SCPA/S2/06/03/A

The Scottish Parliament

SCOTTISH COMMISSION FOR PUBLIC AUDIT

AGENDA

3rd Meeting, 2006 (Session 2)

Wednesday 22 November 2006

The Commission will meet at 10.30 am in Committee Room 3.

1. **Decisions on taking business in private:** The Commission will consider whether to take agenda items 5 and 6 in private.

2. **Pension liabilities:** The Commission will take evidence on the potential liability for former ombudsman pensions from—

   Robert Black, Auditor General for Scotland and Russell Frith, Director of Audit Strategy.

3. **Audit Scotland management report:** The Commission will consider a management report on Audit Scotland's 2005-06 Accounts.

4. **Economy, Efficiency and Effectiveness Examination of Audit Scotland:** The Commission will consider a report from the Auditors of Audit Scotland, Haines Watts CA, on the economy, efficiency and effectiveness examination of Audit Scotland's fees and charges. The Commission will take evidence from—

   Jay Hussein, Partner, Haines Watts.

   And then from—

   Robert Black, Auditor General for Scotland;

   Russell Frith, Director of Audit Strategy; and

   Diane McGiffen, Director of Corporate Services, Audit Scotland.

5. **Response to the Finance Committee's report into Accountability and Governance:** The Commission will consider its response to the Finance Committee's inquiry report on Accountability and Governance.

6. **SCPA Legacy paper:** The Commission will consider a draft legacy paper.

Rosalind Wheeler
Secretary to the Commission

The papers for this meeting are:

Agenda Item 2

Briefing paper	PRIVATE PAPER
Letter from the AGS	SCPA/S2/06/03/1

Agenda Item 3

Management Report on Audit Scotland's 2005-06 Accounts	SCPA/S2/06/03/2

Agenda Item 4

Briefing paper	PRIVATE PAPER
Haines Watts 3Es report on Audit Scotland's fees and charges	SCPA/S2/06/03/3

Agenda Item 5

Draft Commission response	PRIVATE PAPER

Agenda Item 6

Draft legacy paper	PRIVATE PAPER

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SCPA/S2/06/03/1

Margaret Jamieson MSP
Convenor
Scottish Commission for Public Audit
Scottish Parliament
Edinburgh
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16 November 2006

Dear Convenor

I write to inform the Commission of some welcome progress on the issue of Audit Scotland's VAT status. I would be happy to discuss this further when we meet on 22 November 2006.

Background

As the Commission may recall, Audit Scotland started discussing its VAT status with HMRC before its inception. Those discussions lasted for over 2 years and despite the helpful contribution from the Commission, HMRC ruled that Audit Scotland could not continue to enjoy the same favourable VAT treatment as the Accounts Commission had done prior to devolution. The effect of this was to add some £1.5 million to the annual costs of Audit Scotland from April 2002. This cost was paid for through Parliamentary funding until October 2004, from which point it has largely been recovered through increasing charges to audited bodies by around 8%.

Recent developments

Both the Commission and Audit Scotland have expressed their dissatisfaction with both the length of time that it had taken HMRC to resolve this issue, and with the ultimate outcome.

Audit Scotland has continued to consider whether there was any way of at least partially mitigating this position and, with the assistance of an external advisor, constructed an argument for the recovery of input VAT relating to local government audit carried out on behalf of the Accounts Commission. This was discussed at a meeting with HMRC in October 2006 and has been successful in that HMRC have now agreed that the Accounts Commission will be able to recover input VAT arising from the work of firms appointed as auditors of local government bodies.

The effect of this is that the Accounts Commission will be able to recover around £400,000 per annum which is equivalent to a reduction of just over 3% in audit charges to local government bodies. This will be applied from the 2006/07 audits and effectively means that audit charges will not increase at all over those for 2005/06. In addition the Accounts Commission will be allowed to make a retrospective claim back to November 2004 which will recover some £800,000. This will be returned to local government once it is received.

I trust that the Commission will be pleased to see progress in this area which results in reduction in audit fees to local government.

Please do not hesitate to get in touch if you require further information prior to the Commission meeting.

Yours sincerely

Robert W Black
Auditor General for Scotland

Audit Scotland

Management Report to the Scottish Commission of Public Audit and Audit Scotland

Prepared by Haines Watts

23 June 2006

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1. Introduction

1.1. Requirement for report to those charged with governance

As required by auditing standards the external auditor of Audit Scotland is required to bring to the attention of the Scottish Commission for Public Audit and the Audit Committee of Audit Scotland certain findings from the annual audit of the financial statements of Audit Scotland.

1.2. Purpose of report

The purpose of this report is to provide the Scottish Commission for Public Audit and the management team of Audit Scotland with feedback on the internal control systems in place at Audit Scotland and report on any material weaknesses in the accounting and internal controls that have come to our attention during the audit process.

We also express our views on qualitative matters relating to the financial statements and any expected modifications to the audit report.

The report is designed to provide added value to the audit process. The issues raised have been presented to the management team prior to finalisation to ensure factual accuracy and review of our conclusions.

1.3. Scope of Report

As stated in the audit report, we planned and performed our audit to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or other irregularity or error.

This report does not provide a comprehensive statement of all weaknesses which may exist or of all improvements which may be made, but has addressed only those matters which have come to our attention as a result of the audit procedures performed.

This report does not provide an opinion on the financial performance of Audit Scotland.

1.4. Introduction of the Financial Reporting Manual 2005/06

The Financial Reporting Manual replaces the Resource Accounting Manual for resource accounts prepared for the accounting period ending 31 March 2006.

The financial information and relevant disclosure required for the resource accounts has been prepared by Audit Scotland based on the Financial Reporting Manual 2005/06; and reviewed by Haines Watts to ensure compliance with the guidance as required by the Scottish Ministers.

1.5. Respective responsibilities

Under section 19(4) of the Public Finance and Accountability (Scotland) Act 2000 Audit Scotland is required to prepare resource accounts for each financial year, in conformity with the direction of the Scottish Ministers, detailing the resources acquired, held, or disposed of during the year and the use of resources by Audit Scotland during the year.

The Auditor General, as Accountable Officer of Audit Scotland, is aware of Audit Scotland's responsibility for the preparation of these accounts, and his responsibility for signing them.

Accounts prepared by Audit Scotland must, under the Public Finance and Accountability (Scotland) Act 2000, be sent to the Scottish Commission for Public Audit (SCPA) for auditing.

Haines Watts are required to audit the financial statements and express an opinion on the matters required by the legislation.

The detailed respective responsibilities of the Accountable Officer of Audit Scotland and Haines Watts, as auditors, are set out in the appendices to this report.

2. Overview of Auditors and Audit Process

2.1. The SCPA appointed Haines Watts as auditors to Audit Scotland for a three-year period commencing March 2006.

2.2. Haines Watts has over 850 staff operating from approximately 40 offices in the UK, including offices in Glasgow and Edinburgh.

2.3. Richard Gibson BAcc CA is the lead partner coordinating the external audit of the resource accounts by Haines Watts and will be representing Haines Watts at any meetings with the Scottish Commission for Public Audit.

2.4. The audit process:-

Following our appointment as external auditors to Audit Scotland in March 2006, a planning meeting was arranged with members of the management team at Audit Scotland, including Diane McGiffen and Russell Frith, at which they made a presentation on the background and legal structure of Audit Scotland.

A proposed timetable for the preparation of the financial statements and the audit work prepared by Audit Scotland was discussed and agreed in principal.

Some preliminary audit systems testing and review was carried out in April 2006. The testing performed included:-

a. testing of the systems used to produce the audit completion rates and related income and expenditure adjustments;
b. tests designed to confirm the internal controls in place in the payroll, fee income and purchases systems;
c. a detailed review of approved auditor procurement and fee setting systems;
d. a review of the internal controls relating to fixed assets;
e. a review of minutes of meetings for the board of Audit Scotland and the Accounts Commission.

The final audit work started at the beginning of May and the remaining work required to complete the audit was carried out including:-

f. further confirmation of the final audit completion rates, including those of the external approved auditors and sample testing of the calculations performed by in house team leaders;
g. review and reconciliation of staff costs including payroll and pension costs;

h. testing of fee setting systems and related internal controls and delegated authorities;
i. recoverability of debtors post year end was tested to ensure that the balance was fairly stated in the accounts;
j. enquiries were made to the management team regarding the issues raised by a review of the risk register to gain an insight into how the management team identify and deal with risk assessment as a form of internal control.
k. the content of the annual report and accounts was reviewed to ensure that all required disclosures had been made to ensure compliance with the Financial Reporting Manual.

The audit process was completed on schedule and the Annual Report and Accounts of Audit Scotland were signed on the 23rd June 2006.

3. Qualitative Aspects of Accounting Practices and Financial Reporting

3.1. Accounting Policies

The accounting policies adopted by Audit Scotland are appropriate, consistently applied and adequately disclosed.

A full review of the accounting policies disclosed in the notes to the accounts was carried out during the audit process and Audit Scotland has adopted all the recommended and required policies.

3.2. Appropriateness of accounting estimates and judgments

The estimates and judgments made by Audit Scotland during the preparation of the financial statements were reviewed and agreed to be appropriate.

The audit work carried out on the work in progress figures and financial year end estimations of audit work completion were satisfactory. The valuation methods were consistent; and where necessary, subjective judgments were performed by experienced and knowledgeable members of Audit Scotland's staff.

3.3. Implementation of Financial Reporting Manual 2005/06

The implementation of the requirements of the Financial Reporting Manual (FReM) for the current year has resulted in several changes to the format and content of the information included in the accounts.

The most noticeable changes have been in the narrative disclosure required to bring public sector reporting into line with private sector reporting in several areas; specifically the operating and financial review and the remuneration report. This has led to more qualitative information being disclosed on the development, current objectives, and future aims of Audit Scotland in the annual accounts.

The FReM has also implemented a change in the discount rates used by actuaries to value the liabilities of one of the defined benefit pension schemes associated with Audit Scotland, Lothian Pension Scheme.

This change has required the Government Actuary's Department rate to be used by the actuaries, Hyman Robertson, instead of a corporate bond rate; this has contributed to a significant change in the net pension figure from a £8.9m liability at 31st March 2005 to a £2.2m asset at 31st March 2006.

4. Uncorrected Misstatements

There are no material uncorrected errors in the financial statements.

5. Audit Report and Opinion

There are no expected modifications expected to be made to the audit report and this will be unqualified.

This opinion has been reached following satisfactory responses to all audit issues raised.

6. Propriety and Regularity

No occasions of misconduct, fraud or irregularity or incidences of expenditure of an extravagant or wasteful nature were disclosed in the course of the audit work. The financial integrity of the management and members of the board was found to be of a high standard; and full compliance with the delegated authorities was demonstrated by the testing carried out as part of the audit fieldwork.

7. Internal control weaknesses

Observation	Implication	Recommendation	Risk	Response
1) It was noted during the audit work that there was some difficulty in physically identifying fixed assets from the fixed asset register used by the finance department. A register of computer equipment is maintained by the IT department but this cannot be referenced to the financial system and no system is in place to physically identify items in the other asset categories.	Theoretically, Audit Scotland may not be able to safeguard its assets. The financial figures used for processing disposals of fixed assets will be difficult to establish and may be incorrect. There is the possibility that the value of fixed assets in the financial statements may be misstated.	A review of the fixed asset systems in place should be performed to determine the most efficient method of recording and physically identifying the assets on the fixed asset register, enabling individual assets to be identified. This will allow the original cost and associated depreciation to be traced and the true value of fixed assets to be validated without difficulty.	Low	1. Assets will be grouped in the new system to make them easier to reconcile. 2. Audit Scotland will be exploring 'inventory' software to allow a physical check of assets to be made on a rolling basis
2) During the audit process it was noted that that the allocation of some nominal accounts was inconsistent with the prior year as the allocation of nominal accounts within the statutory framework had not been standardised.	This indicates that there may not be sufficient documentation in place for the year end accounts process. Theoretically, there may be inconsistencies in the presentation of the annual accounts.	A review of the process for producing the year end accounts should be carried out and a checklist for disclosure used to ensure that all statutory and regulatory requirements are met. Consultation with the external auditors at the audit planning stage should be used for the maximum benefit of all parties where possible.	Low	1. Suggested review will be undertaken, and a checklist will be developed to ensure requirements are met. 2. Consultation will take place with the auditors at the planning stage.

3) The monthly salary and pension contributions per the payroll are reconciled to the figures in the accounts on a monthly basis but the reconciliation process is not completed by posting the appropriate correcting journals.	There were differences in the cost centre allocations of salaries and the overall staff cost figure that were not discovered until the year end when the finance staff completed the reconciliation for the full year and posted the necessary adjustments.	The monthly reconciliation function should be completed by making any required reallocations or adjustments to the accounting records on a monthly basis. The monthly reconciliation should be reviewed and authorised by a senior member of staff.	Low	A monthly reconciliation has been introduced and, if required, journals are raised to adjust accounts. It is reviewed on a monthly basis by the Accountant.

Key to risk levels:-

High – fundamental internal control weakness requiring immediate attention and action

Medium – internal control weakness that could affect the operation of the organisation and requires action

Low – lesser internal control issue that merits attention

Appendix 1

Statement of Accountable Officer's Responsibilities

Under section 19(4) of the Public Finance and Accountability (Scotland) Act 2000 Audit Scotland is required to prepare resource accounts for each financial year, in conformity with the direction of the Scottish Ministers, detailing the resources acquired, held, or disposed of during the year and the use of resources by Audit Scotland during the year.

The resource accounts are prepared on an accruals basis and must give a true and fair view of the state of affairs of Audit Scotland, the net resource outturn, resources applied to objectives, recognised gains and losses and cash flows for the financial year.

