

# CONSULTATION ON AUDIT SCOTLAND FEE SETTING ARRANGEMENTS

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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# Contents

<b>Contents</b> .....	<b>3</b>
<b>Why are we issuing this consultation?</b> .....	<b>4</b>
How to respond .....	5
<b>Overview</b> .....	<b>6</b>
Introduction .....	6
<b>Funding our work</b> .....	<b>9</b>
Introduction .....	9
What do we charge for? .....	9
<b>Setting audit fees</b> .....	<b>11</b>
Introduction .....	11
Approach to fee setting .....	11
Fee ranges.....	12
Communicating audit fees .....	13
Calculating the audit fee.....	13
Auditor remuneration .....	14
Pooled costs.....	14
Performance audit and best value costs (local government) .....	15
Performance audit (central government, further education & Scottish Water) .....	16
Performance audit (NHS) .....	16
Audit Scotland costs .....	16
<b>Next steps</b> .....	<b>18</b>
<b>Annex 1</b> .....	<b>19</b>
List of consultation questions .....	19

# Why are we issuing this consultation?

1. Audit Scotland audits over 200 public bodies on behalf of the Auditor General and the Accounts Commission. Our vision is to be a world class audit organisation that improves the use of public money.

In order to deliver our world class vision we have:



Consulted stakeholders about their Expectations of Audit



Published *Public Audit in Scotland* – a high level statement on the scope of Public audit by the Auditor General, the Accounts Commission and Audit Scotland



Revised the *Code of Audit Practice* to raise expectations of auditors in conducting wider scope public sector audits and increase the transparency of audit work



Carried out an audit procurement exercise to underpin new audit appointments by the Auditor General and the Accounts Commission for the period 2016/17 to 2020/21.

2. Each organisation within the public sector is audited annually and most are charged for the audit. The charging structure was constructed some years ago and adapted incrementally as changes to the public sector took place. However, the advent of more fundamental changes to the Scottish public sector and the manner in which services are provided has prompted Audit Scotland to consider the whole charging structure, question the funding requirements and assess the fairness by which organisations bear the cost of public audit.
3. New audit appointments will commence in autumn 2016 and Audit Scotland recently completed an exercise to procure the services of independent audit firms to complement the audit teams provided by Audit Scotland. The exercise, together with future Audit Scotland efficiency targets, will result in additional cost savings being achieved for the 5 year duration of the audit appointments.
4. Audit Scotland has now reviewed the funding and fee arrangements to assess whether they are fit for purpose, fair, transparent and understandable to audited bodies and other stakeholders.
5. This Consultation paper sets out our proposed revised approach to funding and fee-setting and seeks stakeholder views.

6. The resulting fee levels proposed will take account of changes now expected of the service provided by auditors as reflected in the new Code of Audit Practice, the results of our recent audit procurement exercise and our budget for 2017/18.

## How to respond

7. Consultation questions are at the end of each section and are also listed in Annex 1. Please e-mail your response to [feesresponse@audit-scotland.gov.uk](mailto:feesresponse@audit-scotland.gov.uk) by 8 August 2016.

# Overview

## Introduction

8. Audit Scotland carries out a range of independent external audits on behalf of the Auditor General and the Accounts Commission. These include annual audits of financial statements, performance audits, best value audits and housing benefit audits. We also support the Auditor General and Accounts Commission in reporting to Parliament and the public. In 2015/16 our work included auditing 323 annual accounts, 11 performance audits, 6 best value audits and 17 housing benefit audits. More information about Audit Scotland's activities is available in our [Corporate Plan](#) and our Annual Report.
9. Audit Scotland submits its annual budget to the Scottish Parliament. Our budget proposal is subject to scrutiny by the Scottish Commission for Public Audit (SCPA), a commission of the Scottish Parliament, and forms part of the annual Budget Act.
10. Our work is funded by a combination of fees charged to audited bodies and direct funding from the Scottish Consolidated Fund. We are committed to demonstrating that we are using our resources as efficiently and effectively as possible. We have reduced the cost of audit by over 24% in real terms since 2010/11 whilst improving audit quality and working towards our world class vision, resulting in significant fee reductions for many audited bodies.
11. In preparation for the new audit appointments we have reviewed all aspects of the approach to funding our work and setting fees. We believe that the revised arrangements proposed in this paper will be more transparent, sustainable and easier to understand.
12. The table below summarises the changes to the method of fee setting we are proposing to make:

Current method	Proposed method	Paragraphs
<b>Overall approach to fee setting</b>		
Annual review of fees taking account of incremental changes in audit scope resulting in differences between cost and income at sector level	Explicit principle that fees should be set with the objective of recovering the full cost of audit work in each sector	24-29
Audited bodies should pay the same fee irrespective of whether their auditor is an Audit Scotland team or any of the appointed private firms	No change	30
<b>Fee ranges</b>		
Audit Scotland sets a fee range,	Audit Scotland sets expected fee	31-34

Current method	Proposed method	Paragraphs
generally + or - 10%, around a mid-point; auditor and audited body agree final fee within that range	with scope for auditor and audited body to agree a higher fee to reflect local circumstances	
<b>Communicating audit fees</b>		
Single fee range notified to audited bodies	Fee broken down between auditor remuneration, pooled costs, performance audit & best value and Audit Scotland costs	35-37
<b>Calculation of fees</b>		
Costs of travel & subsistence, procurement savings, recoverable VAT and in-house team net surplus/cost pooled by sector	No change	45-52
Local government only - contribution to cost of best value audit shared between councils based on relative populations reviewed annually to reflect original funding through LG settlement	No change except relative population levels to be fixed for five years	53-55
Local government only - cost of performance audit shared between bodies based on historic audit fee levels	Cost of performance audit shared among significant bodies on basis of relative auditor remuneration	56-57

13. The outcome of this consultation will be used to inform the fees for the 2016/17 and subsequent audits together with the budget for the 2017/18 financial year and the savings achieved from the audit procurement exercise. At this stage we expect to be able to reduce overall fees in most sectors. The reductions will vary across sectors and between bodies within sectors. A small number of bodies are likely to see increases as audit fees are brought into line with the cost of carrying out the audit. The estimated impact for each sector is:

**Local government** - most councils will see modest decreases. A few councils and other bodies will see a small increase to reflect the actual cost of the audit and the simplified cost allocation approach.

IJBs have all become fully operational from 1 April 2016. The 2016/17 fees will be agreed with their appointed auditors taking into account the scope of the individual IJB's operations in that year. These bodies will also start to make a contribution to overall performance audit costs.

**NHS** - mainland territorial NHS boards will see decreases. Island Boards' existing fees however do not reflect the current cost of carrying out these audits and are likely to see increases.

**Central government** - overall fee levels will fall slightly although a number of bodies will see small increases to better reflect the cost of carrying out their audits.

**Scottish Water** - the fee for 2016/17 is expected to remain at around 2015/16 levels following the recent audit procurement exercise.

**Further education** - overall we expect the level of fees to increase slightly. This reflects the long term position of college audits being difficult to deliver within the available resources as the scope of audit work has consistently exceeded the original fee levels. Recently merged colleges will see small reductions whilst unmerged colleges will see increases to better reflect the actual cost of carrying out the work required to deliver the audits in this sector.

14. The estimated fee movements described are on the basis of the same volume of audit activity being undertaken at each body and overall. If there are changes in the volume of work required at particular bodies, new bodies are created or there is any reorganisation of the public sector there may be an impact on the level of fees described.
15. For councils, in line with other audit bodies in the UK, the additional audit cost relating to the changes to accounting for the Highways Network Asset from 2016/17 will be agreed with individual auditors based on the quality of the council's systems and records and the availability of central assurances. At this stage we expect that for a council with good records and systems in place and assuming the availability of central assurance over rates and common models the work will cost £5,000 - £10,000.



# Funding our work

## Introduction

16. Audit Scotland's work is funded from a combination of fees to the bodies that we audit and funding from the Scottish Parliament. For 2016/17 our budgeted income from fees is £18.1 million (74%) and our income from the Scottish Consolidated Fund is £6.4 million (26%). These have fallen from £21 million of fees and £7.3 million of Parliamentary funding in 2010/11 reflecting the achievement of significant efficiencies and cost savings over the period.
17. Under the Public Finance and Accountability (Scotland) Act 2000 we are able to make reasonable charges for those audits specified in the Act. The Act requires us to aim to broadly break even, taking one year with another, for that work.

