Scottish Government

Assurance and Audit Committee

Progress update

Prepared for Scottish Government Assurance and Audit Committee

September 2017

Introduction

1. This report provides the Scottish Government Assurance and Audit Committee with an update on the progress of external audit work as at 21 September 2017.

Scottish Government annual audit 2016/17

2. We received the unaudited schedules for the core Scottish Government portfolios on 8 June 2017 and the unaudited consolidated accounts on 28 July 2017, both in line with the agreed audit timetable.

3. Our work on the financial statements is now substantially complete. Issues arising from our audit work were raised and discussed with the Scottish Government Finance Directorate and Health Finance on a regular basis during the course of the audit. An audit clearance meeting was also held with the Chief Financial Officer on 4 September 2017.

4. International Standard on Auditing (UK and Ireland) 260 (ISA 260) requires auditors to report specific matters arising from the audit of the financial statements to those charged with governance. Our draft annual report on the 2016/17 audit is provided as a separate paper (Appendix A) and identifies significant findings from the financial statements audit. We are awaiting management responses to be included in the Action Plan within the report. The report will be issued in final form after the financial statements are certified.

5. Following receipt of a signed set of accounts for final review and the letter of representation from the Principal Accountable Officer, the Auditor General will issue the auditor's report on the financial statements.

6. To support the Scottish Parliament in its important scrutiny role of public finances in Scotland, the Auditor General is preparing a report on the 2016/17 consolidated accounts which will be laid in the Scottish Parliament with the audited accounts. The draft report is provided as a separate paper (Appendix B) and will be issued in final form after the financial statements are certified. The Auditor General will present the report to the Public Audit and Post-legislative Scrutiny Committee on 5 October 2017.

Scottish Consolidated Fund 2016/17

7. Our audit work on the SCF financial statements is now substantially complete. The issues arising from the audit were discussed with the Scottish Government Finance Directorate. Our draft annual audit report on the 2016/17 audit is provided to SGAAC members for information (Appendix C). There are no matters arising from our audit of the Fund that we wish to escalate formally to the members of the Committee. We are awaiting management responses to be included in the Action Plan within the report. Our annual audit report will be issued in final form after the financial statements are certified.

8. Following receipt of a signed set of accounts for final review and the letter of representation from the Principal Accountable Officer, the appointed auditor (Stephen Boyle) will issue the auditor's report on the financial statements.

Non-Domestic Rating Account 2016/17

9. We are approaching the conclusion of our audit of the 2016/17 NDR account. Our work so far has highlighted concerns about the overall financial position of the NDR account. The draft account submitted for audit shows an accumulated deficit balance of £296.6 million having increased to this level over the past three financial years. Our concern centres on the future sustainability of the operation of the account and how the Scottish Government plans to address the deficit. Similarly, we are concerned about the wider implications of this for the development and agreement of future Scottish budgets.

10. Given the nature of our concerns the Auditor General is considering preparing a separate statutory report to the Scottish Parliament following the conclusion of the annual audit. The issues arising from the audit were discussed with the Scottish Government Local Government Finance Directorate. In addition, we are meeting with DG Organisational Development and Operations on 3 October 2017 to discuss further.

National performance audits

11. On 27 July 2017, the Auditor General published a report on NHS workforce planning. The report is the first part of a two-stage audit on workforce planning in the NHS in Scotland and focuses on clinical staff in hospitals and other secondary care settings. The Auditor General presented the report to the Public Audit and Post-legislative Scrutiny Committee on 21 September 2017.

12. On 24 August 2017, the Auditor General and Accounts Commission published a joint report on self-directed support. The report provided an update since the previous report published in June 2014 on progress in implementing SDS to achieve the aims of the ten-year strategy. In addition, the report makes a number of recommendations for the Scottish Government, local authorities and NHS boards to consider. The Controller of Audit will provide a briefing on the report to the Public Audit and Post-legislative Scrutiny Committee on 28 September 2017.

13. In October 2017, we will publish a performance audit on Ferry Services in Scotland (19 October) and our annual NHS overview report, NHS in Scotland 2017 (26 October).

Conclusion

14. The Assurance and Audit Committee is asked to note this report.

Appendix A: Scottish Government: Annual Audit Report 2016/17

Appendix B: The 2016/17 audit of the Scottish Government Consolidated Accounts

Appendix C: Scottish Consolidated Fund: Annual Audit Report 2016/17

Scottish Government

2016/17 Annual Audit Report

AUDIT SCOTLAND

Prepared for the Scottish Government and the Auditor General for Scotland

September 2017

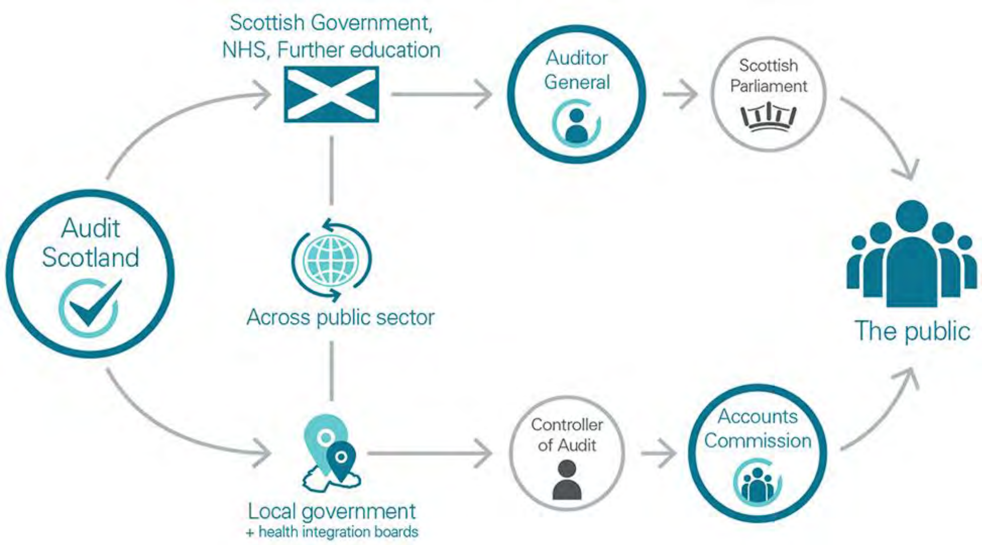
Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- The Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.

- The Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.

- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.



About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money

- reporting our findings and conclusions in public

- identifying risks, making clear and relevant recommendations.

Contents

Key messages

Audit of the 2016/17 financial statements

1 **The financial statements of the Scottish Government give a true and fair view of the financial position and its net expenditure.**

2 **The expenditure and income in the financial statements were incurred or applied in accordance with any applicable enactments and guidance.**

3 **The other information in the annual report and accounts was consistent with the financial statements and prepared in accordance with legal requirements.**

Financial management

4 **We concluded that the Scottish Government had effective overall management of the 2016/17 budget.**

5 **Systems of internal control operated effectively in 2016/17 with a small number of weaknesses identified from our work.**

Financial sustainability

6 **We concluded that the Scottish Government has adequate financial planning arrangements in place.**

7 **Medium to long term financial planning is of increasing importance given the new financial powers and is currently in development.**

Governance and transparency

8 **The Scottish Government has introduced new governance arrangements during the year and these remain in development. It is too early to comment on their effectiveness.**

Value for money

9 **Further developments in relation to performance management and monitoring are required by the Scottish Government to better demonstrate their own performance and contribution to outcomes over the medium term.**

Introduction

1. This report is a summary of our findings arising from the 2016/17 audit of the Scottish Government.

2. The scope of our audit was set out in our Annual Audit Plan presented to the March 2017 meeting of the Scottish Government's Assurance and Audit Committee. This report comprises:

- an audit of the annual report and accounts
- consideration of the wider dimensions set out in the *Code of Audit Practice 2016* as illustrated in Exhibit 1.