The Scottish Commission for Public Audit has appointed the Auditor General for Scotland as Accountable Officer for Audit Scotland with responsibility for preparing the accounts of Audit Scotland and for submitting them for audit to the Scottish Commission for Public Audit.

In preparing the accounts the Accountable Officer is required to comply with the Financial Reporting Manual (FReM) and in particular to:

- observe the accounts direction including the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards, as set out in the FReM, have been followed; and disclose and explain any material departures in the accounts;
- prepare accounts on a going concern basis.

The responsibilities of the Accountable Officer, including responsibility for the propriety and regularity of the public finances for which an Accountable Officer is answerable, for keeping proper records and for safeguarding assets, are set out in the "Accountable Officer's Memorandum".

Appendix 2

Independent Auditors' Report
To the Scottish Commission for Public Audit
(Under section 25(3) of The Public Finance Accountability (Scotland) Act 2000)

AUDIT SCOTLAND

We have audited the organisation's accounts for the year ended 31 March 2006, which comprise the Summary of Resource Outturn, Operating Cost Statement, Statement of Recognised Gains and Losses, Balance Sheet, Cash Flow Statement, Resources by Departmental Aims and Objectives and the related notes 1 to 16. We have also audited the relevant disclosures in the Remuneration Report as required under the direction of the Scottish Ministers. These financial statements have been prepared under the historical cost convention and the accounting policies set out therein.

This report is made solely to the Scottish Commission for Public Audit, as a body, in accordance with Section 22(1) (a) and (b) of the Public Finance and Accountability (Scotland) Act 2000. Our audit work has been undertaken so that we might state to the Scottish Commission for Public Audit those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Scottish Commission for Public Audit as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Audit Scotland and auditors

As described in the Statement of Accountable Officer's Responsibilities, Audit Scotland is responsible for the preparation of the accounts in conformity with the direction of the Scottish Ministers. The Accountable Officer is responsible for the propriety and regularity of the public finances, for keeping proper books and for safeguarding assets, as set out in the Accountable Officer's Memorandum.

Our responsibility is to audit the accounts in accordance with the terms of our appointment, relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you on the matters set out in section 22(1)(a) and (b) of the Public Finance and Accountability (Scotland) Act 2000 and our opinion as to whether the Resource Accounts give a true and fair view and are properly prepared in accordance with section 19(4) of that Act. We also report to you if, in our opinion, the Foreword and the Management Commentary are not consistent with the accounts, if the organisation has not kept proper accounting records, or if we have not received all the information and explanations we require for our audit, or if information specified by the Scottish Ministers regarding the remuneration and other transactions is not disclosed.

We read the other information contained in the Statement on the System of Internal Control, and consider whether it is consistent with the audited accounts. As auditors we are not required to consider whether the Accountable Officer's statement on internal controls covers all risks and controls, nor are we required to form an opinion on the effectiveness of the risk and control procedures. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the accounts. Our responsibilities do not extend to any other information.

Basis of opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Board in the preparation of the financial statements, and of whether the accounting policies are appropriate to Audit Scotland's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the accounts.

Opinion

In our opinion, the accounts give a true and fair view of the state of affairs of Audit Scotland as at 31 March 2006 and of its net resource outturn for the year then ended, have been properly prepared in accordance with section 19(4) of the Public Finance and Accountability (Scotland) Act 2000, and the expenditure has been incurred and receipts have been applied in accordance with section 22(1)(a) and (b) of the Public Finance and Accountability (Scotland) Act 2000.

HAINES WATTS
Chartered Accountants
and Registered Auditors
231/233 St Vincent Street
Glasgow G2 5QY

23 June 2006

Audit Scotland

3 E's Review
2005/06

Fees and Charges

Audit Scotland

3 E's Review
2005/06

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Preface

Background to this study

A 3 E's study is carried out as part of the statutory external audit of Audit Scotland. The Scottish Commission for Public Audit (SCPA) and the Audit Committee considered a range of topics and selected a review of Fees and Charges as the preferred option for 2005/06.

Of the total external audit portfolio in Scotland nearly two thirds is undertaken by Audit Scotland with the remainder being carried out by private firms. Audit Scotland's charging regime is designed to link audit charges to outputs, reflecting both national issues that impact on the auditee as well as local circumstances and allows the major part of the charge to be agreed between the auditor and the audited body.

Audit Scotland's publicised objective is to keep audit fee increases to a minimum whilst delivering an effective and efficient audit.

Scope of the study

This examination has sought, in part, to address an issue raised by the SCPA at previous evidence sessions with Audit Scotland in relation to the detailed presentation of its budgets with respect to direct and indirect costs, including:

- Assessing what proportion of funding is redeployed to cover direct costs and indirect costs;
- Comparing and contrasting the fees charged by Audit Scotland with those levied by the firms; and
- Considering Audit Scotland's approach to ensuring that the fees are utilised to provide an added value external audit service.

Methodology

We have carried out this study using the following techniques:

- An "up front" meeting with the Director of Audit Strategy to understand the fee setting mechanism and wider issues and developments within Audit Scotland;
- A series of structured interviews with Audit Scotland and firm representatives;
- Utilisation of our own cumulative knowledge of the fee setting regime and wider external audit responsibilities in England and Wales by way of providing a point of reference for comparison purposes;
- Analytical review of Audit Scotland's income and expenditure data for both audit year (November to October) and financial year drawing wherever possible on the work that we have undertaken in auditing Audit Scotland's financial statements; and

- Review of documentation – e.g. Audit Scotland's Corporate Plan, external audit output reports, minutes of meetings.

Acknowledgements

We would like to thank Audit Scotland and those staff involved in this review for their time, assistance and co-operation, in particular the Director of Audit Strategy and the Senior Manager (Audit Strategy). In addition, we should also like to thank the firms, notably PwC and Scott Moncrieff, for their assistance and contribution to this review.

Executive Summary

Audit Scotland was formed in 2000 and has a statutory responsibility for providing services to the Accounts Commission and the Auditor General, namely to secure the appointment of external auditors to public sector bodies. It also, through its own in-house audit team, delivers most of these audits (65% of the total audit allocation) with the remainder being outsourced to firms.

The audit charges that audited bodies pay comprise two elements. Firstly, an Agreed Fee that is agreed between the auditor and the audited body based on a standardised rationale that applies regardless of which supplier is delivering the audit. These charges cover the costs incurred in delivering most of the statutory external audit areas as set out in the Code of Audit Practice. Secondly, there is a Fixed Charge that essentially “pays for” the work of Audit Scotland’s Public Reporting Group, namely for undertaking national performance reviews, delivering the statutory best value audits (within local government), producing overview reports, dealing with correspondence received from electors and MSPs and Audit Scotland’s central costs. Most of the total fees that comprise Audit Scotland’s operating income come directly from audited bodies and cover the total costs of audits at these bodies. Parliamentary funding of around £6m per annum is needed to cover the costs of inter alia, delivering non chargeable central government audits and most of the chargeable part of the work of Audit Scotland’s Public Reporting Group for the Central Government and Health sectors. The Agreed Charges plus the Parliamentary funding together allows Audit Scotland to break even as it is required to do so.

The key **strengths** of the prevailing fee setting arrangements and wider management arrangements underpinning this are as follows:

- The derivation of the agreed fee element (i.e. excluding the fixed charge) that are levied on audited bodies is a relatively transparent process and based on standard rates that apply to all suppliers;
- The above ensures a level of consistency in the levels of fees across the various audited bodies. Therefore, the fees charged by Audit Scotland are consistent with those levied by the firms;
- Based upon Audit Scotland’s own benchmarking exercise, its fee levels compare favourably against the fees charged for similar sized authorities in England;
- Audit Scotland has recently categorised its cost structure into direct and indirect costs. This provides a clearer picture of the make up and nature of the costs of delivering audits. This indicates that the cost of “running” Audit Scotland (i.e. the indirect costs) as a proportion of the total fee has in overall terms fallen since 2004/05;

- A new audit methodology, the *Modernised Audit*, has been fully implemented during 2005/06 and it is envisaged that this will support and encourage the delivery of a more risk focused and therefore added value audit;
- A clear articulation within Audit Scotland's Corporate Plan of its commitment to improving the way services are delivered with emphasis given to maximising the value of the audit and building an effective and efficient organisation. This has been backed up notably by a base budget review of corporate services and an internal best value review of administration and facilities management;
- The quality appraisal process that is delivered by Audit Scotland's Audit Strategy Group is operating effectively overall in that it is delivered independently and robustly across all local auditors; and
- Development of good joint working arrangements both internally (between the Audit Services Group and the Public Reporting Group) with other suppliers and with other similar organisations (the Audit Commission, the Wales Audit Office and the National Audit Office) should ensure that synergistic benefits are achieved.

To complement the above strengths there are number of areas where we consider there is scope for **further development and improvement** with respect to the effective and efficient delivery of audit services:

- Audit Scotland should continue to ensure that the fixed charge element of the audit fee is relayed to audited bodies in a manner that makes clear the "outputs" that they can expect to receive for this element;
- The indicative days that inform the derivation of indicative fee estimates (and which in turn form the basis of discussions between auditors and audited bodies in arriving at an Agreed Fee) should be kept under close review given the "fee for audit" environment;
- Audit Scotland should consider further developments in its costing arrangements notably in respect of ensuring that its time recording system is better and more fully utilised. Full use of the time system would support the development of cost measures which in turn could be used as a more accurate basis on which to apportion costs;
- Opportunities to undertake audit work that cross cuts the different audit remits should be promoted as working practices continue to evolve in respect of the new audit methodology. To this end we are pleased to note that revisions to the current Code Of Audit Practice will include a streamlining of the audit remit (from three areas to two);
- The effectiveness of the way national studies are consulted and communicated with audited bodies should be kept under review to ensure that this element of the audit work is not viewed as detached from audited bodies' local issues and concerns;

- Sector planning should continue to be developed across all sectors (Local government, health and central government) so that it increasingly becomes an integral part of Audit Scotland's overall strategic planning processes;
- To complement and enhance the control framework and to address Audit Scotland's key objective relating to "efficient management of financial resources" a greater level of rigour in financial management, in particular monitoring of costs in addition to monitoring of time, should be introduced at group level down to audit engagement/project level; and
- Consideration should be given by Audit Scotland into how it can develop its reported performance monitoring through the introduction of some additional high level performance indicators that measure efficiency and effectiveness and that would be open to scrutiny by the SCPA.

Part I: The Fee Setting Regime for External Audit

1. Introduction

1.1 Audit Scotland has a statutory responsibility for providing services to the Accounts Commission and the Auditor General, including securing or carrying out the audits of most public sector bodies in Scotland. In Table 1 we summarise the overall statutory framework for public sector audit in Scotland.

Table 1: External Audit Framework – roles and responsibilities

Responsible Body	Role
Auditor General for Scotland	The post of Auditor General was created by the Scotland Act 1998. The Auditor General is independent of the Parliament and the Executive and is responsible for securing the external audit of central government bodies in Scotland, health bodies, further education colleges and Scottish Water. He also carries out studies of the economy, efficiency and effectiveness of the use of resources by those bodies.
Accounts Commission for Scotland	The Commission was created as an independent body under the Local Government (Scotland) Act 1973 and is responsible for securing the audit of local authorities including audits of best Value and Community Planning.
Audit Scotland	Audit Scotland is a statutory body created under the Public Finance and Accountability (Scotland) Act 2000 to provide services to the Auditor General and the Accounts Commission.

1.2 Audit Scotland comprises four core departments. The "front line" departments are the Audit Services Group and the Public Reporting Group. These groups are supported by Audit Strategy and Corporate Services. Audit Strategy has responsibility for audit procurement and audit appointments, developing guidance for auditors, liasing with audited bodies in respect of charges, monitoring the work of auditors and instigating formal appraisal processes over the audit regime. Audit Strategy also supervises the National Fraud Initiative in Scotland. Corporate Services provides the "back office" support such as financial management of Audit Scotland, IT support and human resources.

1.3 In Part II we consider in more detail the role of Audit Scotland's front line services in delivering an effective and added value audit service. The scope of this part of the review is to consider, at a high level, one aspect of the efficiency of Audit Scotland by looking into the fee setting regime and associated costs of delivering the external audit. Our work has focused primarily on Audit Scotland's role in delivering the external audit to the local government and health sectors as the charges recovered from these two sectors represent over 80% of Audit Scotland's total fee base.

1.4 The objectives of this part of the report are to:

- ascertain how the external audit fee is calculated;
- undertake a time analysis of fee levels versus the costs incurred by Audit Scotland in delivering its role; and
- assess the extent to which income generated through audit charges goes toward covering the costs of "running" Audit Scotland.

2 The fee calculation process

2.1 Under the Public Finance and Accountability (Scotland) Act 2000 Audit Scotland may make reasonable charges for audits except those of the Scottish Executive, its Executive Agencies and other bodies receiving funds directly from the Scottish Consolidated Fund. Audit Scotland must seek to ensure that the total sum received in respect of charges is, taking one year with another, broadly equivalent to its expenditure (on those matters for which charges are made).