## What do we charge for?

18. At present, Parliamentary funding pays for all performance audit work in central government, further education and Scottish Water, and part of the cost of NHS performance audit work. It also pays for the costs of supporting Parliament and its committees, the annual audits of the central government audits that we cannot charge for, the national fraud initiative and the costs of the Auditor General, Accounts Commission and Audit Scotland Board.
19. Audit Scotland cannot charge for the audits of the Scottish Government, its executive agencies, non-ministerial departments and other bodies funded directly from the Scottish Consolidated Fund. The cost of this work is included in our Parliamentary funding.
20. Local government has its own democratic structure and the Accounts Commission appoints auditors and oversees performance and best value audit arrangements. Local government funding includes an amount for scrutiny costs such as audit and therefore local government bodies pay for all audit work across the sector.

21. Audit Scotland currently charges audited bodies for the following work:

	Local Government	NHS	Central Government	Further Education	Scottish Water
Annual audit	X	X	X	X	X
Performance audit (1)	X	X (part)			
Best value audit	X				
Housing benefit audit	X				

(1) Performance audit costs include value for money examinations, reports by the Auditor General to the Scottish Parliament, reports by the Controller of Audit to the Accounts Commission and costs of responding to correspondence from elected members and the public.

22. We considered alternative approaches to funding our work, including whether it would be appropriate to seek an extension to the work funded by parliament, or whether we should aim to charge for all possible work permitted by legislation. We concluded that with the exception of NHS performance audit work considered below, the current arrangements work well, are generally well understood, reflect the legislation and are consistent with other parts of the UK.
23. The cost of performance audit work for central government, further education and Scottish water is met by funding from the Scottish Consolidated Fund. The funding of this work for the NHS is a combination of contributions from audited bodies through fees and funding from the Scottish Consolidated Fund. We are considering options for funding this work in future and will seek to discuss these with the SCPA in due course including whether funding for all of the cost of this work should in future come from our Parliamentary funding. This would bring the funding for this work into line with that for all other parts of the Auditor General's remit and simplify charging arrangements. If such a change were to be made it would result in a reduction in overall fees to the NHS sector of around £300,000 per year and a corresponding increase in Parliamentary funding.

### Questions on funding our work

Q1 - Do you have any comments on the overall approach to funding the work of Audit Scotland?

Q2 - Do you have any views on the future funding of NHS performance audit work?

# Setting audit fees

## Introduction

24. We review fee levels as part of the annual budget setting process and notify audited bodies of their fees after consideration of our budget by the SCPA each autumn. Budgets are set for financial years whereas audit fees are set for each audit year which runs broadly from November to October. Our budget for a financial year therefore includes estimates of fees and costs for parts of two audit years.
25. At present each year we notify bodies of a single fee range around a midpoint. That mid point is our assessment of the appropriate fee for a well run body of that size facing the normal risks for its part of the public sector. Auditors are then able to agree the exact fee with the audited body to reflect the particular circumstances of the body in that year.

## Approach to fee setting

26. To support the revised Code of Audit Practice and new audit appointments and to reflect stakeholder interest in our business we have reviewed the way in which audit fees are set. The review has taken into account changes in the structure and operation of the public sector, the effect of the new powers being devolved to Scotland on our work, developments in auditing standards and methods and the more integrated way in which audit work is now delivered including
  - Changes to auditing standards which have increased the minimum amount of work required to conduct a fully standards compliant audit
  - Developments in technology in both accounting and auditing which have tended to reduce the amount of work required at the largest bodies
  - Increased expectations on auditors in auditing or reviewing governance statements, remuneration reports and strategic reports/management commentaries
  - Changes in the structure and organisation of the public sector such as the reform of police and fire services and the creation of Integration Joint Boards for the delivery of health and social care.
27. Our objectives for fee setting are to:
  - comply with statute
  - maintain the independence of auditors
  - reflect the way in which public services are organised and audited
  - be transparent and easy to understand
  - be simple to operate
  - sustainable
  - not volatile without reason