Exhibit 1
Audit dimensions

Source: Code of Audit Practice 2016

3. The main elements of our audit work in 2016/17 were:

- an interim audit of the Scottish Government's main financial systems
- an audit of the Scottish Government's 2016/17 annual report and accounts including the issue of an independent auditor's report setting out our audit opinions.

4. The Scottish Government is responsible for preparing financial statements that give a true and fair view, the accuracy of other information in the annual report and accounts, and establishing effective arrangements for governance, propriety and regularity that enable the Executive Board to successfully deliver its objectives.

5. Our responsibilities as independent auditor are established by the Public Finance and Accountability (Scotland) Act 2000 and the *Code of Audit Practice 2016*, supplementary guidance and, guided by the auditing profession's ethical guidance.

6. These responsibilities include giving independent opinions on the financial statements, regularity, the remuneration and staff report, the performance report and the governance statement. We also review and report on the arrangements within the Scottish Government to manage its performance, regularity and use of resources. In doing so, we aim to support improvement and accountability.

7. Further details of the respective responsibilities of management and the auditor can be found in the *Code of Audit Practice 2016* and supplementary guidance.

8. The weaknesses or risks identified in this report are only those that have come to our attention during our normal audit work, and may not be all that exist. Also, our annual audit report contains an action plan at Appendix 1 (page 31). It sets out specific recommendations, responsible officers and dates for implementation.

9. Communication of matters arising from the audit or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

10. As part of the requirement to provide fair and full disclosure of matters relating to our independence, we can confirm that we have not undertaken non-audit related services. The 2016/17 audit fee was set out in our Annual Audit Plan and as we did not carry out any work additional to our planned audit activity, the fee remains unchanged.

11. This report is addressed to both the Executive Board and the Auditor General for Scotland and will be made available on Audit Scotland's website www.audit-scotland.gov.uk.

12. We would like to thank all management and staff who have been involved in our work for their cooperation and assistance during the audit.

Part 1

Audit of 2016/17 financial statements

Main judgements

Our audit opinions are all unqualified. These covered the financial statements, regularity of transactions, remuneration and staff report, performance report and governance statement.

Unqualified audit opinions

13. We reported, within our independent auditor's report:

- an unqualified opinion on the financial statements;
- an unqualified opinion on regularity of expenditure and income; and
- an unqualified audit opinion on the remuneration and staff report, performance report and governance statement.

14. Additionally, we are satisfied that there are no matters which we are required by the Auditor General to report by exception. In line with recent years, the Auditor General will present a separate, statutory report on the 2016/17 Scottish Government audit to the Scottish Parliament's Public Audit and Post-legislative Scrutiny Committee.

The annual report and accounts are the principal means of accounting for the stewardship of its resources and its performance in the use of those resources.

Submission of annual report and accounts for audit

15. We received the unaudited core schedules on 8 June 2017 and the first version of the unaudited consolidated accounts on 28 July 2017 in line with our agreed audit timetable.

16. Further presentational changes were made this year to the accounts as part of the Scottish Government's developing financial reporting programme. The revised presentation improved the accounts. For example, changes made to the portfolio outturn statements should help the readers' understanding of portfolios' financial performance and information on NHS non-current assets is reported separately for the first time.

17. A complete Governance Statement was received separately on 25 August 2017 as a result of the internal process and timetable for its preparation and approval. We understand preparing the Governance Statement presents challenges in obtaining the necessary assurances from across the Scottish Government. The Governance Statement is a key component of the Government's consolidated accounts. There is a risk that there is insufficient time for audit to review, and form an independent opinion, on the Governance Statement in line with the Government's own timetable for finalising its annual report and accounts. The timetable should be revised next year to ensure a complete Governance Statement is submitted as part of the unaudited accounts.

Action Plan point 1 (Appendix 1)

18. Scottish Government finance encountered challenges in preparing the Consolidated Statement of Cash Flows due to inconsistencies between audited consolidation packs and audited cash flow data. The Scottish Government has plans in place to review its processes for the preparation of this statement in 2017/18.

19. The working papers provided in support of the accounts were of a satisfactory standard. The Scottish Government staff provided good support to the audit team and we substantially completed our audit on 1 September 2017.

Whole of Government Accounts

20. The draft Whole of Government Accounts (WGA) pack was provided to audit in August in accordance with the audit timetable. In accordance with the WGA guidance we plan to complete the required assurance statement and submit it to the National Audit Office (NAO) by the 30 September 2017 deadline.

Risk of material misstatement

21. Appendix 2 (page 35) provides a description of the risks of material misstatement that were identified and assessed during the planning process. These risks had the greatest effect on the overall audit strategy, the allocation of resources to the audit and directing the efforts of the audit team.

Materiality

22. Materiality defines the maximum error that we are prepared to accept and still conclude that our audit objective has been achieved. The assessment of what is material is a matter of professional judgement. It involves considering both the amount and nature of the misstatement.

23. Our initial assessment of materiality for the annual report and accounts was undertaken during the planning phase of the audit and is summarised in Exhibit 2. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

24. On receipt of the annual report and accounts we reviewed our original materiality calculations and concluded that they remained appropriate.

Exhibit 2
Materiality values

Materiality level	Amount
Overall materiality – This is the calculated figure we use in assessing the overall impact of audit adjustments on the financial statements. It was set at one per cent of total outturn for the year ended 31 March 2017.	£338 million
Performance materiality – This acts as a trigger point. If the aggregate of errors identified during the financial statements audit exceeds performance materiality, this would indicate that further audit procedures should be considered. Using our professional judgement we have calculated performance materiality at 20 per cent of overall materiality. Given the specific nature of the Scottish Government audit and the lower materiality levels in respect of individual errors identified, we apply judgement and consider the nature and circumstances of each error identified. Therefore, in practice, we work to much lower materiality levels and any individual error in the range £10 million to £20	£68 million

Materiality level	Amount
million and above may be material depending on its nature and impact.	
Reporting threshold – We are required to report to those charged with governance on all unadjusted misstatements in excess of the 'reporting threshold' amount. This was calculated at one per cent of overall materiality but capped at £0.1 million.	£0.1 million

Source: Audit Scotland

Evaluation of misstatements

25. A number of presentational and monetary misstatements were identified during the audit. These were discussed with senior finance officials who agreed to make the necessary adjustments.

26. Gross monetary misstatements for the Scottish Government core, in excess of the 'reporting threshold' amount (£0.1 million) totalled £95.71 million. The significant adjustments that make up this balance are:

- £48 million adjustment for the incorrect discount rate being applied to the student loans model. A rate of 0.7 per cent should have been applied and not 2.2 per cent (Exhibit 3, point 4). This decreased net assets.
- £14 million relating to the payment of the European Structural Funds self-correction provision due. The self-correction payment was incorrectly accounted for under 'provisions not required written back' instead of 'provisions utilised in year'. No impact on net assets.
- £15 million relating to a mis-posting in the cash advances figures of the Financial Assets note. The mis-posting arose due to use of an incorrect account code. No impact on net assets.
- £7m reclassification of financial assets revaluation to outturn to fair value adjustments. No impact on net assets.

27. These were corrected and the overall effect was to increase comprehensive net expenditure by £53.25 million and decrease net assets by the same amount. All adjusted misstatements for NHS boards and executive agencies are reported in the annual audit reports of these bodies.