2.2 The amount charged by Audit Scotland to the audited bodies is made up of two key components, namely, an Agreed Fee and the Fixed Charge. This has been illustrated in the flow chart below (Figure 1.1):

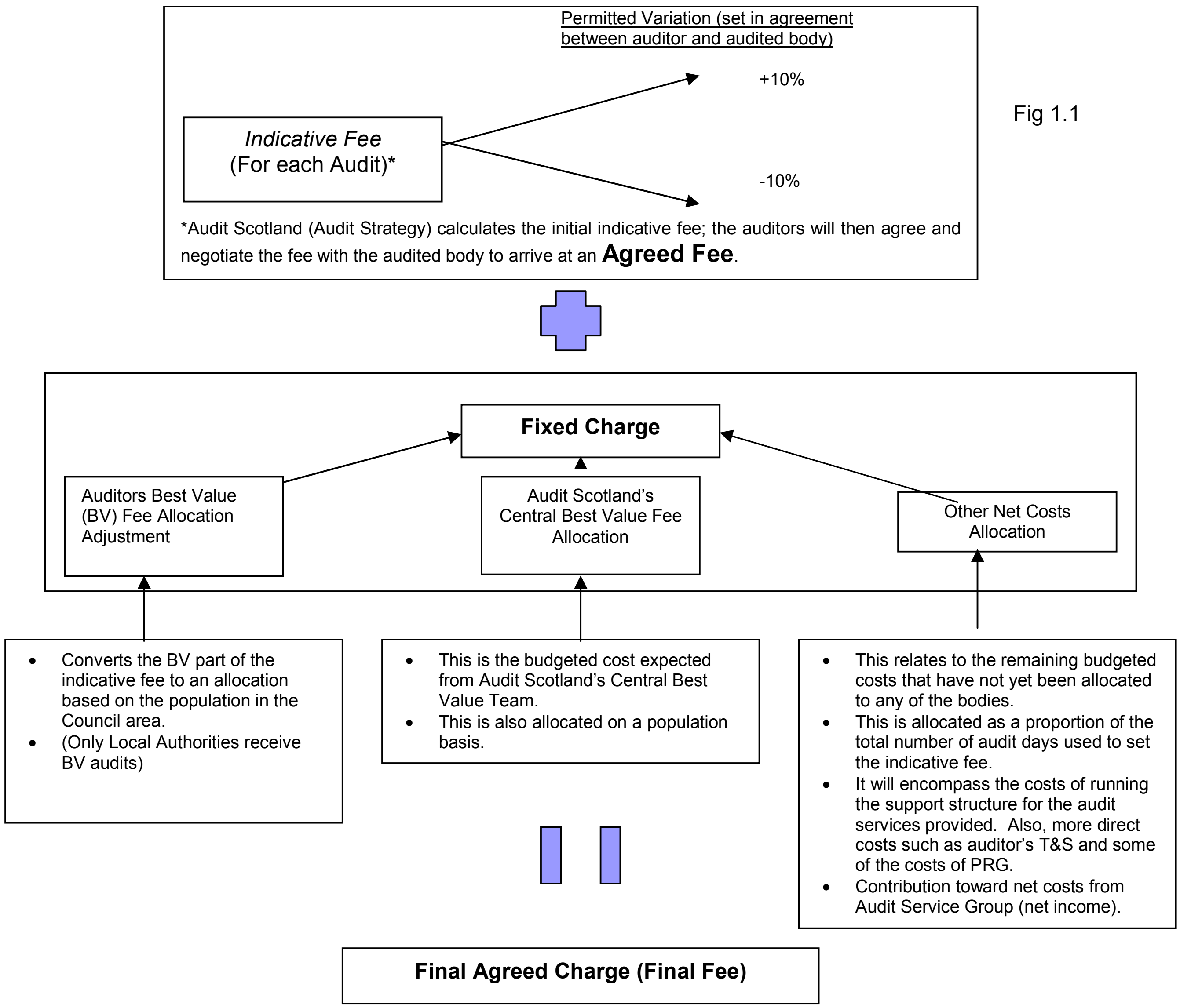


Fig 1.1

2.3 As part of the annual budget setting process Audit Scotland staff prepare proposals for increases in audit charges for the forthcoming and subsequent audit years. These proposals are considered by the Audit Scotland Board and then submitted to the Auditor General and the Accounts Commission for discussion and approval.

2.4 In the following section we focus in more detail on the Agreed Fee and the Fixed Charge.

Indicative Fee

2.5 The fee estimation process commences well in advance of the start of the audit year (the audit year for 2006/07 being November 2006 to October 2007). Based upon an initial estimate of fees Parliamentary funding is requested for those review areas that are not funded via the fee mechanism as illustrated above (Figure 1.1). The indicative fees are finalised during the October of the forthcoming audit period at which time letters are issued by Audit Strategy to each audited body outlining their individual indicative fee range (and the amount of fixed charge payable) before the start of the audit.

2.6 The basis for the calculation of the indicative fee is grounded in the estimates of the input days and staff mix needed to undertake the statutory audit. Up until 2000 the Regulations required an input based charging regime that inherently required auditors to demonstrate that they had delivered the requisite number of days in order to receive their fee. The drawbacks of this previous "input" approach to audit delivery were:

- a lack of incentive for the auditors to complete audits before the stipulated number of days;
- the creation of disharmony amongst the externally sourced providers of the audits (i.e. the firms) in that they had to align their standard hourly rates downward to meet Audit Scotland's pre-determined rates and had little opportunity to recoup this through delivering the audits in less than the stipulated number of days;
- a negative impact on auditors to seek efficiencies in the audit process; and
- charges levied on bodies could not be calculated until the end of the audit and the timing of audit work created significant year on year variations.

2.7 As a result of these drawbacks and new legislative arrangements governing audit charges, Audit Scotland commissioned an external consultant (RSM Robson Rhodes) to work with Audit Strategy in reviewing the fee setting arrangements. A key outcome of the review was the introduction of a "fee for audit" arrangement with the onus on outputs rather than input days. To reflect better the specific issues at an audited body the current fee-setting regime now allows an element of discretion on part of auditors to negotiate a +/-10% variation around the indicative fee level. In exceptional circumstances the auditor can request to agree a fee outside the 10% limit. In all cases, where the proposed fee is above or below the indicative range the auditor is required to submit to Audit Strategy a justification statement underpinning the fee. This is reviewed and then authorised by Audit Strategy following which the auditor will notify, discuss and agree the fee with the audited body.

2.8 The indicative fee for an audit is calculated by using the estimated input levels (days) of varying levels of staff at differing daily remuneration rates for the audits. The input levels will be derived based upon previous experience and audits performed.

2.9 The daily rates that are used to construct the indicative fee have recently been linked mainly to local government APT&C pay settlements and, from 2006/07, this has been formally included in the auditors' appointment letters. Audit Scotland's policy is for the same rates to be used regardless of whether the audit is performed by Audit Scotland or the auditing firms; this ensures so far as possible that an audited body pays the same rate for the audit whether it is undertaken by Audit Scotland or a firm.

2.10 Figures 1.2 and 1.3 below compare Audit Scotland's and other auditing firms' indicative fee fluctuations (i.e. agreed fee versus indicative fee) for the Local Government and the Health Sector that have taken place over the past three years. The charts show the variation from the indicative fee that Audit Strategy initially determines (100% representing the indicative fee).

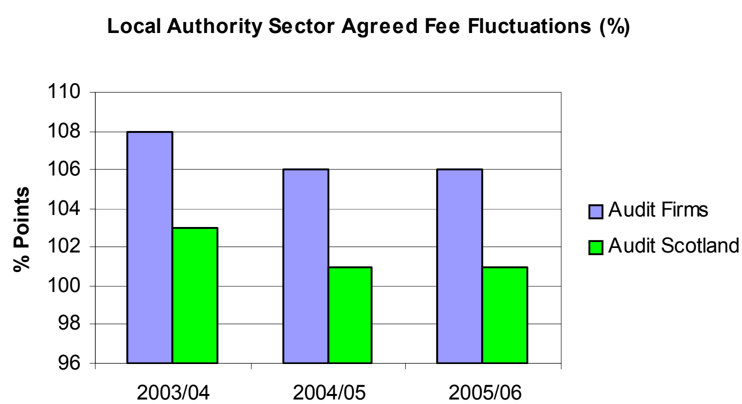


Fig 1.2

2.11 Figure 1.2 illustrates that the agreed fees that are levied by the auditing firms has reduced over the three-year span, levelling out to an average increase variation of 6% per annum.

2.12 Audit Scotland's in-house auditors also show a very similar pattern but with smaller increments year on year. The downward trend in the annual agreed fee levels is as expected. This is as a result of more cumulative audit knowledge and experience gathered by the auditor hence more reliance being placed on controls within the audited bodies. This would in turn reduce the levels of substantive work that would ordinarily be required to be completed.

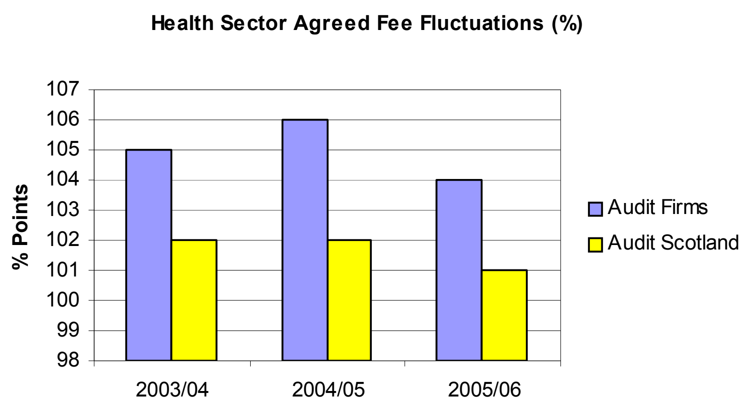


Fig 1.3

2.13 The above figure illustrates a very similar pattern to that applicable to the local government sector, with both Audit Scotland's and audit firm's agreed fee levels reducing over the three-year span.

2.14 The charts also show a marked difference in agreed fees compared to the indicative levels between the firms and Audit Scotland's in house team. The difference could be viewed as partly attributable to the contrasting financial objectives, with Audit Scotland's Audit Services Group's (ASG) objective being to ensure that the sum received from the audited bodies is broadly sufficient to contribute to Audit Scotland's budgeted costs for delivering the external audits (Section 11(3) Part 2 – Accountability & Audit, Public Finance and Accountability (Scotland) Act 2000). In contrast the Firms' objectives are driven by commercial motives. We understand from discussions with Audit Strategy that the firms have, over the years, varied to a greater extent than Audit Scotland around the indicative fee set by Audit Strategy although in terms of actual agreed fees charged per audit assignment fee levels are consistent across the firms and Audit Scotland (see Figure 1.7 below).

2.15 The use of days for the indicative fee calculation is a means to an end and demonstrates a level of transparency in how indicative fees are set. Nevertheless, given the move to "fee for audit" and the drawbacks of an input approach to audit delivery summarised above, Audit Scotland should keep under close review the analysis of input days which feeds into the indicative fee calculation.

Fixed Charge – Local Authorities

2.16 For Local Authorities the fixed charge is made up of the following components:

a) Best value and performance audits: Audit Scotland's Public Reporting Group undertakes most of the work around the statutory best value (BV) audits and other performance related audits and reviews at all local authorities including those where the external audit has been outsourced (i.e. to accountancy firms). The exception is an element of the best value work relating to best value transitional and follow up reviews and more detailed audit work performed at a local level – this is undertaken by the local auditors (Audit Scotland's in house teams and the firms). For 2005/06 the split in the best value audit fee between the work undertaken by local auditors and Audit Scotland's Public Reporting Group was £0.3m and £1.25m respectively. Both of these amounts are allocated across all councils based on a population criterion[1]. This matches the way that central government provide funds to councils for this work.

b) Other Net Costs (£3,046,000, 2006 Local Government Sector allocation): This is the amount left from the sector's total cost allocation after deducting the auditors' indicative fees. It is allocated on the basis of the audited body's audit indicative input (number of days) as a proportion of the total indicative input multiplied by the overhead allocation. It should be noted that this allocation covers some costs that might otherwise be seen as direct costs for audit delivery –e.g. auditors' travel and subsistence costs and the costs of the Public Reporting Group.

Fixed Charge – Health sector

2.17 Since statutory Best Value audits apply only to Local Authorities, for other bodies there will only be the net cost allocation once the agreed fee has been deducted. This is calculated and apportioned on the same basis as for local authorities, namely, on indicative audit day apportionment.

[1] Population Basis: The population of the area covered by a local authority is taken as a proportion of the total population covered by all local authorities and multiplied by the total best value fee.

Final Agreed Charge (Final Fee)

2.18 This is simply derived from the amalgam of fixed charges and the agreed fee for the audit to yield the final agreed charge.

2.19 Audit Scotland sends out a letter to each of the audited bodies describing the calculated indicative fee, together with the fixed charge allocation stating that the final charge is dependent upon the fee being agreed between the local auditor and the audited body. The letter also describes what the charges include and any reasons for any fluctuations in the charge.

3. Time analysis of Income

Income Overview

3.1 This section of the review will aim to analyse the income levels that are recovered from the varying audited bodies over a span of three years.

3.2 Figure 1.4 below illustrates the annual operating income collected by Audit Scotland from the audited bodies.

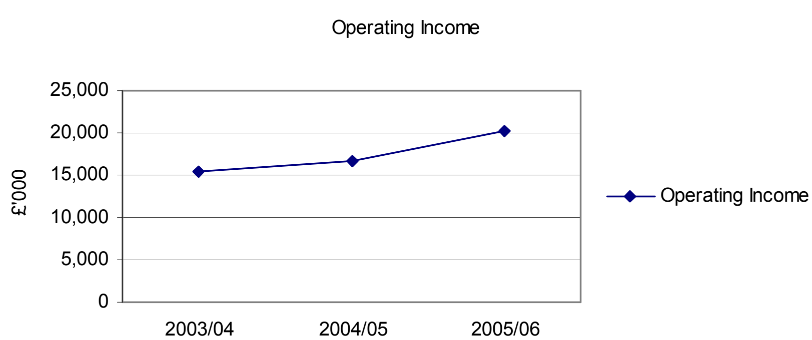


Fig 1.4

3.3 Operating income primarily comprises of the following:

- Agreed Fee; and
- Fixed Charges.

3.4 As the chart indicates there has been approximately a 33% increase (£5million) in the operating income from 2003/04 to 2005/06. The following are significant contributors to the increase:

- Best Value audit regime commencing in 2004, hence generating higher charges; and

- The increase in the expenditure base given the negative impact of the VAT ruling (see 3.7 below).