28. Audit Scotland is required to aim to broadly break even on audit work that is charged for taking one year with another either for each audit or for classes of audits. We have determined each sector as being a class of audits.
29. Audit Scotland considers that audit fees should be set with the objective of recovering the full cost of audit work in each sector. Within sectors there may be a degree of cross subsidisation, for example where the costs of travel and subsistence are pooled across a sector.
30. Audit appointments are made by the Auditor General or the Accounts Commission rather than by audited bodies themselves thereby enhancing the independence of external audit. The identity or location of the appointed auditor could therefore affect the total cost of undertaking the audit. We believe that an audited body should, as far as possible, pay the same audit fee irrespective of whether the audit is carried out by an Audit Scotland team or by any of the appointed private firms. We therefore pool some costs such as travel and subsistence and savings from the audit procurement exercise and apportion them between audited bodies within the same sector in proportion to the levels of auditor remuneration.

### Questions on overall principles for fee setting

Q3 Do you agree that audit fees should be set with the objective of recovering the full cost of audit work in each sector? If not what alternative would you suggest?

Q4 Do you agree that an audited body should pay the same fee irrespective of whether the auditor is an Audit Scotland team or any of the appointed private firms? If not what alternative would you suggest?

### Fee ranges

31. We have considered our approach to setting fee ranges. Currently the mid point of the range assumes that the audited body is well governed, has effective internal controls and prepares complete draft accounts to the agreed timetable. As auditing and ethical standards have developed and the nature and extent of internal audit work has evolved, the scope for fees to be agreed significantly below the mid point has diminished.
32. We therefore propose to set an expected fee for each audit, based on the current assumptions about good governance, effective internal control and quality of draft accounts and prior years' actual costs. Audited bodies and auditors would then be allowed to agree fees up to 10 per cent above the expected fee (20 per cent for bodies with auditor remuneration below £20,000); either where local circumstances mean that the implicit assumptions are not being met or where significant local issues require additional audit work. In exceptional circumstances fees could be agreed above the range with the prior agreement of Audit Scotland.
33. Audited bodies and auditors will no longer be able to agree fees below the expected level. However, fee levels are reviewed annually and if the auditor and audited body agree that a permanent reduction in fees is justified then, subject to Audit Scotland agreement, the

expected fee will be adjusted from the following year. In agreeing such a proposal Audit Scotland would consider any potential impact on audit quality.

34. If, exceptionally, the auditor and the body cannot agree a fee then, as now, Audit Scotland will impose a fee having considered the views of each party.

### Question on fee ranges

Q5 - Do you agree with the proposed move to an expected fee with a fee range to cover any additional audit work required? If not what alternative do you suggest?

## Communicating audit fees

35. For each audited body Audit Scotland currently sets a single fee range around a mid point, which combines all the elements that they pay for. Some bodies have suggested that they would like a breakdown of the total charge so that they can see separately the cost of the annual audit work undertaken by their appointed auditor and other items.
36. We agree that a breakdown of the overall fee would increase transparency and help understanding of the fee. This would allow audited bodies to see how their fee is made up and how each component moves over time. We therefore propose that future letters to audited bodies notifying them of their fees should contain the following breakdown:

£	Current year	Prior year
Auditor remuneration	XX,XXX	XX,XXX
Pooled costs	X,XXX	X,XXX
Performance audit & best value (where relevant)	X,XXX	X,XXX
Audit Scotland costs	X,XXX	X,XXX
Total Expected fee	XX,XXX	XX,XXX

37. Details on how each component is calculated is outlined below

### Question on communication of fees

Q6 - Would you find the proposed breakdown of the total fee helpful? Do you have any comments on the individual components? Is there any other information you would find useful?