28. We are required to report to those charged with governance all unadjusted misstatements which we identified during the course of our audit, other than those of an insignificant small amount. The total of unadjusted misstatements identified during the audit was £23.08 million (gross). Of which:

- £3.33 million related to the Scottish Government core financial statements and
- £19.75 million related to the NHS boards.

29. If these adjustments were made, the potential net impact would be to reduce total comprehensive net expenditure in the Scottish Government consolidated accounts by £7.5 million and increase net assets by £7.5 million. There were no unadjusted misstatements in excess of £0.1 million for the executive agencies.

30. The total value of adjustments exceeds our performance materiality level of £68 million and we have considered the implications of this for our audit. The largest adjustment of £48 million was due to the incorrect discount rate being applied to the student loans model. In our judgement as the student loan adjustment was 40 per cent of the total adjustments there was no overall impact on our audit approach.

31. Appendix 3 (page 41) details the unadjusted misstatements for the Scottish Government core and their expected impact on the consolidated accounts. The individual unadjusted misstatements for NHS boards and executive agencies can be found in their respective annual audit reports.

Significant findings from the audit

32. International Standard on Auditing (UK and Ireland) 260 requires us to report significant findings from the audit. These are summarised in Exhibit 3. Where a finding has resulted in a recommendation to management, a cross reference to the Action Plan in Appendix 1 (page 31) has been included.

Exhibit 3

Significant findings from the audit of financial statements

Issue	Resolution
1. European Structural Funds (ESF) The Scottish Government's closure work on the 2007-13 programmes identified that the Scottish Government had overpaid project sponsors approximately £16 million as a result of internal audit findings. As a result, subsequent penalties were applied to the project sponsors. As at 31 March 2017, the Scottish Government had identified this debt but had not made a decision whether it should be recovered. No disclosures were made in the unaudited accounts about this activity. If the Scottish Government does not pursue this debt, there is a risk that the European Commission takes a view that this money is out-with their approved state aid schemes and applies state aid penalties which could be an additional cost to the Scottish Government.	The Scottish Government has started to raise invoices for this debt. The recovery still remains uncertain as amounts may be subject to appeal. Since there is uncertainty about the full recovery of this debt, we recommended that the Scottish Government recognise it as a contingent asset. The Scottish Government amended the Consolidated Accounts to include a contingent asset but it does not quantify an amount. Action Plan point 2 (Appendix 1)
2. Common Agricultural Policy (CAP) Futures The Scottish Government commissioned an independent technical assurance review in December 2016 to help assess the capability and stability of parts of the Future rural payments system. In the Consolidated Statement of Financial Position, an amount of £124 million was capitalised as an intangible asset for CAP Futures with no impairment of the asset. The technical assurance review was used to inform an impairment review of the system. The Scottish Government is working with the review's authors and CGI (the main supplier of software) to develop an action plan and to determine the value of investment needed to address the issues	We have accepted the review's conclusion that no impairment is required on the basis that the Scottish Government plan to do another review in 2017/18 taking into consideration the remedial actions as a result of the technical assurance review. The implications for the future of the system as a result of the UK leaving the European Union may be clearer at this time.

Issue	Resolution
highlighted in the report. The lack of system documentation makes it difficult to judge how the system should be working and what the system could offer until this system documentation exercise is completed in 2017/18.	
3. Common Agricultural Policy (CAP) contingent liability disclosures The draft consolidated accounts issued for audit did not include any contingent liability disclosures relating to the Common Agricultural Policy programme. We are aware through Scottish Government reports to the Scottish Parliament that the Government missed an extended payment deadline for the 2015 payments. The exact amount of Scotland's share is still to be negotiated and agreed with the UK Government and therefore is too uncertain to quantify in the 2016/17 Consolidated Accounts. We are also aware that the Scottish Government is awaiting correspondence from the European Union in relation to a number of audits: Voluntary Coupled Support Beef 2016, Desk audit of National Reserve, Rural Development Land based measures and the accreditation findings from the external auditors findings reported to Europe. It is unclear if these audit reports will result in potential disallowances.	The revised Scottish Consolidated accounts include a contingent liability covering both the penalty in relation to the missed extended deadline and potential disallowances following European Commission audits that are still to be negotiated and agreed.
4. Student loans We queried the rate used in the cost of capital calculation for student loans which assesses the future value of loans at current price levels. The calculations are informed by a model which holds data on demographic and behavioural characteristics of students to predict borrowing behaviour and estimate the likely repayments of loans. The Scottish Government confirmed that it should have used the HM Treasury discount rate of 0.7 per cent instead of 2.2 per cent.	We reviewed and confirmed the correct rate to apply was 0.7 per cent. We also reviewed the accounting adjustments made by the Scottish Government which decreased investments by £48 million. This was met from the Annual Managed Expenditure (AME) budget and therefore did not impact on the spending power in other areas of the Scottish budget.
5. Gender analysis The FReM requires an analysis of the number of persons of each sex who were directors, senior civil servants and employees to be reported. This analysis is not reported in the consolidated accounts because this information was not captured by the consolidation packs submitted by consolidated bodies.	This disclosure is not within the auditable part of the remuneration and staff report. The Scottish Government will review the arrangements in place to collect the gender analysis data in 2017/18. Action Plan point 3 (Appendix 1)

Issue	Resolution
6. Transport Scotland – valuation of road network The valuation of the trunk road network is based on interim valuation data contained within the roads asset valuation system (RAVS). Once the final valuation data is available there is a need to adjust the financial statements of Transport Scotland to reflect the movement between the interim and final data sets. In 2016/17 the impact of the movement was a £144.7 million increase in the net book value of the trunk road network. This included an increase of £158.6 million in revaluations netted off against a reduction of £9.8 million in detrunkings and £4.1 million of historic adjustments.	Transport Scotland's audited 2016/17 financial statements have been adjusted to reflect the final valuation which is therefore also reflected in the Scottish Government consolidated accounts.

Source: Audit Scotland

Other findings

33. Our audit identified a number of presentational and disclosure issues which were discussed with management. These were adjusted and reflected in the audited financial statements.

Part 2

Financial management

Main judgements

The Scottish Government managed the overall budget for 2016/17 effectively.

Systems of internal control operated effectively in 2016/17 with a small number of weaknesses identified from our work.

There was good engagement with the National Fraud Initiative exercise at this early stage but improvements to the approach can be made.

Financial performance in 2016/17

34. The main financial objective for the Scottish Government is to ensure that the financial outturn for the year is within the budget authorised by Scottish Parliament.

35. The Scottish Government reported an outturn of £33,870 million, therefore remaining within its overall budget for 2016/17 with an underspend of £85 million. The financial performance against budgets is shown in Exhibit 4.

Exhibit 4

Performance against budgets in 2016/17

Performance	Final budget £m	Actual outturn £m	Overspend/ (underspend) £m
Resource	31,890	31,862	(28)
Capital	2,065	2,008	(57)
Total	33,955	33,870	(85)

Source: Scottish Government Consolidated Accounts and Budget Documents

36. The Scottish Budget consists of the Scottish Block Grant determined within the framework of public expenditure control in the United Kingdom and other sources of income, mainly Non-Domestic Rates, funding connected with European programmes of financial assistance and receipts from the devolved taxes. The Block Grant is calculated using the Barnett formula which adjusts the grant on the basis of a population share of changes in comparable programmes of expenditure in the rest of the UK. This is then adjusted for the devolved taxes and forecast amounts from the Scottish Rate of Income Tax. The UK Parliament votes the necessary provision to the Secretary of State for Scotland who makes grants to the Scottish Government into the Scottish Consolidated Fund.