3.5 Best value audits were required to be conducted due to an update that was made to the statutory requirements set out in the Local Government in Scotland Act 2003. This naturally increased the operating income in subsequent years.

3.6 The total increase on the face of it appears more significant than it actually was, in that in 2005/06 an element of the total income received related to 2004/05 work that was completed and billed for in 2005/06. This timing difference was due in part to the phased introduction of the new audit methodology during 2004/05, which created a natural learning curve for auditors.

3.7 Prior to the creation of Audit Scotland in 2000, the Accounts Commission benefited from a favourable VAT position that allowed it to recover all input VAT (i.e. VAT paid on eligible purchases) without having to charge output VAT (i.e. VAT included on invoices for eligible services provided). However, in November 2004 HM Revenue and Customs ruled that Audit Scotland, which was formed in 2000 and took on the roles and the staff of the Accounts Commission and the National Audit Office (Scotland), would not be able to recover any of the input VAT and could not charge VAT on outputs, including audit fees. Accordingly, all input VAT remained on Audit Scotland's expenditure accounts. Audit fees are therefore inclusive of irrecoverable VAT and VAT on other inputs and eventually have to be recovered from audited bodes within the fixed charge element of the audit charges. The additional cost that was incurred by Audit Scotland resulted in an 8% increase from 2004/05 to 2005/06 in the recovered charges.

3.8 In respect of the billing arrangement where the firms are involved Audit Scotland remains responsible for billing firm clients. Audit Scotland will recompense the firms throughout the audit year. Audit firms, as commercial organisations, are not bound by the VAT rules relating to output VAT and therefore will "bill" Audit Scotland inclusive of VAT. Given that Audit Scotland cannot reclaim such VAT this amount adds to Audit Scotland's expenditure which, as mentioned above, will then be re-charged out to clients via the fixed charge mechanism and Audit Scotland bills are non VAT. Ultimately, audited bodies are funding Audit Scotland's unfavourable VAT position. Audit Scotland has made this clear within the annual fee letters to audited bodies.

3.9 We understand that in October 2006 HM Revenue and Customs issued a revised ruling that indicates that Audit Scotland will be permitted to recover input tax on local authority audit fees. The amounts will be backdated to 2004.

3.10 Audit Scotland regularly undertakes a benchmarking exercise that compares the levels of audit charges levied on councils within Scotland, comparing these to charges levied on similar sized councils within England. The results of a recent exercise are shown below.

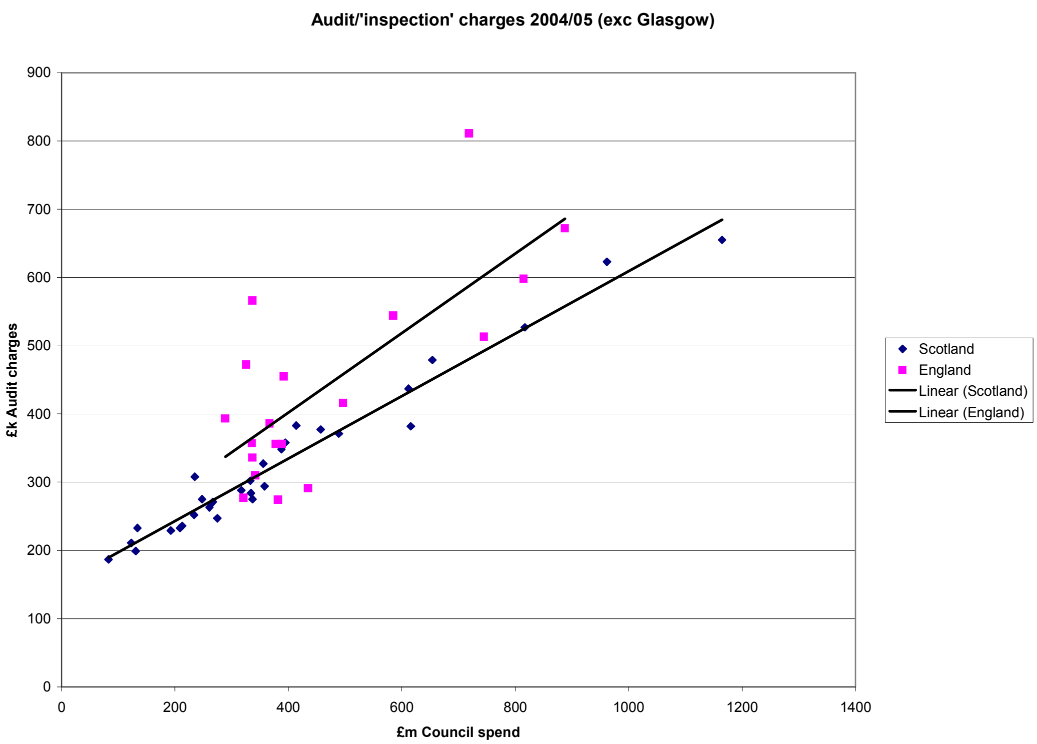


Fig 1.5

3.11 This chart shows that Audit Scotland's charges are lower than their English counterparts. We welcome this provision of benchmarking on a national basis as it demonstrates good governance and wider awareness of national developments; although benchmarking is only one of the components of checks that should be conducted to ensure that the fees that are charged remain competitive. We are therefore also pleased to note that Audit Scotland has also compared its daily rates with those typically charged for internal audit work by the firms and to the Audit Commission's grade related rates.

Income Analysis by Sector

3.12 This element of the report will analyse the operating income in greater detail. The income will be analysed on a sector basis, comparing the levels of income earned over a three-year span. This section will also seek to review significant patterns and fluctuations in the fee levels by comparing Audit Scotland to private firms over various sectors.

3.13 A breakdown of the operating income by sectors is illustrated in figure 1.6 below.

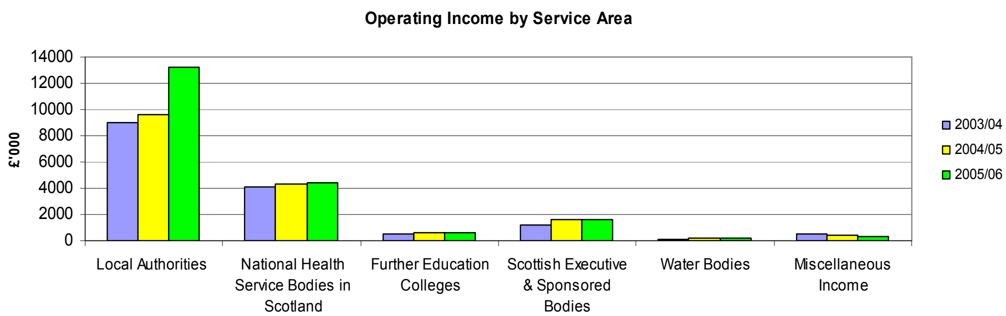


Fig 1.6

3.14 The chart above shows that income generated by the key service areas has increased over the three year period. The most significant increase has been within local government where notably the introduction of Best Value auditing has contributed to a rise in fees charged (as described above).

3.15 The chart below shows a more detailed illustration of the operating income, showing the average income generated by Audit Scotland compared to the auditing firms per audit appointment by sector (2006).

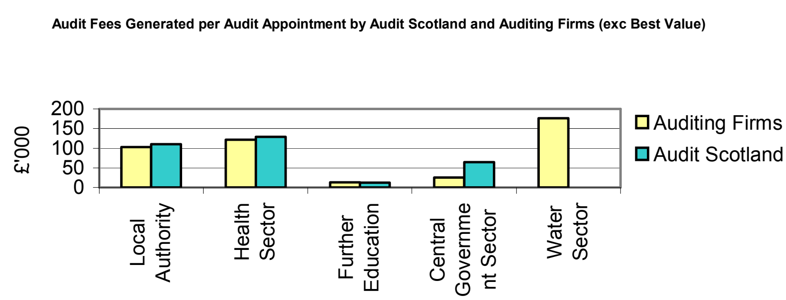


Fig 1.7

3.16 The chart shows the audit fees that are charged by Audit Scotland are largely consistent with that of the auditing firms, with firms charging marginally lower. We are advised that the primary reason for the difference is related to the respective size of the audits awarded to the ASG and the firms but does demonstrate (due to the marginal difference in fees) the overall equity in the process of awarding contracts.

3.17 The difference in audit fees applicable to central government bodies is due wholly to the fact that the larger, more complex bodies are audited by Audit Scotland. The audit charges at these bodies will therefore be higher to reflect their size and audit risks.

3.18 Overall, income levels generated by Audit Scotland through audit charges are comparable to the Firms and also, based on the benchmarking exercise undertaken by Audit Scotland would appear competitive at a national level. The comparison with the firms is as expected given the nature of the fee setting regime and the standardised daily rates that are used. The following section will be analysing the expenditure that Audit Scotland has incurred in providing the services to yield the income from the audited bodies.

4. Time Analysis of Expenditure

Expenditure Overview

4.1 This section reviews the expenditure that has been incurred by Audit Scotland in providing the auditing services to the audited bodies. This will assess both the costs that are attributable both to the indicative fee income and the fixed charge.

4.2 The chart below illustrates the operating costs that have been incurred by Audit Scotland over the three-year span under review.

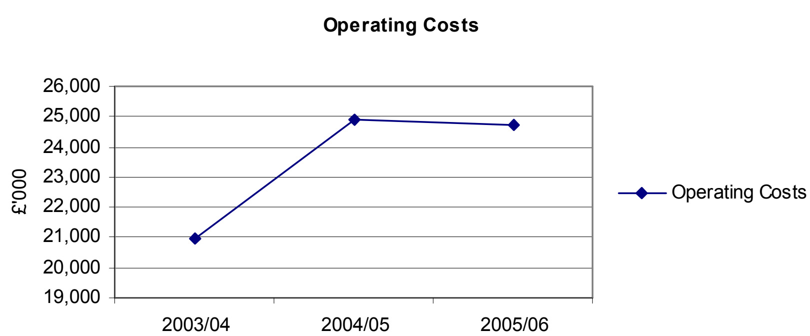


Fig 1.8

4.3 There has been a significant increase in the levels of costs, mainly from 2003/04 to 2004/05. This increase is more marked than the equivalent movement in operating income for the same period (Fig 1.4) as evidenced by the fact that costs have increased by 19% compared to the income increasing by only 8%. This is expected and is mainly due as result of income being recognised as and when the audit has been conducted and concluded, whereas, the costs are incurred throughout the year.

4.4 As will be noted by the comparison between the income chart (Fig 1.4) and the cost chart above, the difference between operating income and expenditure gives rise to a funding requirement to cover the expenditure incurred by Audit Scotland (included within the expenditure analysis within Figure 1.9) in carrying out the following:

- The audit of a significant proportion of central government bodies where the fees are not recoverable directly;
- The bulk of the work carried out by the of the Public Reporting Group within the health and other sectors except local government (see Part II); and
- Funding the office of the Auditor General.

4.5 Audit Scotland's operating costs are classified within its Statement of Accounts as follows:

- Staff costs, and
- Other administration costs

These two areas have been charted separately in the figure below showing fluctuations between the costs in greater detail.

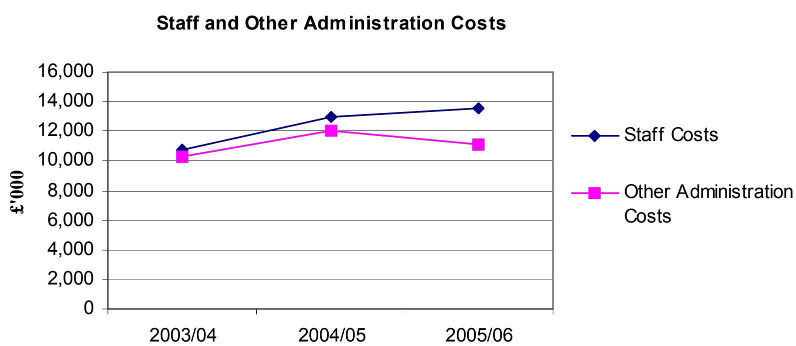


Fig 1.9

4.6 Staff costs have steadily increased at an average rate of 13% from 2003/04 to 2005/06. Staff costs mainly comprise salaries, national insurance contributions and other staff related costs. The increase has been caused by an absolute increase in the number of employees (up by 37 employees from 2003/04 to 2005/06) necessitated by the additional resource requirements of both delivering the best value audits that commenced in 2003/04 and the centralisation of performance audit reviews, previously undertaken by local auditors. Moreover, the public sector pay settlement (in the region of 2-3%) together with increases in employers pension contributions have added to the upward pressure on costs.

4.7 Administration costs are consistent with staff costs for 2003/04 to 2004/05. However, between 2004/05 and 2005/06 these costs begin to fall. Administration costs are mainly made up of the audit fees payable to the firms (2005/06: making up 54% of the other administration costs), with the remaining balance comprising of the following (2005/06 percentages used for illustrative purposes):

- Rent & Rates (8%);
- Other Accommodation Costs (4%);
- Travel & Subsistence (8%);
- Legal & Other Fees (7%);
- Information Technology (4%); and
- Depreciation (3%)

4.8 The initial increase from 2003/04 to 2004/05 was mainly due to the impact on Audit Scotland's expenditure of the issue concerning irrecoverable VAT. The other contributing factors to the initial increase were as follows:

- Accommodation costs (£132,000) - this mainly related to cost of survey works relating to asbestos as part of the refurbishment of the offices at 18 George Street and increases in service charges;
- External consultancy fees (£661,000) - the vast majority of this was incurred by Audit Scotland's Public Reporting Group to assist it in delivering specialist national studies; and
- Information Technology (£119,000) - the majority of this increase was in relation to the acquisition and renewal of software licences.

