these issues, but as I am sure you will appreciate, these are technically complex areas. My staff are engaged in active and constructive dialogues with HMRC in order to resolve each of these issues in the most cost effective way for the public purse.

It is not possible to be entirely clear what level of resource and cash I may need to discharge these liabilities until each of the issues has been resolved. I have included a substantial provision in the accounts for 2011-12, but owing to timing differences between the making of

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this provision and when I may need to discharge any liabilities, I have returned to the Welsh Consolidated Fund cash of £1.945 million. Should these, and any other additional, liabilities fall due for payment, I will need to fund them through a combination of fee increases, funding from the Welsh Consolidated Fund and cost savings.

### **VAT (£2,392,000)**

This is a long standing issue, which has been reported in every Auditor General estimate paper, and annual report and accounts, since the creation of the Wales Audit Office in 2005. There is correspondence dating back to 9 September 2004, which seeks clarification on this issue.

The issues are two-fold: the VAT status of the Auditor General and the VAT status of work undertaken on behalf of the Auditor General

### **VAT status of the Auditor General**

Primary EU legislation provides that bodies "governed by public law" are not subject to the same VAT regime as other organisations. This provision is not directly reproduced in UK legislation. Rather, UK legislation (VAT Act 1994) contains the following separate provisions:

- section 33 allows bodies undertaking a function ordinarily carried out by a local government body, and having the power to draw their funding directly from local taxation, to recover VAT on certain activities; and
- section 41 allows "government departments" to recover VAT incurred in specific circumstances.

It was uncertain whether my office was subject to either of these provisions and I sought clarification from HMRC on this question. On 29 March 2012 the HMRC Policy Unit confirmed that neither of these provisions applied to me.

### **VAT status of work undertaken on behalf of the Auditor General**

Following resolution of my VAT status, the second question that needs to be resolved is that of the VAT status of my work. On the formation of the Wales Audit Office, the existing VAT treatments of the National Audit Office and the Audit Commission continued to be applied to our work. This approach was followed with the knowledge of HMRC.

It is possible however that HMRC may seek to argue that the VAT treatment adopted for some activities was incorrect, and that as a consequence I recovered too much VAT. I am in correspondence with HMRC explaining why I do not believe that this is the case. My arguments focus on both the technical VAT classification of my work and on the fact that I believe HMRC was aware of the treatment, and indeed approved the approach being followed on several occasions.

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### **Employment status (£165,000)**

We have identified a small number of contractors who we believe HMRC may argue should have been treated as self-employed rather than employed. This is a complex area of tax legislation with a series of common law tests having been developed over time to determine the tax status of individuals. In our situation, these individuals were often engaged to undertake a small specific piece of work, but the volume of that work increased over time leading to a situation where their tax classification may have changed from one of "self-employed" to "employed". We have introduced new procedures to strengthen the monitoring of these engagements, to identify when such a change may be about to occur, and to take appropriate action in that event. The final settlement with HMRC may be at a lower level than the provision of £165,000 as HMRC may be willing to offset tax paid by the individuals on this income against the WAO's liability.

### **Taxation of travel and subsistence expenses (£48,000)**

The nature of the work of my audit staff means that they are expected to travel to different audited bodies and offices across Wales. For operational purposes, my staff are allocated to a notional travel base within Wales from which they can claim travel and subsistence costs. We do not reimburse travel expenses for journeys between home and these notional travel bases. In 2007, we obtained clearance from HMRC that audit staff could be classified a "geographically based" for tax purposes. As a consequence of this status, any payments for travel and subsistence in undertaking business journeys can be made free of tax and national insurance. More recently, my staff have been reviewing the travel patterns of all groups of staff. This review has indicated that a number of groups of staff may have developed patterns of working that HMRC may argue do not satisfy the criteria for them to be regarded as geographically based. In particular, some members of my staff are of necessity basing themselves at audited body sites for large periods of time (HMRC guidelines contain a 40% threshold) or are travelling to audited body sites on a regular basis. HMRC may seek to argue that these groups of staff have established permanent places of work at these audited body sites, and that some staff may have established two such permanent places of work. If this were the case HMRC will probably argue that payments for journeys to these sites should have been taxed.

I intend to robustly challenge any assertion by HMRC that these expense payments should have been taxed, as the very nature of our work requires my staff to spend large periods of time working at audited bodies. I am aware that other Welsh public bodies and another UK audit agency have experienced similar difficulties

It is not possible at present to specify the potential level of liability that may arise as a consequence of this issue. I have made disclosure to HMRC requesting their confirmation that the clearance provided in 2007 remains valid, but have yet to receive a response on this specific query. On the basis of professional advice, as outlined above, I have not included any provision in my accounts for this potential issue.

My accounts do however include a provision of £48,000 in respect of liabilities regarding two of my Assistant Auditor Generals, who are based in North Wales. Following a specific review of their travel patterns we concluded that it was probable that HMRC would successfully argue that



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they had both established permanent places of work in Cardiff, in addition to their current Ewloe bases, and that as a consequence their travel, hotel and meals when visiting Cardiff were taxable. The Wales Audit Office is an all-Wales organisation and I do not consider that staff should necessarily have to relocate to Cardiff. As a consequence, I consider that it is appropriate for the Wales Audit Office to bear these tax costs.

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## Cash management

I have three primary sources of cash: the Welsh Consolidated Fund, audit fees and WPI grant from the Welsh Government. It is essential in my view that these different streams of cash are managed and accounted for separately and that, for example, I am not seen to be using fees from audited bodies to finance expenditure covered by my estimate. The expenditure funded through the estimate is largely staff costs, which are incurred on a regular basis throughout the year. As a consequence, I draw down cash approved through the estimate process in regular monthly instalments.

As at 31 March 2012, my accounts show a cash holding of £6,667,000 with cash of £1,945,000 being shown as payable to the Welsh Consolidated Fund, effectively giving a net cash availability figure of £4,722,000. This figure of available cash essentially underpins the following balances:

- Deferred Income - £2,279,000 (this is audit fees I have received in advance of work being undertaken, under monthly billing arrangements I have with audited bodies); and
- Provisions - £3,839,000 (Note 15).

The deferred income balance is fully supported by the cash I hold, but only part of the provisions are cash backed by net available cash. This shortfall is reflected in the deficit of £1,235,000 in my Statement of Financial Position at 31 March 2012, which I am required to balance taking one year with another.

It is in the very nature of provisions that timing differences may arise between their recognition in accounts and the point at which cash becomes payable. This timing difference between the recognition of the expenditure and the potential defrayment of cash was a contributory factor to the £1,945,000 of cash I have paid into the Welsh Consolidated Fund. Should the liabilities in my accounts become payable, I expect to have to request additional cash to enable me to settle the resulting liability.



**HUW VAUGHAN THOMAS**  
AUDITOR GENERAL FOR WALES