37. The Scottish Parliament approves the resources to be used by all bodies whose expenditure is payable out of the Scottish Consolidated Fund by passing the annual Budget Act. The majority of the Scottish Budget relates to spending programmes and administration costs covered by the Scottish Government consolidated accounts, but amounts are also allocated to other parts of the Scottish Administration and directly-funded bodies.

38. The Scottish Government is required to manage overall spending within both the Scottish Budget and UK Treasury limits. The consolidated accounts reflect the areas that it is directly responsible and accountable for. They include spending against the relevant components of the Scottish Budget. Separate accounts are prepared by other bodies to reflect their own accountability to Parliament.

39. Budget management during 2016/17 was effective in managing overall spending against the Scottish Budget. The Scottish Government operated within its budget, resulting in an overall underspend of £85 million (0.25 per cent of final budget) – resource by £28 million and capital by £57 million.

Financial management is about financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

40. High-level information on variances in each portfolio is shown in the accounts. This, for example, shows that Health and Sport overspent by £112 million which was largely the result of a change in discount rate used to assess legal claims against NHS boards creating additional non-cash costs. The largest portfolio underspend (£62 million) was in Communities, Social Securities and Equalities. The underspend primarily related to capital spending in housing. Higher than expected levels of capital receipts (£43 million compared to a forecast of £10 million) were received which was offset against spending. In addition, spending on the Infrastructure Loan Fund established in 2016/17 was lower than planned as it relies upon sites becoming available from councils and private developers.

Internal controls

41. As part of our audit we identify and inspect the key internal controls in the accounting systems which we regard as significant for the production of the financial statements. Our objective is to gain assurance that the Scottish Government has systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.

42. Our findings were included in an interim audit report presented to the Scottish Government Assurance and Audit Committee on 22 June 2017. We concluded that the controls were operating effectively. No significant internal control weaknesses were identified during the audit which could affect the Scottish Government's ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

43. We identified an overpayment from our earlier work on staff leavers and we reported the risk in our interim report. We undertook further audit work on the payroll system to ensure our sample testing covered the full financial year. As part of this work we found that one of the leavers tested received an overpayment of £986.80. This demonstrates weaknesses both in the notification of leavers to payroll and also in the identification of overpayments. Our full year's sample therefore contained two overpayments out of a sample of 32. Good practice is for the line manager to notify payroll of a leaver once resignation is received rather than after the leaving date, to prevent an overpayment. This recommendation was included in our interim report presented to the Scottish Government Assurance and Audit Committee on 22 June 2017.

44. Our testing of European Structural Funds (ESF) involved a review of project documentation to verify the closing balance of projects and payments to and from the European Commission. Within the sample tested, examples were identified where the Scottish Government managing authority team started a review of a project claim but did not complete it until the following year, by which point, the final payment had been made. The Scottish Government's review of project claims is a key control in the management of EU funding. In our sample, this meant the Scottish Government overpaid the project sponsor as errors were identified from internal audit findings or management review. The Scottish Government review of project claims classified gaps in documentation as audit trail errors. Yet when these project claims were audited, the gaps in documentation were identified as procurement errors which attract higher penalties from the European Commission.

Action Plan point 4 (Appendix 1)

45. Our work on receivables identified a number of balances that had been written off substantially later than we would have expected. For example two balances were written off in 2016/17 in relation to companies who had stopped trading in 2009 and 2012 respectively which indicates a lack of timely review of aged debt. Our work also identified a number of receipts which were unallocated as they could not be matched to invoices.

46. In addition, our work on European Structural Funds identified a number of invoices that had been cancelled using credit memos with a view to raising new invoices. However, no new invoices were raised. We were advised the debt was still being pursued therefore the credit memo meant the receivables balance was understated. Management agreed to adjust the accounts in relation to this issue. However, the use of credit memos in this way is contrary to good practice. Together, these issues highlight that the Scottish Government should ensure effective debt management processes are in place.

Action Plan point 5 (Appendix 1)

Prevention and detection of fraud and irregularity

47. We assessed the Scottish Government's arrangements for the prevention and detection of fraud. Our audit work covered reviews of the Scottish Government's Fraud Policy, Counter-Fraud Strategy, Whistleblowing Policy and its Annual Fraud Report and how these arrangements are communicated across the organisation.

48. We concluded that the Scottish Government is proactive in promoting fraud awareness and had appropriate and adequate arrangements in place for fraud detection and prevention during 2016/17.

National Fraud Initiative

49. The National Fraud Initiative (NFI) in Scotland is a counter-fraud exercise coordinated by Audit Scotland. It uses computerised techniques to compare information about individuals held by different public bodies, and on different financial systems, to identify 'matches' that might suggest the existence of fraud or error (Exhibit 5).

Exhibit 5

Total number of matches	Number recommended for investigation	Completed/closed investigations

3,689

800

861 (of which 788 were recommended matches)

Source: NFI FMS as at September 2017

50. The Scottish Government participates in the biennial NFI exercise through uploads of payroll and accounts payable data. The data submitted by the Scottish Government covers of all those bodies which use its payroll and accounts payable shared services in addition to its own operations.

51. We reviewed the Scottish Government's progress during 2016/17 in investigating data matches. As with the previous NFI exercise, good progress had been made investigating the accounts payable matches with slower progress in investigating recommended payroll matches due to resourcing pressures. No progress had been made on investigating the procurement matches at the time our review was undertaken in June 2017. As at September 2017, investigation of procurement matches remains outstanding.

52. The Scottish Government should consider a more joined-up approach with a central NFI contact responsible for co-ordinating match investigation work and ensuring that results are reported and disseminated across the Scottish Government.

Action Plan point 6 (Appendix 1)

Standards of conduct and arrangements for the prevention and detection of bribery and corruption

53. We reviewed the arrangements in place to maintain standards of conduct including the Staff Handbook and Civil Service and Members' Codes of Conduct. There are established procedures for preventing and detecting any breaches of these standards including any instances of corruption.

54. The Scottish Government has adopted the Integrity model as recommended by Police Scotland for public sector bodies to improve the prevention of and response to fraud, bribery, corruption and wrongdoing. The Integrity Group has a broader remit than the Counter Fraud Group, its predecessor. The Group is responsible for improving fraud prevention measures across corporate services within the Scottish Government as well as monitoring relevant cases of suspected external and internal wrongdoing made through formal reporting lines. We will review the arrangements and remit of this group as part of our work in planning the 2017/18 audit.

55. Based on our review of the evidence we concluded that the Scottish Government has appropriate arrangements in place for the prevention and detection of bribery and corruption. We are not aware of any specific issues that require inclusion within this report.

Part 3

Financial sustainability

Main judgements

There are no significant concerns about the overall financial position of the Scottish Government.

Medium to long-term financial planning is of increasing importance given the implementation of new financial powers and is currently in development.

The Scottish Government needs to implement longer-term solutions to ensure it has the staff and skills in place to deliver its current priorities and new responsibilities.

Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.

2016/17 financial position

56. The Statement of Financial Position summarises what is owned and owed by the Scottish Government. This shows taxpayers' equity – an accounting measurement of the amount invested that has continuing public benefit. It shows how much of this has arisen from the application of revenues and that which has resulted through changes over time in the value of physical assets.