4.9 In the following year (2005/06) Other Administration costs levelled off and began to fall (by around £800,000). This was due to the reduction in audit fees payable to the firms as a result of centralising Performance Audit reviews during 2004/05 and 2005/06. The external consultancy fees also fell during 2005/06 and other smaller contributors such as a £50,000 reduction in training costs all affected the reduction.

Income and costs relating to the Local Authority and Health sectors

4.10 This section will bring together the net effect of income and expenditure by focusing on the Local Authority and the Health sectors. We have concentrated on these two areas as both sectors in total account for over 85% of the operating income for 2005/06.

Local Authority

4.11 The local authority sector is the only sector that receives statutory best value audits, accounting for 66% of the 2006 operating income earned. The chart below shows the agreed fees (i.e. exclusive of fixed charges) levied by Audit Scotland compared to those charged by the firms.

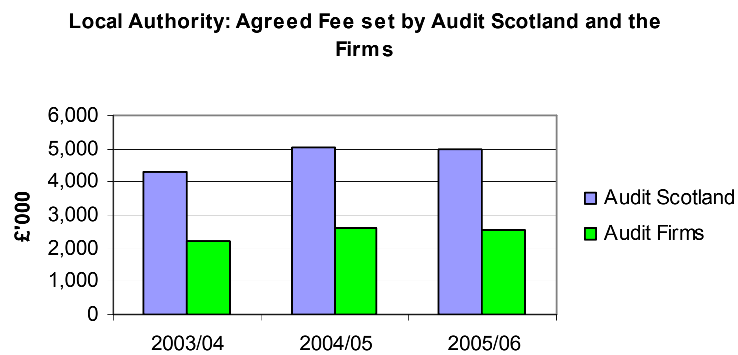


Fig 1.10

4.12 The chart shows that Audit Scotland generates local audit fees that are twice that of the audit firms. This is as expected given that 65% of all audit appointments are delivered by Audit Scotland's in-house team. Audit Scotland's agreed fees have increased in proportion to the auditing firms' agreed fees increases, averaging 17% (from 2003/04 to 2005/06). This is as a direct result of:

- Annual increases in the daily rates charged within the indicative fee calculation (2004/05: 4%; 2005/06: 3%);
- The inclusion of irrecoverable VAT within the indicative fee calculation (17.5%);
- The above partly offset by a transfer of resources from indicative fees to the Public Reporting Group (in respect of centralisation of performance audit work).

4.13 The chart below shows the total audit charge comprising the constituent elements as described earlier (Figure 1.1). The best value income and the net cost apportionment to audited bodies together make up the "fixed charge" element of the total audit charge. The work performed by the Public Reporting Group is incorporated within the net cost apportionment and so is charged via the fixed charge element of the audit fee.

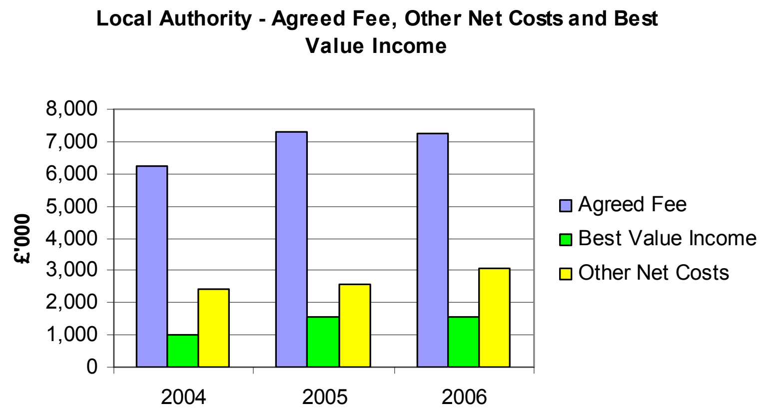


Fig 1.11

4.14 The reasons for the increases in agreed fee and the best value fee have been provided above. The net cost element of the fee increased between 2004/05 and 2005/06 (20% increase). The main reason for this increase was due to the performance audit work shifting from the agreed fee to the central net costs with more of this type of work being conducted by the central team instead of local auditors. Other explanations for increases in Administration Costs, which contribute to Net Costs, are provided above.

Health Sector

4.15 The Health sector, unlike the Local Authority sector, does not receive statutory best value audits, and accounts for 19% of the 2006 operating income earned. The chart below (Figure 1.12) shows the agreed fees calculated by Audit Scotland, split between Audit Scotland and the firms. The audit fees shown exclude the fixed charge element of the income earned from the sector.

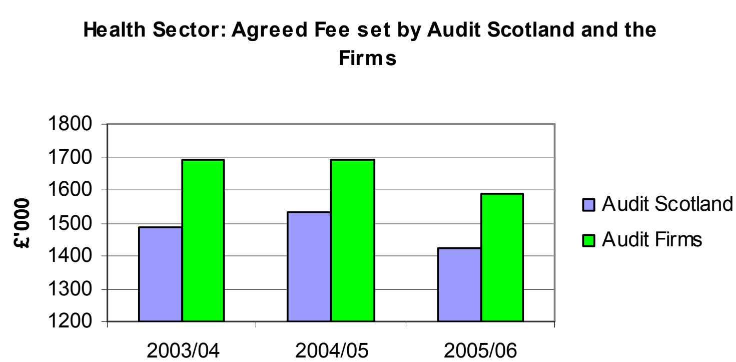


Fig 1.12

4.16 The chart below (Figure 1.13) shows that there was a decrease (7%) in the agreed fees for 2005/06 when compared to the previous year. This was mainly as a result of a significant reduction in the indicative days assigned for the health sector, arising from the transfer of the performance audit work to the Public Reporting Group. Hence, this amount was transferred from the agreed fee to net costs, thereby explaining the proportional increase in net costs as illustrated in the chart below. Of the total reduction (638 days) 414 days is resource transfer as described. The balance is attributable to the efficiency savings arising due to the merger of the former trusts and health boards.

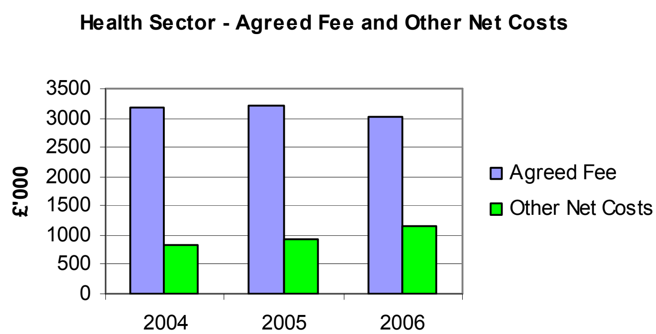


Fig 1.13

4.17 Both the Local Authority and the Health sectors have shown similar characteristics in trends with the exception of the best value audits, indicating that overall the agreed fee is reducing but with a broadly corresponding increase in net costs. The following section will look to analyse the extent to which income generated through fees goes toward covering the costs of "running" Audit Scotland.

5. Fee recovered versus costs incurred in running Audit Scotland

5.1 As previously stated not all of the costs that are incurred by Audit Scotland in delivering audit services are recovered directly from the audited bodies, giving rise to a funding requirement that is sourced from the SCPA, as illustrated in Figure 1.14.

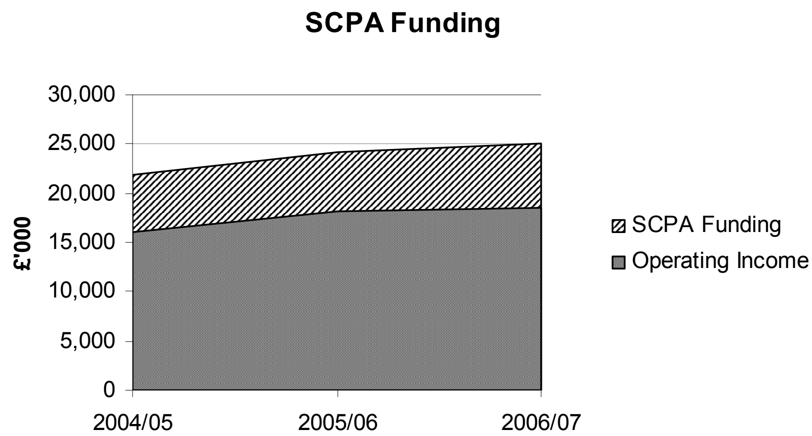


Fig 1.14

5.2 The operating income shown in the chart above is the amount that is recovered for the audit year by Audit Scotland. The SCPA funding averages £6 million per annum, with a forecasted increase for the year 2006/07. Just under £2.5million of this is needed to cover the costs of auditing central government bodies from which audit fees cannot be recovered directly and another £3.4million supports the costs of undertaking performance audits within the health and other sectors except local government. The remainder contributes to supporting the office of the Auditor General.

5.3 The costs that have been incurred as shown in the chart above have increased in proportion to the level of income that has been earned during the audit year. The SCPA funding can cover both direct and indirect costs, using the following definitions for each:

- Direct Costs: costs that are directly attributable to the income that is generated, for example the indicative fee.
- Indirect Costs: Costs that are not directly attributable to the income that is generated, for example the overhead element of the fixed charge including the costs relating to "back office" functions such as finance and human resources.

5.4 Although in the past Audit Scotland has not analysed its costs into direct and indirect (the statutory accounts do not require such a split) Audit Scotland has recently began to produce such data. This is a positive step in moving towards more effective management of costs.

5.5 The chart below illustrates the application of the costing analysis made by Audit Scotland for the Other Administration Costs and the Staff Costs.

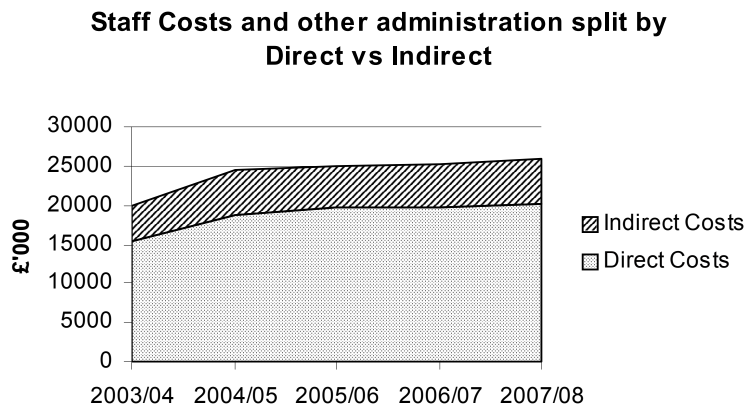


Fig 1.15

5.6 As the chart above shows the proportion of direct costs to indirect cost has remained and is forecasted to remain relatively constant. Indirect costs include recruitment, premises, office expenses, IT, depreciation, Accounts Commission costs as well as an element of the staff costs (12%-13%) for Audit Scotland.

5.7 Direct costs include the remaining staff costs, the agreed fees paid to the auditing firms, travel and subsistence costs incurred in delivering audit work and the majority of training and development and audit/consultancy fees.

5.8 Table 2 below shows the proportion of operating income covered by direct and indirect costs.

Table 2: Direct and Indirect costs as a percentage Of Operating Income

	Direct Costs £'000	Indirect Costs £'000
2004/05	116%	36%
2005/06	108%	29%
2006/07	106%	30%

5.9 As can be seen from the table above the direct costs are not fully recovered through fees levied directly by Audit Scotland as some of these costs will relate to non chargeable audits (in central government) and national work such as overview reporting and national studies (performed by the Public Reporting Group). This element of the costs is funded by the SCPA.

5.10 Table 2 shows that from 2004/05 to 2005/06 operating income has grown proportionally faster when compared to the direct and indirect costs. Indirect costs have reduced between 2004/05 and 2006/07; this is to be expected, due to efficiencies in working practices as well as the benefits gained from the base budget review of corporate services. The direct costs were expected to increase in direct relation to the operating income as costs such as fees to approved auditors and travel and subsistence are directly indexed to the levels of work performed, hence income generated.

5.11 Looking forward Audit Scotland should continue to consider developments in its costing arrangements notably in respect of ensuring that its time recording system is better and more fully utilised. Full use of the time system would support the development of cost measures which in turn could be used as a more accurate basis on which to apportion costs. A working group has recently been established to look into this particular area.

6. Summary and conclusion

6.1 The operating income that is received by Audit Scotland is largely from audited bodies covering both direct and indirect costs. The fees levied by Audit Scotland to the local authorities are favourable compared to its English counterparts. Audit Scotland's charges to audited bodies are consistent with that charged by the firms, and this is to be expected given that the indicative fees are derived using a standard rationale based on input days and uniform daily "charge out" rates. Given the "fee for audit" regime within which auditors now operate Audit Scotland should keep under close review the indicative days used. Nevertheless, the use of days is very much viewed as a means to an end and does to a large extent demonstrate a level of transparency in how indicative fees are set.

6.2 To enhance the quality and extent of financial management information Audit Scotland has taken positive steps in identifying its total costs between direct and indirect. This is being complemented by an ongoing review of its time recording system which is widely viewed by directors as under utilised. Full use of the time system would support the development of cost measures which in turn could be used as a more accurate basis on which to apportion costs. This is ultimately important given Audit Scotland's' corporate objective to deliver an effective and efficient audit service.

Part II Delivering an added value external audit

1. Introduction

1.1 In the last section we detailed Audit Scotland's cost and fee structure with a view to obtaining an understanding of, in essence, the efficiency to date of delivering the external audit. In this part of the review we consider in more detail the management arrangements underpinning the way the external audit fee is utilised to form a view of how effective the work is. We also consider potential areas for improvements and further developments in these arrangements going forward which we consider will add to both the efficiency and effectiveness of delivering the external audit.