## Calculating the audit fee

38. We have reviewed the way in which each component of the audit fee is calculated and allocated between bodies.

## Auditor remuneration

39. The auditor remuneration element is based on our assessment of the audit input likely to be required for a body of that size facing the normal risks for its part of the public sector. The fee assumes that the body is well governed, has effective internal controls and prepares complete draft accounts in accordance with the agreed timetable.
40. Since we last reviewed the balance of fees between bodies in each sector there have been a number of changes affecting audits outlined at paragraph 26.
41. Changes in auditing standards mean that, whilst the size of a body is still important in determining the amount of audit work required, the complexity of the body's operations and the nature of the accounting and auditing issues specific to the body have become increasingly important factors. We have received feedback from auditors that, for smaller bodies the required audit work is challenging at the current mid point remuneration, while for some larger bodies the remuneration is more generous.
42. We have therefore reviewed the relative audit fee levels for smaller and larger public bodies in other parts of the UK, and our analysis confirms that current Scottish fees tend to be lower for small bodies and higher for large bodies.
43. We therefore propose to adjust auditor remuneration to better reflect actual experience of the costs of each audit. This is likely to mean reductions for some of the largest bodies and increases for some of the smaller bodies. In most cases we expect to be able to mitigate or eliminate the effect of any increases through cost savings.
44. In the further education sector our experience suggests that fee levels do not reflect the work needed to deliver an effective audit. Where colleges have merged auditors have been encouraged to agree new fees that reflect the full cost of the work required. Where colleges have not merged no adjustment to fees has occurred and we are now proposing to increase those fees to better reflect the work required.

## Pooled costs

45. One of the principles underlying our approach to setting fees is that as far as possible an audited body should pay the same fee irrespective of whether the auditor is an Audit Scotland team or any of the appointed private firms. To achieve this aim we pool certain costs which would otherwise lead to different fees being charged depending on the identity or location of the appointed auditor. These pooled costs are currently apportioned across the audited bodies in each sector in proportion to the expected level of auditor remuneration.

## Travel and subsistence

46. Auditor remuneration reflects the cost of the time estimated to be spent by the auditor in delivering the audit at a local level. It does not include the costs of travel and subsistence incurred by the auditor, which will depend on the location(s) of the audited body and the auditor.

47. External auditors are appointed by the Auditor General or the Accounts Commission and, whilst the location of the auditor's offices are taken into account in constructing portfolios of audit appointments, other factors such as rotation of auditors and conflicts of interest take priority. The 2016/17 budget for auditor travel costs is around £770,000.
48. The impact of pooling these costs is that smaller and more remote bodies bear less of the total cost of travel than if the actual cost was charged directly to each body. For example, an island council contributes around £8,000, whereas the actual costs might be around £27,000.
49. Given that external auditors are appointed by the Auditor General or the Accounts Commission rather than the bodies themselves we consider that the pooling approach is transparent, fair and understandable and propose that it should continue.

### **Procurement savings, recoverable VAT and in house team costs**

50. In the audit procurement exercise auditors bid for work in each sector in the form of discounts against the existing remuneration levels quoted in the tender documents. Each firm can offer different discounts for each sector. After each procurement exercise the auditor remuneration element is reduced by the smallest discount offered in that sector so that this element more closely reflects the actual remuneration of auditors. Any savings above this level are pooled and shared between all audits in the sector in proportion to the level of auditor remuneration. A similar pooling approach is adopted for any difference, positive or negative, between the budgeted full cost of the Audit Scotland teams and the total auditor remuneration for their audits.
51. By taking this approach the financial benefit of the savings arising from the audit procurement exercise is shared between all bodies in a sector. A similar approach is taken to the input VAT recoverable on firms' fees for local government audit.
52. An alternative approach would be to pass the savings or costs directly to the bodies audited by each firm but we consider pooling to be fairest method given that the auditor is not appointed by the audited body and therefore propose to retain it.

### **Performance audit and best value costs (local government)**

53. Local government bodies pay for the cost of all audit work carried out in the sector including national performance audits, best value audits and housing benefit audits. All councils carry out a similar range of services and therefore all can benefit from the recommendations for improvement and good practices identified in best value reports at other councils.
54. For best value audit and housing benefit audit the amount of money received by councils towards the cost of this work is apportioned between the 32 councils only on the basis of relative populations, being a proxy for the distribution of the funding through the local government settlement. We fully recognise that this approach to charging for best value does not reflect the actual costs incurred in relation to each council but believe that it is fair when considering the way in which councils were funded for it. To apportion the best value element on the basis of relative levels of auditor remuneration across all local government bodies

would reduce fees for the largest councils by up to £80,000 but correspondingly increase fees for smaller councils by up to £25,000. Joint Boards and other local government bodies would also see significant percentage increases. Relative populations are currently revised annually. We propose to fix the relative populations for five years at 2015 levels in order to avoid volatility in amounts charged.