57. The Statement of Financial Position includes:

- items which are owned, have already been funded from revenues and will provide continuing economic benefit in future periods. These increase taxpayers' equity.
- items which are owed and expected to require to be funded from future revenues. These decrease taxpayers' equity.
- an analysis between amounts that will release or require funding within a year and those which will be carried into future years.

58. The financial statements show that the Scottish Government has net assets of £31,171 million, an increase of £990 million from 2015/16 largely attributable to increased valuations in financial investments and property, plant and equipment.

59. There are no significant concerns about the overall financial position. The performance report (which forms part of the annual report) includes a commentary on the statement of financial position and its components.

Financial planning

60. The Scottish Government published its 2017/18 draft budget in December 2016. This included a resource allocation of £32,128.9 million which is £2,565 million (2.5 per cent) more than the initial 2016/17 budget allocation.

61. The Scottish Government plans to use its full capital borrowing allowance for the year of £450 million (an increase from £333 million in 2016/17). Amounts carried forward from 2016/17 will also be used to support 2017/18 budget commitments. For example, the financial transactions budget has a carry forward of £53.5 million from 2016/17. Financial transactions are used to make loans or equity investment but must be repaid in future years. The financial transactions budget will therefore be critical to any loan initiative the Scottish Government may choose to offer to farmers during 2017/18.

62. The Scottish Rate of Income Tax forecast for 2017/18 is £11,858 million compared to £4,900 million in 2016/17. This is due to the Scottish Government's tax powers extending as part of the Scotland Act 2016 to cover all non-saving non-dividend income tax, the rates and bands of which have been set by the Scottish Ministers.

63. The importance of medium to long-term financial planning cannot be understated particularly given the increase in uncertainty that new borrowing and tax powers bring to the Scottish Government's budget. The Scottish Government will need a different approach to budget management, moving away from an in-year, annually managed approach; to a longer term multi-annual approach using the new tools at their disposal to smooth variations in budgets from internal and external factors. Further details on Scottish Government plans in this area are outlined at paragraphs 82-85.

64. The Scottish Budget is now intrinsically linked to the performance of the Scottish economy relative to the performance of the rest of the UK's economy. If the Scottish economy performs better to the rest of the UK economy, then Scotland retains any surplus in devolved taxes receipts compared to the block grant adjustment applied.

65. The performance of the Scottish economy is also influenced by macro economic policies set by the UK as well as taxpayer's behaviour as a result of tax policies set and applied in Scotland, which in turn also impacts the Scottish Budget. The Scottish Government needs to ensure it has good scenario planning in place taking all these factors into account, when setting budgets to support fiscal decisions such as the level of borrowing.

66. To help the Scottish Government manage any shortfalls in budget, from 2017/18 the Scottish Government can also borrow to support revenue spending. The annual limit for resource borrowing for 2017/18 is £600 million to be used where there is a shortfall in tax receipts or a forecast error.

Devolved taxes

67. The 2016/17 financial year was the first year that all three devolved tax powers from the Scotland Act 2012 were fully implemented. The Scottish Government prepared forecasts for Land and Buildings Transactions Tax (LBTT) and Scottish Landfill Tax (SLfT) revenues for inclusion in the draft budget, while a Scottish Rate of Income Tax (SRIT) was set for the first time.

68. The Scottish Fiscal Commission (SFC) was responsible for providing independent scrutiny of the Scottish Government's tax forecasts. For 2016/17, the SFC assessed the forecasts for LBTT and SLfT as reasonable based on the data available. The amounts raised from LBTT and SLfT in 2016/17 were £484 million and £149 million respectively. This was £38 million less than the total £671 million forecast as part of the 2016/17 budget. The Forecast Evaluation Report published by the SFC in September explains that forecasts for LBTT are influenced by transactions and house price forecasts. The SFC reported that variances were due to overestimating the house price forecast within the LBTT forecast; and for SLfT underestimating the level of standard rated waste which led to higher receipts than forecast.

69. As with any forecast, actual amounts are likely to differ from those predicted. For example, in 2015/16, tax receipts from LBTT and SLfT were £74 million higher than forecast. This additional income was transferred to a cash reserve designed to help offset any future shortfalls between forecast amounts and income received. In 2016/17, the Scottish Government managed its £38 million shortfall from LBTT and SLfT through underspends in its overall budget, therefore the cash reserve balance remains at £74 million. From 1 April 2017, this balance transferred to the Scotland Reserve in line with Scotland's Fiscal Framework agreement. Any surplus or shortfalls in the budget will now need to be met from the Scotland Reserve.

70. In March 2017, we reported in our Managing new financial powers update that the Scottish Government urgently needs to finalise policies and principles for capital and revenue borrowing and reserves, and further develop its longer-term financial scenario planning. Making these publicly available will enhance financial transparency and help demonstrate good public financial management.

71. From 1 April 2017, forecasts for Non-domestic rates income and devolved tax powers will be provided by the Scottish Fiscal Commission. Forecasts will be produced at least twice a year, at the same time as the Scottish Government publishes its draft budget and introduces the Budget Bill to the Scottish Parliament. This will introduce greater independence and challenge to the Scottish Government's forecasts which underpin its budget proposals and longer-term spending plans.

Capital borrowing

72. The treatment of Private Finance Initiative, Public Private Partnership and Non-Profit Distributing (NPD) investment projects in the Consolidated Accounts is based on accounting standards. The Scottish Government has applied the correct accounting treatment and such projects are generally treated as 'on-balance sheet' capital investment in the accounts.

73. In July 2015, the Office for National Statistics decided that the Aberdeen Western Peripheral Route, which was a Scottish NPD investment project, (AWPR) should be classified as a public sector project in the National Accounts. In accordance with HM Treasury Consolidated Budgeting Guidance, budget treatment of these projects is determined by their position in the National Accounts. In November 2016, the ONS confirmed a similar classification for three further projects (Edinburgh Sick Kids Hospital, Dumfries & Galloway Royal Infirmary and the National Blood Centre). This classification means that capital budget cover is required at the point of initial investment, rather than revenue budget cover for the annual payments over the lifetime of the contract.

74. This resulted in charges against fiscal DEL budgets which required to be managed within budget limits. This meant that spending plans had to accommodate NPD expenditure within overall annual budget limits. In both 2015/16 and 2016/17, the Scottish Government agreed with HM Treasury that it could record these amounts against its capital borrowing limit. In 2016/17, the Scottish Government used its total capital borrowing limit of £333 million for this purpose. Although this did not result in actual borrowing, it removed the Scottish Government's power to borrow for capital purposes in 2016/17.

75. Looking ahead the draft Scottish budget estimates further capital spending of £190 million for these four projects in 2017/18. In March 2017, HM Treasury informed the Scottish Government that any capital pressures arising from NPD projects as a result of the ONS classification would have to be absorbed within capital DEL limits with capital borrowing powers to be used as intended. The additional capital borrowing powers introduced in 2017/18 from the Scotland Act 2016 provides the Scottish Government with more flexibility in responding to spending pressures across its capital programme.

CAP loan schemes

76. In our annual audit plan, we highlighted potential risks to the financial transactions budget as a result of loan schemes created to ensure farmers received money as a result of delays to Common Agricultural Policy subsidy payments. The Scottish Government established two loan schemes during 2016/17 to help farmers and rural businesses receive money more quickly. The loans were funded from the Scottish Government's financial transactions budget which supports loan schemes that go beyond the public sector. Note 9 (page 85) of the Consolidated Accounts discloses that £370 million of loan payments were made in 2016/17 with £196 million repaid. An additional £43 million was repaid in 2016/17 relating to the 2015 Less Favoured Area Support Scheme (LFASS) loan scheme, with £239 million recovered overall by 31 March 2017. A further loan scheme in relation to the 2016 LFASS was launched in April 2017 and a loan scheme in relation to the 2017 Basic Payment Scheme (BPS) was announced in September 2017.