1.2 Given external audit's statutory mandate the criteria for judging effectiveness and by implication the performance of external audit providers should be twofold:

- external auditors report fully on those areas of an auditee's "business" that fall within the areas as set out in the external audit Code of Audit Practice and do so consistently across all audited bodies; and
- the work undertaken on those Code areas is planned and executed such that it addresses both the concerns of the auditor and the audited body.

1.3 External auditors will need to satisfy themselves that an audited body has arrangements in place to ensure the sound stewardship of public funds that are managed and used in accordance with transparent plans and that the use of these funds is reported accurately and completely within the statutory accounts. In carrying out the work a comprehensive understanding of an auditee's "business" and the environment in which it operates is essential in formulating a programme of work that is relevant and ultimately useful to the auditee. External audit work that is relevant and useful to an auditee in our opinion is equivalent to an added value service.

1.4 This part of the report covers the following areas:

- a brief synopsis of the statutory and evolving role of external audit and Audit Scotland's role within the audit and inspection regime (Section 2);
- how the external audit process attempts to ensure that the work is relevant and useful to an auditee (Sections 3 and 4); and
- a summary analysis of the internal control mechanism within Audit Scotland to ensure the continual effective and efficient delivery of the external audit service (Section 5).

2. The Role of External Audit and Audit Scotland

External Audit

2.1 The remit of external audit is grounded in legislation and is set out in detail within the Code of Audit Practice (the “Code”). The diagram below (Figure 2.1) illustrates the Code areas.

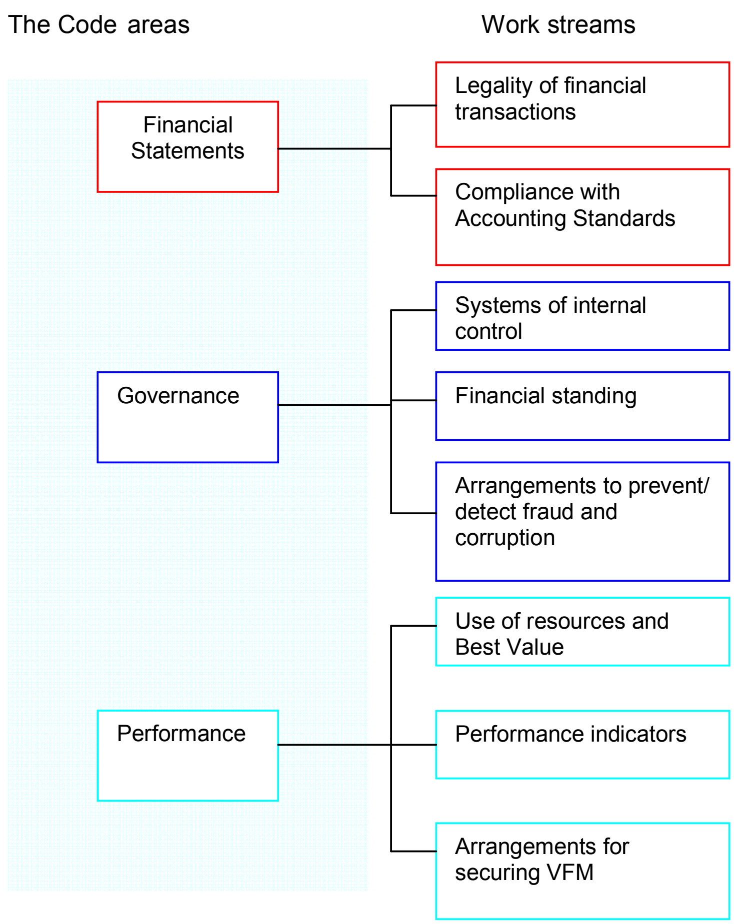


Figure 2.1

External Audit remit

Audit work on all but one of the above work streams is delivered by locally appointed auditors (Audit Scotland’s in-house team and the firms). However, the studies and reviews relating to Use of Resources are undertaken centrally by Audit Scotland, as are the statutory Best Value audits.

2.2 The prevailing Code has been in existence since 2001/02 and is currently being updated to apply to the first year of the new audit appointments (2006/07). There have been some significant developments since the Code was published that have impacted on the work of auditors, notably:

- the introduction by the Accounts Commission of a best value audit regime in response to the new requirement stipulated within the Local Government in Scotland Act 2003, for local authorities to have in place best value and community planning arrangements;
- new international accounting standards and the increasing onus on auditors to address the added complexities these create within the financial statements; and
- linked to the previous point, the implications of a revised Audit Practices Note 10 which reflect the introduction of International Standards on Auditing (ISAs).

2.3 In addition to the above developments, our review of the existing Code has highlighted the following areas where there is potentially scope for complementing the current drive by Audit Scotland and indeed all external audit providers to modernise the external audit approach:

- Opportunities to undertake audit work that cross-cuts Code areas should be considered and undertaken. The current Code alludes to this in several areas, however, the new Code should recognise the inter-linkages between the different Code areas in a way that supports work of a cross-cutting nature. Cross cutting work allows the auditor to meet statutory Code requirements in a more streamlined and ultimately efficient way. Our review of a sample of audit plans produced by Audit Scotland highlighted the potential need for clearer categorisation of risks against Code areas – this would be a starting point to then considering how and if risks and resulting audit work can be cross cut across Code areas.
- Greater clarity is needed in terms of Code work on value for money and performance in light of the recent introduction of the Best Value audit regime within the local authority sector. Our discussions with auditors have indicated that work under the Performance remit is restricted very much to arrangements underpinning the performance indicators and general commentary on high level arrangements in place within an audited body to secure value for money. However, local performance audits can and may be undertaken and, although these are rare, there may be a risk of differing emphasis being placed on Performance areas by different auditors, particularly in light of Audit Scotland's new audit methodology.
- Making clear the reporting responsibilities of auditors relating to their various functions (e.g., providing an opinion on the financial statements; auditing the system underpinning the performance indicators) and the range of outputs that will be required to satisfy minimum reporting requirements. This will help mitigate significant variations across the suppliers in the level and extent of audit reporting. It is acknowledged however that these variations are less marked than in the past

and within Audit Scotland the introduction of the new audit methodology is encouraging a move towards less but more focused reporting. This should contribute to the delivery of a more efficient audit.

2.4 Developments in the Code and the issues raised above are important in pre-empting any potential concerns, particularly within local authorities, of an increasing burden of audit and inspection. Such a concern in England & Wales contributed to the re-configuration by the Audit Commission of its Code areas from six to two (Financial Statements and Use of Resources) and the notable introduction of an audit opinion for Value for Money. Work underpinning this opinion requires the auditor to draw upon his/her cumulative audit knowledge of the management arrangements in place to demonstrate value for money, and the findings and conclusions of other reviews and studies being undertaken by other inspection agencies. Audit work on value for money and other areas that comprise the Use of Resources Code area are informed by Key Lines of Enquiry adopted by all auditors in fulfilling their work thus ensuring a level of consistency in the way Code work is delivered.

2.5 A review of the Code by Audit Scotland's Audit Strategy Group is currently ongoing and we understand that an updated Code will be completed in time for the next audit year. A draft Code has been produced and a key development is the streamlining of the Code areas from the current three down to two by virtue of the fact that it is intended to merge the Financial Statements and Governance Code objectives into one Code area. This recognises the linkages between the governance streams and their impact on financial statements and consequently should prompt auditors to undertake work of a more "cross cutting" nature as highlighted above.

Audit Scotland

2.6 The responsibility for delivering external audit to public sector bodies is enshrined within the Local Government (Scotland) Act 1973 and the Public Finance and Accountability (Scotland) Act 2000 (the "Acts"). These Acts place the responsibility on the Auditor General and the Accounts Commission for securing external audits. The former has responsibility for securing the audits of health bodies, central government (the Scottish Executive), further education colleges and Scottish Water. The latter is charged with delivering the external audit to local authorities, police authorities, fire authorities and a number of other smaller boards and committees.

2.7 Audit Scotland's role is to advise the Auditor General and the Accounts Commission on the appointment of auditors and to ensure the following:

- "Deliver a comprehensive public audit;
- Promote high standards of governance, stewardship and management;
- Support service improvements and best value; and
- Report in the public interest"[2]

2.8 Audit Scotland has clearly set out its commitment to improving the way that services are delivered. Within its 2006-09 Corporate Plan Audit Scotland details its main priority areas looking ahead which includes: "Maximising the value of the audit"; and "Building an effective and efficient organisation". Specific objectives underneath these priorities significantly include the need to have processes in place to improve the way Audit Scotland works and the efficient management of financial resources. In relation to these areas Audit Scotland has over the past two years taken some important steps, namely:

- ✓ base budget review of Audit Scotland's Corporate Services Group together with an internal Best Value review of the administration and facilities management functions;
- ✓ a review and subsequent "re-engineering" of the way the Performance Code area is delivered; and
- ✓ the development and roll out of a new audit methodology.

In the remainder of this part of the report we consider how Audit Scotland delivers the external audit, considering, in the process, the above areas. We also highlight our observations on potential areas for further improvements in effectiveness and efficiencies.

3 Delivering the external audit

3.1 Audit Scotland staff deliver most of the public sector external audits in Scotland. Of all external audit appointments 65% rests with Audit Scotland's in-house team, the remainder being provided by accountancy and audit firms who are selected in accordance with competition rules. Earlier this year the "next round" of appointments to cover the next five years was announced and the split of appointments (i.e. volume of work) between in- house and external suppliers has remained unaltered.

3.2 External audit work, as summarised, above is delivered by two departments or "Groups" of Audit Scotland, as follows:

[2] Audit Scotland Corporate Plan 2006-09

- The ***Audit Services Group*** is responsible for delivering Code work, primarily relating to Financial Statements and the Governance Code areas and, to a lesser extent, the Performance area (performance indicator systems and complementing the centralised Best Value audits).
- The ***Public Reporting Group*** delivers, at the behest of the Auditor General and the Accounts Commission, all of the national studies that contribute to the Use of Resources Code objective and all the Best Value audits within the local government sector.

3.3 We now consider in turn the respective roles of the two groups in contributing to the delivery of an added value audit service together with potential areas for improvement and further efficiencies in the way the work is delivered.

The Public Reporting Group

3.4 Figure 2.2 below illustrates the organisational and governance structure of the Public Reporting Group (PRG) including the source of funding for the work of the Group.

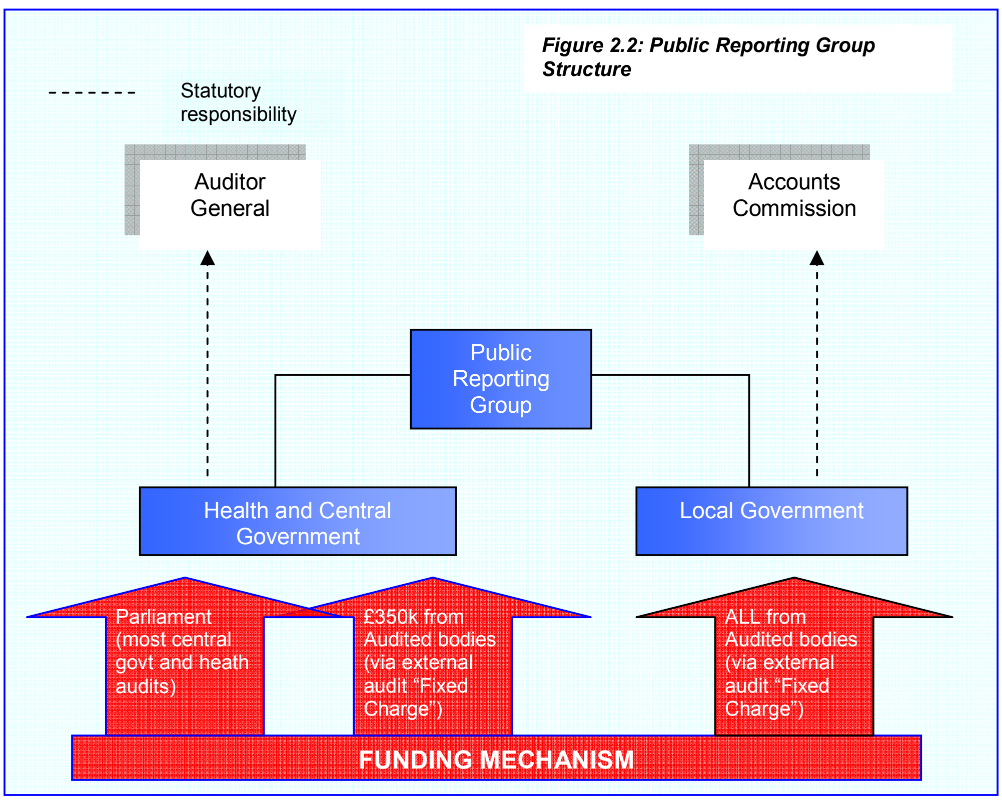


Figure 2.2: Public Reporting Group Structure

3.5 As shown, for the Health sector the majority of funding for the performance audit work undertaken comes from Parliament and so the primary accountability line is to the

Auditor General. A smaller sum (for 2005/06: £350,000) is recovered from audited bodies via the fixed charge mechanism and Audit Scotland should continue to ensure that audited bodies are made aware that this element of funding is charged directly to them via the fixed charge part of the total audit fee.