55. We considered the impact of the creation of Integration Joint Boards (IJBs) on our approach to fees for best value audit. IJBs currently do not contribute to the cost of best value audit. Our work on health and social care integration has so far been at a national level looking at progress in preparations for integration. We will keep this area under review as IJBs take on their full functions.
56. For performance audit work, including the costs of responding to correspondence from elected representatives and members of the public about issues in local government bodies, the budgeted costs are apportioned between significant local government bodies (councils, IJBs and Strathclyde Passenger Transport) in proportion to the level of auditor remuneration.
57. We consider that these approaches remain fair and reasonable and that the proposed breakdown of audit fees will increase transparency.

### **Performance audit (central government, further education & Scottish Water)**

58. The cost of performance audit work in these sectors is funded from the Scottish Consolidated Fund. We are not proposing any change to this arrangement and therefore fees for these sectors do not include any element relating to the cost of performance audit work.

### **Performance audit (NHS)**

59. As described in the section on Funding we are considering options for the future funding of NHS performance audit work. The part of the current cost of NHS performance audit work recovered through fees is included in the overall fee in a way which results in mainland territorial boards bearing most of the cost with island and special boards bearing relatively little of the cost. If the current funding approach continues we propose to apportion the cost of performance audit work between all territorial NHS Boards relative to the levels of auditor remuneration.

### **Audit Scotland costs**

60. Audit Scotland incurs costs in making audit appointments, providing assurance on audit quality, providing technical guidance and support to all appointed auditors and contributing to the development of auditing and accounting guidance within Scotland and across the UK. These costs are apportioned across all audits relative to the level of auditor remuneration.

### **Questions on the calculation of fees**

Q7 - Do you agree that Audit Scotland should continue to pool costs as described above and apportion them among audited bodies on the basis of relative levels of auditor remuneration? If not what alternative do you suggest?



Q8 - Do you agree that councils should continue to contribute to the cost of best value audit work on the basis of their relative populations? If not what alternative do you suggest?

Q9 - Do you agree with the approach to sharing the cost of local government performance audit work between significant bodies on the basis of relative levels of auditor remuneration? If not what alternative do you suggest? Do you have any comments on the approach to sharing the cost of NHS performance audit work if the current funding arrangement continues?

Q10 - Do you have any other comments on Audit Scotland's approach to setting fees overall or at any specific audited body?

# Next steps

61. This consultation forms an important part of the overall review process and we welcome your input to inform the final outcome. The next steps are:

Step	Date
Consultation responses received	August 2016
Preparation of 2017/18 financial year budget and final proposals for 2016/17 audit fees	July - September 2016
Submission of 2017/18 budget to Scottish Commission for Public Audit	September 2016
Evidence session with SCPA	October 2016
Issue 2016/17 fee letters to audited bodies	November 2016

# Annex 1

## List of consultation questions

### Questions on funding our work

Q1 - Do you have any comments on the overall approach to funding the work of Audit Scotland?

Q2 - Do you have any views on the future funding of NHS performance audit work?

### Questions on overall principles for fee setting

Q3 Do you agree that as far as practicable all audited bodies should pay for the full cost of the direct annual audit work required at each body? If not what alternative would you suggest?

Q4 Do you agree that as far as practicable an audited body should pay the same fee irrespective of whether the auditor is an Audit Scotland team or a private firm? If not what alternative would you suggest?

### Questions on communication of fees

Q5 - Do you agree with the proposed move to an Expected fee with a fee range reflecting any additional audit work required? If not what alternative do you suggest?

Q6 - Would you find the proposed breakdown of the total fee helpful? Do you have any comments on the individual components? Is there any other information you would find useful?

### Questions on the calculation of fees

Q7 - Do you agree that Audit Scotland should continue to pool costs as described above and apportion them between audited bodies on the basis of relative levels of auditor remuneration? If not what alternative do you suggest?

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Q9 - Do you agree with the approach to sharing the cost of local government performance audit work between significant bodies on the basis of relative levels of auditor remuneration? If not what alternative do you suggest? Do you have any comments on the approach to sharing the cost of NHS performance audit work if the current funding arrangement continues?

Q10 - Do you have any other comments on Audit Scotland's approach to setting fees overall or at any specific audited body?