77. The Scottish Government had to manage in-year loan funding carefully to minimise the risk of overspends against its 2016/17 capital financial transactions budget. The Financial Transactions budget was supplemented by £33 million capital budget to meet loan scheme commitments. Underspends in other financial transactions budgets meant that the Scottish Government was able to carry forward £53.5 million of financial transaction budget to support 2017/18 budget plans.

78. As part of our financial statements audit work we reviewed a sample of payments made to farmers to satisfy ourselves that the year-end balance disclosed in the consolidated accounts was correct. We did not identify any issues as part of this testing.

Workforce capacity

79. We highlighted in our annual audit plan that financial devolution under the 2012 and 2016 Scotland Acts brings increased responsibility for financial management at a time of increasing pressures on resources. It is therefore important the Scottish Government ensures it has sufficient capacity and resources to effectively manage its increased financial responsibilities and implement the new financial powers, alongside business as usual activities.

80. The Scottish Government recognises the significant staffing implications of the new financial powers and the challenges it faces in recruiting staff with the required skills. It has started to reallocate existing staff and recruit new people to meet immediate pressures. The Scottish Government now needs to implement longer-term solutions to ensure it has the staff and skills in place to deliver its current priorities and new responsibilities. It will be important that it integrates new approaches to workforce planning, developed through SG2020, into its processes at all levels of the organisation.

81. As part of their 2016/17 programme of audits, internal audit reviewed capacity, resources and shared service provision within the Information and Technology Services (iTECS) division. The review highlighted a risk around capacity as it found that iTECS continues to operate with less than their full complement of staff. Contractors are used to address specific skills and resource gaps and other general staff shortages in both IT and non-IT posts. Internal audit raised concerns that as the number of bodies who plan to use Scottish Government’s shared services increases, resourcing challenges significantly increase the risk that iTECS will be unable to deliver an effective service.

Medium to long term financial planning

82. The Scottish Government acknowledges the benefits of taking a longer-term view and has been developing its processes to reflect the fiscal framework. It undertakes longer-term analysis and assessments to support financial decision making. This has included, for example, modelling scenarios to assess the potential impact on tax raising and spending projections. It has not yet finalised an overarching longer term approach for managing Scotland's public finances which reflects its new financial powers.

83. A key element to strategic public financial management is a medium-term financial strategy setting out the expectations and broad financial plans for the next five years. This should be underpinned by clear policies and principles for using, managing and controlling the available financial powers. The Scottish Government is currently considering a number of detailed recommendations prepared by the Budget Process Review Group, established by the Finance and Constitution Committee, which includes the need for a medium-term financial strategy.

84. This would involve the Scottish Government setting out its expectations and broad financial plans and projections for at least the next five years following the UK Government's Spring Budget Statement.

85. Developing a medium-term financial strategy will help the Scottish Government to assess and keep under review the long-term sustainability of Scotland's public finances. This includes considering the longer-term implications of policy decisions and how these sit alongside existing commitments and anticipated changes in the economy, revenues and spending.

Developing financial reporting

86. The Scottish Government plan to bring forward their reporting on the final outturn for the Scottish Administration. The Scottish Government plan to produce the Scottish Administration Statement of Financial Position (previously called the balance sheet) information alongside the outturn information normally produced. In doing so, it provides the Scottish Government with the opportunity to explain how some of the liabilities for the Scottish Public Sector will be met, including pension liabilities from unfunded pension schemes such as those for NHS staff, teachers and police officers.

87. Plans for producing a Scotland Public Sector 'shadow account' for 2016/17 are underway and the Scottish Government plan to complete the shadow account in Spring 2018. The Scottish Government intend to use of Whole of Government Accounts input to do this. The scope for the first year has been limited to bodies included in the WGA process such as material executive non-departmental public bodies (NDPBs) and local authorities.

Part 4

Governance and transparency

Main judgements

The Scottish Government has introduced new governance arrangements during the year and these remain in development. It is therefore too early to comments on their effectiveness.

The Scottish Government has committed to open and transparent government and there is scope to be more transparent and lead the Scottish Public Sector in transparency and citizen experience

Internal audit operates in accordance with the Public Sector Internal Audit Standards.

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision-making and transparent reporting of financial and performance information.

Governance arrangements

88. In October 2016, the Scottish Government implemented new governance arrangements with the aim that they better reflect the demands placed on the organisation created by new financial powers and constitutional change.

89. There is now three core corporate boards replacing the previous six boards. These boards are supported by a new structure of quarterly Director General led assurance group meetings. The number of non-executive directors reduced from twelve (including some overlap between changes in appointments) to seven although the individual time commitment has increased. Each non-executive director is now paired with a Director General with the aim of allowing greater development of subject knowledge.

90. The UK Corporate Governance Code 2014 suggests board dialogue should be constructive and challenging to avoid the risk of 'group think'. Aligning Non-Executives to Director Generals should encourage greater knowledge in specific areas, helping to facilitate constructive challenge. At the same time, it is important that non-executive directors are able to provide an appropriate balance of support and challenge and their level of engagement should reflect this independent role.

91. In July 2017, the governance arrangements changed further at Executive Team level. The Director General Finance role was changed to reflect Scotland's new fiscal responsibilities; and a Chief Financial Officer role was also created to oversee financial management and operational matters, reporting to Director General Organisational Development and Operations.

92. We reviewed the revised corporate governance manual and followed up the principles of good practice as set out in our *Role of Boards* report published in 2010. We also considered minutes and papers from our attendance at all Scottish Government Assurance and Audit Committee meetings and a sample of Director General assurance meetings. We observed that meetings had extensive agendas and this limited the time for discussion on key issues. Similarly we noted overlap in discussions arising from the same non-executives attending a number of different corporate boards and groups as part of their new remit. This may result in the perception of reduced scrutiny if detailed discussions have already taken place in other forums. It will be important for the Scottish Government to reflect on these issues to ensure that, as arrangements evolve, they become both efficient and effective in allowing good scrutiny, challenge and support.

93. During summer 2017, an independent review of the governance arrangements led by the Crown Agent, a Non-Executive Director and the Director of Internal Audit took place. Separate interviews have taken place with Non-Executive Directors and Audit Scotland as part of this review. We consider undertaking a review a positive step and evidence of good practice. At the time of writing the review's findings were due to be presented to the Scottish Government in October 2017.

94. Overall, the governance arrangements continue to evolve since the new structure was introduced in October 2016. We will continue to monitor the development of these arrangements to support proactive management of internal controls and risks and foster an environment in which constructive challenge in corporate forums strengthens decision-making and accountability. The success of the new arrangements will be determined by how they operate in practice. Central to this will be the culture and behaviours adopted by those involved to ensure scrutiny and challenge are effective and transparency is exercised.

The Annual Governance Statement

95. Under HM Treasury's Financial Reporting Manual (FReM), the Scottish Government must prepare an annual governance statement within the Annual Report and Accounts. Guidance is set out within the Scottish Public Finance Manual (SPFM) for the content of the statement and provides assurances around the achievement of the organisation's strategic objectives.

96. The SPFM does not prescribe a format for the annual governance statement, but sets out minimum requirements for central government bodies. The process undertaken by management included conducting an assurance mapping exercise and working to an assurance plan that assessed the evidence underpinning the preparation of the governance statement.