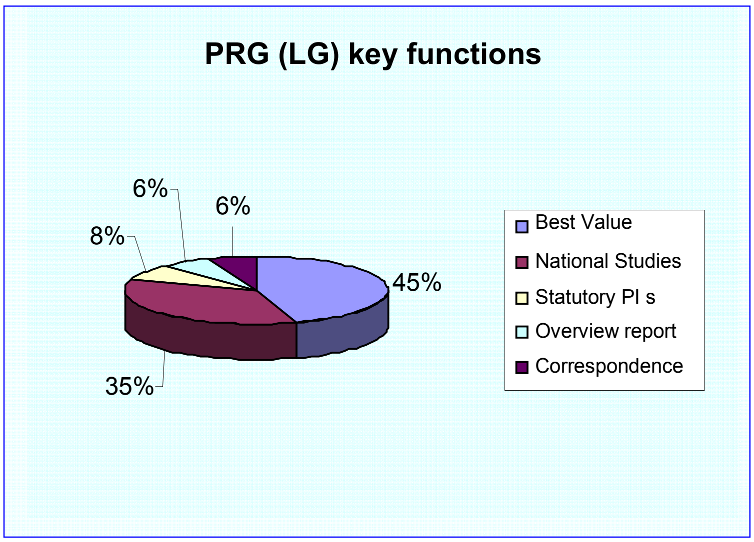
3.6 Whilst the Code makes it clear that "depending upon the sector involved and the nature of the review this work may be carried out by the auditor, central Audit Scotland staff or by others" discussions with a range of Audit Scotland staff and Firm representatives have confirmed that, in the main, all work is undertaken by the Public Reporting Group. Audit Scotland identified that the previous method of delivering some national studies using input from all appointed auditors was not working efficiently for several reasons including the ability of local auditors to consistently provide specialist expertise, the high cost of co-ordinating the work of many auditors and timing issues arising when national study work and final accounts audits were required to be undertaken at the same time. Centralisation of the work was decided upon to improve the flow of studies and to provide greater flexibility in the type of resource required e.g. specialists and the timing of work undertaken. These factors resulted in a decision to redistribute notional audit days from the indicative fee (local auditor allocation) to the Public Reporting Group (fixed charge). This re-distribution took place during 2004/05 and 2005/06.

3.7 As well as delivering the national studies and the Best Value audits, the PRG produces national performance audit reports on all sectors including cross cutting reports covering 2 or more sectors; annual overview reports in local government and health; periodic overview reports in further education; and is developing similar reports on central government policy areas. In addition, the PRG manages the production of section 22 reports for the Auditor General and publishes statutory performance indicators about local government performance. The Group also handles correspondence from MSPs and members of the public which often leads to detailed audit work (see below).

3.8 The planned national studies undertaken by the PRG is developed once every eighteen months. The programme is informed both by an analysis of risk and a consultation exercise that includes a range of stakeholders including local authorities and health bodies, the Scottish Executive, members of the Scottish Parliament and other scrutiny bodies. Stakeholders therefore have an opportunity to engage in the process and shape the work programme. In the LG sector in particular where all the time of carrying out the work is allocated via the fixed charge to local authorities the Accounts Commission is required by statute to consult on their programme of studies. This engagement with stakeholders is critical in creating a link between a national study and relevance of that study to local authorities. Audit Scotland recognises that there is an ongoing risk that the work of the PRG may be viewed by audited bodies as detached from their individual business risks and so has a number of initiatives underway designed to, inter alia, address this issue. Examples include the Seamless Audit Project which aims to coordinate better the work of local auditors and the PRG and Sector Planning meetings that are attended by local auditors, Audit Strategy and the PRG.

3.9 A broad breakdown of the time spent by the Performance Reporting Group (LG) on its core areas of activity is provided in Figure 2.3.

Figure 2.3: Split of key functions of the Public Reporting Group (LG)



3.10 PRG's work on dealing with correspondence is currently subject of an internal review (by the Director of PRG (LG)) to look into the way the work is delivered. This is in light of the increasing amount of correspondence being received and the resulting additional pressures on PRG staff time. The workload has increased with a surge in queries from MSPs and with the growing profile of Audit Scotland and the Scottish Parliament. The time expended by PRG on dealing with correspondence forms part of PRG's total expenditure base which in turn is re-allocated to audited bodies as part of the fixed charge mechanism (net cost allocation). The basis of recharge is currently not adjusted to take account of the fact that a query will only relate to a given body and so there is arguably an inherent inequity in this process. Conversely, where an audited body is the "victim" of serial correspondents it could be viewed as equitable that the associated costs are shared across all bodies. This is an issue that Audit Scotland has regularly considered but will review again as part of the correspondence review.

3.11 Both the Local Government and Health Sectors have recently introduced "Sector Plans" – these are integrated plans which consolidate and build upon the individual plans produced by the Audit Services Group and the Public Reporting Group, together with contributions by the firms. There is also a plan for central government although this has yet to be finalised. The current Health Sector plan exhibits a number of good practice points including:

- ✓ setting out strategic aims and detailed objectives;
- ✓ highlighting the working arrangements with other parties; and
- ✓ acknowledging areas where further improvements are needed (e.g., increasing the impact of PRG reports; better project management techniques to delivering national studies; and developing closer working relationships with partner firms).

3.12 Looking ahead the Sector Plans should continue to be developed expanding on the good practice points referred to above. These plans should increasingly form an integral part of Audit Scotland's overall strategic planning processes and will also contribute to the development of a culture of more detailed "business" planning approach to planning and delivery at Group and "business unit"/project level, particularly in respect of cost awareness and monitoring.

3.13 The introduction of sector planning and associated detailed business planning and management will add to the clarity of the audit trail in support of the costs incurred in carrying out audit work and, in our view, will yield a number of benefits including:

- Greater transparency in demonstrating the reason for the level of the fixed charge;
- Building upon the good progress made recently in reviewing its costs, notably the base budget review twelve months ago of Audit Scotland's Corporate Services Group. We understand that the PRG has not carried out a base budget review;
- Creating an additional fillip to review and improve working practices and project management arrangements in respect of national studies as already identified within the Health Sector Plan; and
- Cost centre managers/Project Managers are driven by cost control as well as meeting output and quality targets.

The Audit Services Group

3.14 Figure 2.4 below illustrates the organisational and governance structure of the Audit Services Group (ASG) including the source of funding for the work of the Group.

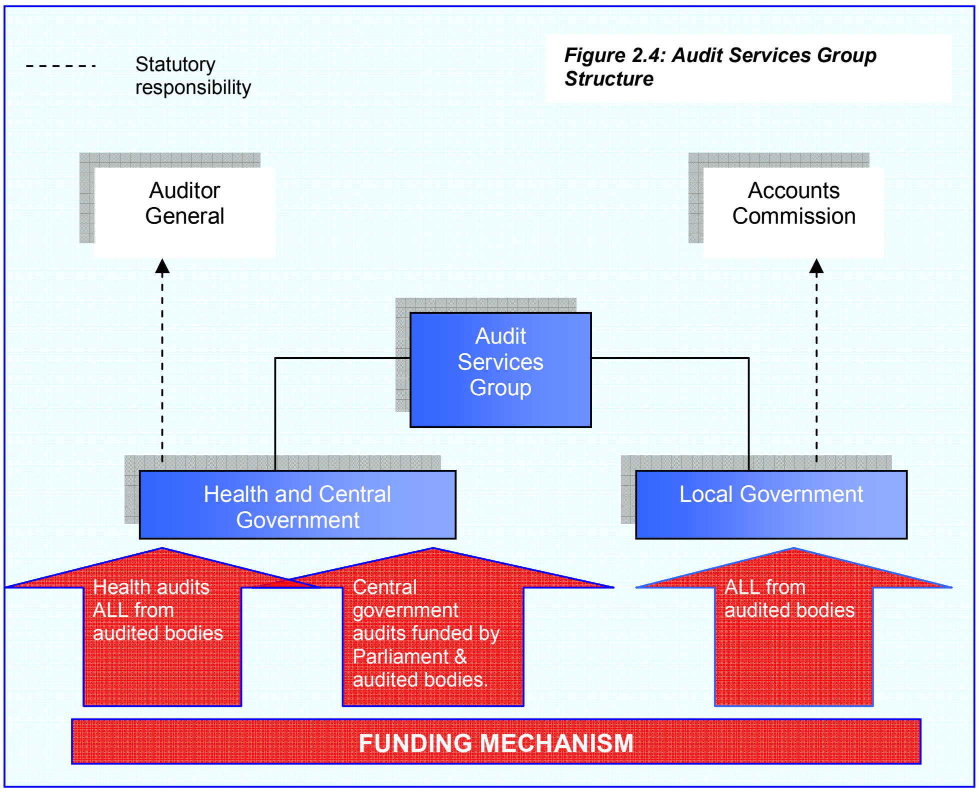


Figure 2.4: Audit Services Group Structure

As shown health and local government (LG) audits are billed directly to audited bodies. The audits of central government bodies are funded through a mixture Scottish Parliament funding and direct billing to audited bodies. In respect of LG and health audits auditors are therefore directly accountable for the fees charged to the audited bodies. Even where a central government body does not “pay” for its audit (because it is funded by Parliament) the auditor is still required to agree an appropriate fee with the body which is disclosed in the audited body’s accounts.

3.15 The ASG delivers work to satisfy all but one of the audit work streams. In respect of locally determined performance audit reviews we understand that these have been relatively rare. However, in 2005/06 both central government and health auditors reviewed Best Value arrangements and progress with efficient government. Audit Scotland considers that the national studies carried out by the PRG reflect common issues faced by audited bodies, particularly in view of the fact that the programme of national studies is informed by extensive consultation with a range of stakeholders, notably the audited bodies themselves.

3.16 The localised nature of the work of the ASG (i.e., audits are planned for individual bodies and then undertaken by an audit team dedicated to those bodies) pre-empts any views that audit work is detached from an audited bodies issues and concerns and therefore adds limited value. We understand from discussions with auditors and Audit Strategy (Audit Strategy is responsible for quality appraising the work of local auditors, including considering feedback from auditees) that there are no overt concerns regarding the added value of that aspect of the external audit delivered by the ASG and this is borne out by the client surveys that Audit Strategy conducts as part of the overall quality appraisal framework (See Section 5 below).

3.17 As with the PRG discussions confirmed that there are some opportunities to develop the business planning arrangements underpinning the work of the ASG. Notably, cost budgets should be reviewed with a view to identifying potential savings. Whilst the derivation of the audit fee for the work of the ASG (and the firms) is relatively transparent, such an exercise could result in a positive impact upon audited bodies in terms of annual fee increases for Audit Scotland's client's given the fee setting mechanism (i.e. the fixed charge element of the audit fee is a function of Audit Scotland's expenditure).

3.18 In the following section we consider the evolving nature of the external audit methodology used by the ASG and how the working arrangements with the PRG are being developed to ensure that, between the two groups, the external audit being delivered is improved further in terms of adding value to organisations.

4. The external audit methodology

4.1 Over the past two years Audit Scotland's ASG has reviewed and updated its external audit methodology in order to make the approach more risk focused with a greater onus on adding value. 2005/06 was the first year of the full roll out of the new methodology, the *Modernised Audit*. The roll out was preceded by a "trial run" within the health sector during 2004/05 and has been well received by auditors and, we are advised, by audited bodies.

4.2 A key manifestation of the new approach has been the shift in the weighting of audit time and effort to the planning phase of the audit. This echoes a similar change in approach by auditors in England and Wales following both the changes to the Code of Audit Practice there and the introduction of ISAs. The benefits of this emphasis on planning are as follows:

- ✓ a better and fuller understanding of the key issues facing an auditee;
- ✓ an alignment in approach with some of the firms who have been using a risk based approach for a number of years; and
- ✓ identification, through a better insight into the business risks of an organisation, of potential added value reviews.

4.3 The ASG, in planning the audit work at individual audit bodies, is now informed by the Priorities and Risk Framework (PRF). This is a document produced by Audit Scotland that captures the key risks and issues facing audited bodies. A PRF is produced for both the LG and Health sectors. It offers all auditors (from the ASG and the firms) a common denominator in terms of compiling information on their respective audited bodies by undertaking work as part of the planning stage of the audit. This then allows them to form an early view of how risks pertaining to the common issues articulated in the PRF are being addressed by bodies which in turn allows the identification of significant residual risks where audit effort can then be targeted. The PRF also informs and is informed by the national studies programme. Audited bodies that are audited by the ASG receive a detailed Audit Risk & Analysis Plan (ARAP) that is a culmination of the detailed planning work. Figure 2.5 below illustrates the key phases of the audit planning and delivery process and the outputs that are generated for audited bodies.

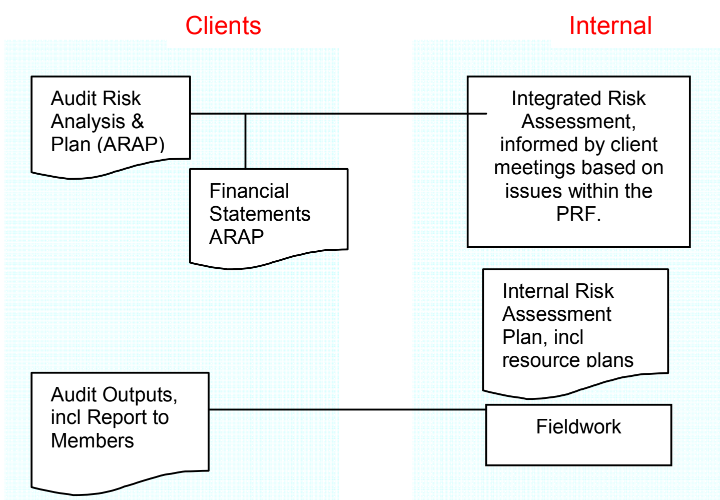


Figure 2.5: Audit Planning & delivery

4.4 Audit Scotland is committed to developing this new methodology with a view to ensuring that feedback is sought and modifications are made as appropriate looking forward. Our review of the new methodology and the accompany documentation has highlighted a number of benefits of this approach together with some further areas for consideration (Table 3). Some of the areas for further consideration are taken from the experiences in England & Wales and aim to provide pointers to further efficiencies in the audit methodology.