97. We concluded that the annual governance statement 2016/17 complies with the guidance issued by the Scottish Ministers and based on our knowledge and work performed, presents an appropriate assessment of governance arrangements and matters.

Internal audit

98. The Scottish Government Internal Audit Directorate (IAD) provides the Scottish Government and each Accountable Officer with independent assurance on the Scottish Government's overall risk management, internal control and corporate governance processes.

99. We carried out a review of the adequacy of the internal audit function and concluded that the Scottish Government's IAD operates in accordance with the Public Sector Internal Audit Standards (PSIAS) and has sound documentation standards and reporting procedures in place.

100. As with the previous year, 2016/17 continued to be a period of transition for IAD. For example:

- a new Director of Internal Audit took up post in April 2016 and additional appointments were made, in particular to the audit manager grades;
- the internal audit year was realigned to the financial year;
- revised Scottish Government governance arrangements were implemented during the year;

- recommendations from the 2015 Strategic Review of IAD were progressed further.

101. Our review found:

- During 2016/17, 13 per cent of 115 planned assignments were either postponed or deferred to 2017/18. This was due to either pressure on resources or because local arrangements were not in place (such as planned systems changes) to allow the audit to proceed.

- IAD continued to face staffing pressures in 2016/17 through a combination of increased demand for internal audit work and competing priorities during which overall staff numbers were below establishment. IAD increased staff numbers during 2016/17 and more recently concluded a recruitment campaign to further enhance capacity and take them to establishment.

- IAD continues to make progress against the recommendations set out in the Strategic Review of Internal Audit from 2015. Progress against these recommendations and the findings from IAD's own internal review were presented to the Scottish Government Assurance and Audit Committee in June 2017. The internal review included a planned revision of the Internal Audit Manual which is essential to ensure it complies with PSIAS.

- Under the new governance arrangements, IAD report to the Scottish Government Assurance and Audit Committee and individual public body audit committees (PBACs). Summary progress reports are received by the Scottish Government Assurance and Audit Committee and also to the related Director General assurance group meetings. Individual audit reports are presented to relevant PBACs but reports relating to the core Scottish Government are not presented to either the Scottish Government Assurance and Audit Committee or Director General assurance groups. There is no agreed framework in place between IAD and the Scottish Government to determine the nature and level of reporting to audit committees or assurance groups.

- Looking to 2017/18, there remains a risk to the successful delivery of the internal audit plan as a result of increasing demand pressures on IAD at the same time as organisational changes take place. As the Scottish Government implements new devolved powers, it is important that IAD sets out a clear plan to identify the right skills and training necessary to ensure it is able to provide a strong and effective audit service in this evolving environment.

ICT

102. On 12 May 2017 a number of health bodies in Scotland were affected by a global ransomware cyber attack. A report was presented to the Scottish Government Assurance and Audit Committee in June 2017. This report discussed the impact of the WannaCry attack and the mitigations put in place by the Cyber Security Operations Centre. The Scottish Government was not directly impacted by the attack but co-ordinated responses across central and local government.

103. A Cyber Security Strategy 2020 has been agreed. The Scottish Government intends to develop an action plan to promote a common approach to cyber resilience capabilities across Scotland's public bodies. This will include encouraging organisations to sign up to the Cyber Essentials Scheme to help protect themselves against cyber threats.

104. In May 2017 we published an interactive briefing Principles for a digital future: Lessons learned from public sector ICT projects. The briefing summarises the issues we have identified in our previous reports on public sector ICT projects and considers how other countries are managing ICT programmes. The briefing highlights a number of common themes and organises them into a set of core principles. This briefing was considered by the Scottish Government Assurance and Audit Committee in June 2017 as part of our progress update.

105. The summary does not aim to provide all the answers, or provide a different story to previous lessons-learned summaries. It aims to pull together the main findings from our series of recent reports on ICT project failures in Scotland, and to signpost Scottish public bodies to the learning points of others. The principles are supplemented with case studies and examples to highlight our messages.

Risk management

106. As part of our planning work, we performed a high-level review of the Scottish Government's risk management arrangements. However these arrangements were still in development and under review as part of the new governance structure implemented in October 2016.

107. The Scottish Government has continued to develop its risk management arrangements during the year. The Scottish Government's risk improvement project piloted new ways to embed risk into meetings and agendas using risk themes as a way to focus discussions. Guidance around risk management is being developed to provide updated tools and techniques to support users. Different versions of a risk register template are being trialled by directorates as a way to improve risk reporting.

108. The strategic risk register is reviewed by the Executive Team and by the Scottish Government Assurance and Audit committee. Therefore risks escalated to this level should ensure senior management review and allow more visibility and challenge.

Transparency

109. Transparency means that the public has access to understandable, relevant and timely information about how the Scottish Government is taking decisions and using its resources.

110. In April 2015, Scotland became one of 15 pioneer governments of the Open Government Partnership. The Open Government Partnership is an initiative which aims to secure commitments from governments to promote openness, transparency and citizen experience. A National Action Plan was prepared during 2016/17 to support transparency and improve citizen participation.

111. Executive Board meetings are held in private with summarised minutes published on the Scottish Government's website. With increasing public expectations for more openness in the conduct of public business, the Scottish Government needs to keep this area under review and consider whether there is scope to enhance transparency in the publication of meeting agendas, papers and minutes.

112. The Scottish Government currently does not make available its Register of Interests for board members on its website. This is good practice in line with 'On Board' guidance developed by the Scottish Government in March 2017. Doing so would support the Scottish Government's commitment to open government and match its own expectations regarding transparency in public bodies. Taking steps to increasing transparency would help strengthen its commitment to the Open Government Partnership and improve public trust and confidence in Government.

Action Plan point 7 (Appendix 1)

113. The Scottish Government's performance in meeting Freedom of Information (FOI) statutory 20 day targets requires improvement. The Information Commissioner has given the Scottish Government interim targets of 85 per cent, 90 per cent and 95 per cent over the next three years with the aim of improving response times. This concern has also been reflected in the Scottish Government's Governance Statement. The Scottish Government has established an improvement project with the aim of addressing the issue.

Part 5

Value for money

Main judgements

Performance management and monitoring arrangements are in the process of being redeveloped.

Further developments in this area are required by the Scottish Government to better demonstrate their own performance and contribution to outcomes over the medium term.

Performance management

114. The National Performance Framework sets out the overall aims of the Scottish Government including a series of indicators against which performance is monitored. Indicators include National Outcomes, Purpose Targets and National Indicators and performance against these targets is reported publically via the Scotland Performs website.

115. Overall responsibility for the delivery of performance targets lies with the Executive Board. As reported in the governance statement, work is underway to develop a balanced scorecard for use by the Board to highlight organisational performance and drive improvement. It is important that the Executive Team have access to relevant accurate and timely information in order to monitor performance against targets and ensure desired outcomes are achieved. We will continue to monitor development of performance information for the Executive Board as part of the 2017/18 audit.

116. As part of the new governance structure introduced in October 2016, a Performance and Priorities Board was established. The overall responsibility of the board is to track delivery of Programme for Government commitments, with the Performance Framework a key focus of the board's activity. From a review of minutes it is apparent that the latter part of 2016/17 was a developing period for the Board, with questions over, and subsequent revisions to their remit. Going forward it will be important for the Board to have a clear, established remit and role in order to drive performance improvements. Again, we will continue to monitor the operation of the Board as the new governance arrangements become more established.