Table 3: The Modernised Audit: Summary of benefits and areas for further consideration

Benefits	Areas for further consideration
✓ More focused audit with emphasis on continuous improvement. ✓ More effective use of audit resource. ✓ Higher level of "ownership" on part of the audited body of the programme of audit work. ✓ Key national issues affecting all organisations are addressed by auditors. ✓ Supports the production of consistently high quality audit reports across all audit teams. ✓ Encourages greater discipline over resource planning. ✓ Improvements in joint working arrangements with the PRG. The Seamless Audit Project initiated by Audit Scotland aims to improve the effectiveness of the external audit by linking the local audit (undertaken by the ASG) more closely to the Performance an Best Value audit (carried out by the PRG).	• Better linkage between the key risk issues in the ARAP and PRF to Code work streams. • Using an audited bodies internal risk register as the key driver in informing the auditors risk assessment. • Linked to the above and to assist the clarity of the audit trail from the work undertaken to the fee charged, splitting the total audit fee within the ARAP between the different Code areas, including the amount charged for the national studies. • Amalgamating the Financial Statements ARAP within the main ARAP. This would be consistent with the principle of greater cohesion between the various Code areas and also reduce the burden of work on auditors. • Identification of the key business risks relating to the issues raised in the PRF set within a summary "Checklist" format. • Audit planning meetings with clients should as far as practicable take the form of workshops comprising the "key players" within an organisation, including members. This approach makes the planning process more efficient and possibly more effective in that it results in a shared ownership with clients of the audit plan.

4.5 The revisions to the Code that are currently being considered includes the amalgamation of Governance and Financial Statements. This would be consistent with that area for improvement above that suggests the incorporation of audit work on financial statements into wider audit work.

Joint Working arrangements

4.6 In respect of joint working arrangements between the ASG, the firms and the PRG this is recognised by all parties as an important area for ensuring that audited bodies receive a joined up audit. The Seamless Audit Project is an important initiative in integrating better the work of the two groups thereby contributing to a more efficient and effective total audit. Whilst centralisation of Performance Code work was viewed as a necessary requirement to improve the quality and timeliness of performance related work, it is equally recognised that synergies exist in tapping into the cumulative audit knowledge of local auditors in developing performance work programmes. Conversely, the findings and recommendations of national studies should inform the local risk assessments undertaken by the ASG on its audited bodies and to this end Audit Scotland may wish to consider the way the impact of recommendations from national studies are conveyed so that there is more of an overt link and relevance to audited bodies. Our discussions with the PRG confirmed an acknowledgement and desire to continue to address this issue and the Group is examining ways to achieve this –e.g., by targeting non executive directors in the NHS Boards.

4.7 To support joint working amongst all the audit suppliers (Audit Scotland and the firms) and the general sharing of thoughts, three sector meetings take place during the year (for LG and Health) that comprise representatives from the ASG, firms, PRG and Audit Strategy.

4.8 As well as internal joint working arrangements the PRG in particular has developed liaison arrangements with the National Audit Office, the Wales Audit Office and the Audit Commission. For example, there is ongoing dialogue with the NAO on the health service consultants' contract whereby the NAO have had access to Audit Scotland's survey tool, whilst Audit Scotland have used the NAO's knowledge and experience in the field of private finance initiative to support its performance work in this area. The PRG (Health) is also looking at the potential of working with the Healthcare Commission in England and Wales. Audit Scotland is also part of a four way review (with the Audit Commission, the Wales Audit Office and the National Audit Office) looking into development of performance indicators that will allow a way of undertaking meaningful comparisons of performance areas, notably costs.

4.9 Such joint working arrangements are essential in avoiding duplication in effort, and the associated time and effort that is expended, and delivering products to audited bodies that complement one another.

5. Control framework over audit efficiency and effectiveness

5.1 There are a number of building blocks that make up a control framework within any organisation. Within the context of this review and in light of our observations to date we highlight below four such building blocks that we consider help to ensure that audits are delivered efficiently and effectively:

- A robust quality assurance framework;
- A rigorous and rounded strategic performance monitoring regime;
- Sound financial management and controls; and
- Technical resource and advice.

Quality Appraisal

5.2 As mentioned above the Modernised Audit is aimed at improving the quality of audit outputs delivered by local auditors by making the outputs more relevant to an audited body's business risks, and streamlining the way the audit is planned and delivered. This is complemented by greater coordination between the local auditor and the central team (the PRG).

5.3 In terms of reviewing the quality of the work of local auditors a quality appraisal (QA) framework is in place. Responsibility for undertaking QA reviews rests with the Audit Strategy Group and a terms of reference is in place setting out the roles and responsibilities. In Appendix 1 we include the QA Appraisal Process as set out in the QA team's terms of reference, and can conclude that the process overall is operating effectively in that it is delivered independently and robustly across all local auditors.

5.4 In addition to the QA arrangements within Audit Strategy, we understand that the Audit Services Group also conducts its own internal quality assurance exercises. The firms will also be required to ensure that audit work meets their internal quality requirements. Looking ahead, Audit Strategy should consider the merits of rationalising the number of detailed QA exercises it undertakes by placing reliance on the internal arrangements within the ASG and the firms. This could release some capacity that could be re-distributed to other areas, such as increased product reading and audit planning arrangements in light of both the full roll out of the new audit methodology and the introduction of the revised Code.

5.5 The QA regime has yet to be fully extended to the PRG although we acknowledge that pilot reviews of compliance with PRG's Project Management Framework are being carried out. Given that the work of the PRG is a part of the overall audit it is important that appropriate QA processes are applied to the work of the PRG, particularly for the LG sector where the work of the PRG is fully funded through the fixed charges levied on audited bodies. A robust QA process over this aspect of Audit Scotland's work will add to its overall accountability for the audit charges made.

Performance monitoring

5.6 Audit Scotland's Corporate Plan, as mentioned earlier, sets out ambitious aspirations and objectives including details of how progress is to be measured including an objective on improving efficiency. Progress against these objectives is published within Audit Scotland's annual report. For example, progress on financial statements sign off and budget efficiency savings are reported within the Annual report and the results of client surveys are fed back to the Auditor General and the Accounts Commission. We set out within Appendix 2 the range of formal performance indicators that are currently reported within Audit Scotland's Annual Report.

5.7 To complement the current strategic performance management arrangements Audit Scotland could consider putting into place some high level indicators to provide greater detail on its performance and which would be open to scrutiny by the SCPA through its discussions with Audit Scotland of the Corporate Plan, budget proposals and the Annual Report and Accounts. In the following table (Table 4) we include some examples of further performance indicators that could be considered.

Table 4: Possible Performance measures for use by the SCPA

Effectiveness	Efficiency
• National Reporting progress and reasons for slippages • Annual audit report to members issued within pre-determined timeframes • BV reports issued within pre-determined timeframes(see * below) • Progress on following up key recommendations within reports.	• Efficiency savings • Absence management • Impact on processes of new IT

* The timeframes are set by the Accounts Commission. The Accounts Commission therefore exercises scrutiny and challenge over this area and so the role of the SCPA in this respect would be to remain updated on progress as opposed to exercising detailed challenge.

Financial management and controls

5.8 As mentioned in section 3 above financial monitoring arrangements at sector, "business unit" and individual audit appointment level within Audit Scotland have yet to be fully developed. In both the ASG and PRG resource plans are created that set out the time needed to undertake work together with the skills mix required. In addition, the ASG also produces Management Information Packs that set out these audit inputs together with audit progress activity analysis and productivity reports. However, audit inputs are measures solely on input days only, with no associated costing and, under productivity reports, our review of the Health sector Management Information Pack indicated that no staff utilisation targets had been set.

5.9 Within the PRG, project plans and briefs for national studies are produced that include staff resource and time budgets that are monitored against the project plan. However, there are no associated cost budgets. Slippages do occur given the nature of national studies and as a result of unplanned reactive work arising from current events or correspondence. The impact of such slippages on Audit Scotland's' total expenditure should be measured with a view to assessing their ultimate impact on fixed charges. Discussions with the PRG confirmed a clear leaning toward the quality of work as opposed to how long/how much the work takes/requires. National studies are high profile with no margin for error and with Audit Scotland under the exposure of significant reputational risk. Consequently, all measures are taken to ensure the accuracy and completeness of the reports. Nevertheless, there is recognition by the PRG Directors of Health and LG that there is a need to have a more systematic approach to cost management.

5.10 The performance management regime within Audit Scotland very much focuses on the quality and timelines of audit work being produced and delivered. These are important measures and Audit Strategy monitors the progress of local audits throughout the year, with local auditors being required to submit quarterly audit progress reports. In respect of the work of the PRG, discussions indicate that their work is reported within quarterly Performance and Financial Update reports that are presented to the Senior Management Team, with a truncated version of this being subject to scrutiny by the full Board.

5.11 To complement and enhance the control framework and to directly address Audit Scotland's key objective relating to the "efficient management of financial resources", a greater level of rigour in financial management should be introduced at sector level down to audit engagement/PRG project level. Currently, Audit Scotland has a commitment to make annual savings which it has achieved, however the absence of consistent and robust financial monitoring arrangements at sector and business unit levels increases the risk of not identifying areas of "slack" whilst also perpetuating a culture that is not fully grounded in the awareness of costs of service delivery. Consequently work may not be entirely efficient or effective.

5.12 Our discussions within the Health sector indicated a desire to use the recent round of audit appointments as an opportunity to undertake medium to long range planning to cover the next five year audit appointment tenure. As part of such a process a greater emphasis on financial management and planning could be introduced which in turn could include a review of the skills mix of staff needed as well as embracing targets around staff utilisation and income generation possibilities (outside of the Code work). Such an approach would be consistent with Audit Scotland's corporate aims and should be encouraged and implemented across all the groups.

Technical support

5.13 Discussions with ASG auditors and the firms indicated that technical support provided by Audit Scotland was viewed as good. The periodic sector meetings referred to earlier also include an agenda item on technical matters whilst a separate meeting is convened twice yearly to address LG technical issues. This involves all suppliers. Audit Strategy produce technical bulletins each quarter and these are supplemented by Notes for Guidance and ad hoc Urgent Issues documents.

5.14 Discussions with the firms suggested that there could be potential improvement in the way that technical accounting matters are discussed and how actions are agreed. For example, we were advised that on some occasions the ASG have taken the lead on how to deal with specific matters, as opposed to the technical support group. The formation of a Technical Issues Group was raised as a possible way forward. The benefits of such a group vis a vis the mechanism already in place (notably the sector meetings) should be considered by the firms and Audit Scotland as the effectiveness of any such arrangement is vital in enhancing the financial statements audit. The effectiveness of such arrangements is also important in mitigating the reputational risks to auditors (arising from variations in how auditors interpret a given issue) by promoting consistency in the way technical issues are dealt with.

6. Summary and conclusion

6.1 Audit Scotland's aspirations to continue to develop the efficiency and effectiveness of the way it delivers its services are clearly articulated within its medium term corporate plan. These aspirations build upon initiatives and steps already taken in recent years, notably the development of a new audit methodology, a recognition that the two "front line" groups of Audit Scotland (The Audit Services Group and the Public Reporting Group) can work together more effectively to deliver a more rounded and focused audit and a review of the cost base of Audit Scotland's Corporate Services, that has included an internal best value review of the Administration and Facilities Management functions.

6.2 To help achieve the objectives that Audit Scotland has set itself to meet these aspirations, notably in respect of "Building an effective and efficient organisation", financial management arrangements, in particular cost/budget monitoring arrangements at "business unit"/project level should be reviewed. Improvements to monitoring arrangements could be made to ensure that savings "on the ground" are fully realised and, on a wider note, help to promote a culture where cost awareness becomes an increasingly important key driver for performance.

6.3 The revisions to the Code of Audit Practice (which set out the statutory duties of external auditors) should complement the commitment of all audit suppliers to provide a highly focused and risk based audit that addresses the needs and concerns of audited bodies. It is intended for example that the previous duties of auditors to undertake work on financial statements and governance will be combined into one single area. Such streamlining will compel auditors to focus on audit risk areas in a more joined up way thereby minimising the need to undertake reviews that are discrete form one another. This is consistent with the changes that have taken place England and Wales and, with regard to Audit Scotland, when combined with its new methodology, should contribute to significant progress against its aspirations.

6.4 As Audit Scotland's new audit methodology continues to "bed in" auditors should continually assess the level and extent to which work that is undertaken is able to "cross cut" the various audit areas as a means of achieving not only further efficiencies but to also provide a more effective range of outputs. To this end Audit Scotland's quality appraisal process will continue to be a critical building block for ensuring that effective audits are being delivered that not only meet minimum reporting requirements but also add value to an audited body.

Appendix 1

Quality Appraisal Framework

Objectives

Assess quality of auditors' work

Promote high quality audit

Outcome/Performance Monitoring

- Reviews of outline audit plans
- Monitoring of fee submissions/progress reports
- Reviews of audit outputs ("product readings")

Correspondence/complaints from bodies

Service Quality Surveys

Review visit to auditors

Review risk-based planning and quality assurance procedures

Detailed reviews of audit work

- Comprehensive reviews of audits
- Reviews of specific aspects of audits

Reports to auditors

- Individual reports on findings from review visits
- Papers to all auditors disseminating good practice/areas for improvement identified at visits

Reports to AGS and Accounts Commission

- Review assessments
- Inform future audit appointments

Source: Audit Strategy document setting out terms of reference for the work of the QA team

Appendix 2

Audit Scotland's performance indicators

Strategic Aim	Performance Indicator
Supporting effective democratic scrutiny	• Number of performance audit reports published. • Response times for correspondence from members of the public concerning potential audit issues.
Building an effective and efficient organisation	• % of invoices paid within 30 days. • Sickness Absence. • Staff Turnover.
Maximising the value of the audit	• % of audits delivered against statutory or Accounts Commission timescale for each sector. • % of audit plans submitted and fees agreed within specified timescales. • Results of quality appraisal scheme.

Source: Audit Scotland's Annual Report 2005/06