117. In previous years we have highlighted that there remains scope for the Scottish Government to develop its annual reporting to provide a more extensive analysis of its overall performance and development during the year, drawing on relevant performance data including key financial information from the accounts. That remains the case. Greater transparency about the Scottish Government's own performance towards meeting its strategic objectives would provide greater accountability for the use of financial resources outlined in the consolidated accounts.

Value for money is concerned with using resources effectively and continually improving services.

118. A more rounded account of the Scottish Government's overall performance would enhance reporting to the Scottish Parliament and the public, and help strengthen accountability and scrutiny. A key challenge in managing performance is aligning financial and performance information in a meaningful way, so that the impact of spending decisions on performance and outcomes is better understood.

119. Relevant and reliable performance information is central to measuring the Scottish Government's contribution to delivering outcomes. In seeking greater links between spending and outcomes, the Budget Process Review Group recommended that the Scottish Government clearly links its detailed spending proposals to relevant policies, strategies and plans. The Group also recommended that the Scottish Government strengthens its performance planning and reporting to provide a greater focus on the delivery of outcomes.

120. As Scotland's fiscal responsibilities continue to grow, expectations are increasing for the Scottish Government to produce more detailed and transparent performance reporting. Further developments in this area are required by the Scottish Government to better demonstrate their own performance and contribution to outcomes over the medium term. This would provide a strong example to other public bodies and mirror the Government's own expectations of how other bodies should demonstrate their performance.

Following the public pound

121. As part of our 2016/17 Annual Audit Plan we set out planned work to give us assurance over the Scottish Government's arrangements and the steps it takes to ensure that public money is used for the purposes intended in a number of specific areas:

- We completed expenditure testing which covered work on grant monitoring. We reviewed evidence of monitoring by the Scottish Government on a sample basis to ensure funds were spent in line with the conditions set out in the grant offer letter. We concluded that appropriate monitoring arrangements were in place.
- We conducted a review of the newly created Attainment Fund. We reviewed the high-level controls in place and the oversight and accountability arrangements between the Scottish Government and local authorities/schools. No issues were identified from this work.
- We followed up the recommendations from our 2015/16 work on T in the Park and found that all grant conditions had been followed as expected.

National performance audit reports

122. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. Since our previous annual audit report, we published a number of reports which are of direct interest to the Scottish Government. These are outlined in Appendix 4 (page 43) accompanying this report. There are two reports which are of particular relevance, *Managing New Financial Powers: An Update* published in March 2017 and *Common Agricultural Policy Futures Programme, Further Update* published in June 2017.

123. The Managing New Financial Powers report focused on the new powers devolved to the Scottish Parliament as a result of the 2012 and 2016 Scotland Acts (the Scotland Acts). The report made a number of recommendations including that the Scottish Government should:

- monitor regularly how much is being spent on implementing the financial powers in the Scotland Acts against what has been planned

- develop more detailed estimates of how much it will cost to implement the financial powers in the Scotland Acts
- integrate new approaches to workforce planning, developed through its SG2020 change programme, into its processes at all levels of the organisation
- share its approach to implementing the social security powers publicly
- develop a medium-term financial strategy
- finalise principles for using its borrowing powers and the Scotland Reserve as a matter of urgency and make these publicly available
- demonstrate publicly the progress it is making toward introducing a comprehensive account of Scotland's public finances.

124. The Common Agricultural Policy Futures programme, further update report looked at the Scottish Government’s Common Agricultural Policy (CAP) Futures programme which started in 2012 and was a five-year business change and Information Technology (IT) programme to deliver CAP reform. We had previously reported in May 2016 that the programme was having significant difficulties and made a number of recommendations to mitigate the risks that remained. The 2017 report found that some progress had been made with the now closed programme, but it had not yet delivered value for money or all planned benefits for farmers and rural businesses. It notes that the Scottish Government used loan schemes to get money to farmers more quickly, but payment delays for 2016 applications meant loans took longer to recover than planned, which introduced more risk to the wider Scottish budget and put pressure on payment timescales and staff.

125. Our 2017 report updated our 2016 recommendations and made a number of other recommendations. These included that the Scottish Government should:

- Complete a detailed assessment of the risk of financial penalties to inform decisions on the prioritisation of further work to improve and add functionality to the system.
- Prioritise time for the transfer of knowledge and expertise from programme staff to staff in the business.
- Develop and test a disaster recovery solution covering the whole IT system taking account of the level of risk that the Scottish Government is prepared to accept.
- Develop and keep under review processes for monitoring and testing quality.
- Develop a framework to prioritise future investment in the system.
- Develop a benefit realisation plan to record and monitor all potential benefits and value that the system can provide.
- Communicate clearly the payment timescales and processes to farmers, crofters and rural businesses.
- Communicate clearly with staff about the values and new ways of working of the directorate.
- Ensure leadership operates strategically across the directorate.

126. The Executive Board considers our national reports. Details of relevant reports are included in the finance report to the board. In addition we highlight relevant reports to the Scottish Government Assurance and Audit Committee in our regular updates to the committee.

Appendix 1

Action plan 2016/17

2016/17 recommendations for improvement

Paragraph no.	Issue/risk	Recommendation	Agreed management action/timing
17	**1. Governance Statement** The Governance Statement was received after the submission of the financial statements for audit. This was due to the internal timetable the Scottish Government had in place for its preparation and approval. **Risk** The Governance Statement is a key component of the Government's consolidated accounts. There is a risk that there is insufficient time for audit to review, and form an independent opinion, on the Governance Statement in line with the Government's own timetable for finalising its annual report and accounts.	The Scottish Government should review the process and timetable to ensure a complete Governance Statement is presented to audit as part of its submission of the unaudited accounts.	Narrative on agreed action. Responsible officer. Agreed date.
Exhibit 3,1	**2. European Structural Funds** The Scottish Government has a contingent asset in the consolidated accounts to recognise that debt owed to them from project sponsors may be recovered. **Risk** If the Scottish Government does not pursue this debt, there is a risk that the European Commission may apply state aid penalties.	The Scottish Government has started to raise invoices for this debt. The recovery still remains uncertain as amounts may be subject to appeal. If a decision is taken that results in debts being written off, the Scottish Government should clearly outlines the reasons why and also includes an assessment of the potential risk and impact of the European Commission applying state aid penalties.	Narrative on agreed action Responsible officer Agreed date

Paragraph no.	Issue/risk	Recommendation	Agreed management action/timing
Exhibit 3,5	**3. Gender analysis** The FReM requires an analysis of the number of persons of each sex who were directors, senior civil servants and employees to be reported. This analysis is not reported in the consolidated accounts because this information was not captured by the consolidation packs submitted by consolidated bodies. **Risk** There is a risk that the remuneration and staff report does not fully meet the requirements of the FReM.	The Scottish Government should review its arrangements to ensure it captures this information to meet the requirements of the FReM.	Narrative on agreed action Responsible officer Agreed date
44	**4. Training on European funding controls and procedures** From our sample of closure work on the 2007-13 programmes, gaps in project documentation were found to be assigned to audit trail errors rather than breaches in procurement procedures as subsequently identified by internal audit. Errors in procurement procedures attract higher penalties. In the new programmes, the review of project documentation has been designed to occur before any payment is made. The review is a key control and therefore staff should be suitably trained to ensure it operates effectively. **Risk** Without further training there is a risk of a high error rate which may result in financial penalties.	We recommend training on procurement rules and good practice to support Scottish Government teams reviewing the quality of project documentation.	Narrative on agreed action Responsible officer Agreed date
45-46	**5. Debt management**	We recommend the Scottish	Narrative on agreed action

Paragraph no.	Issue/risk	Recommendation	Agreed management action/timing
	We identified a number of areas where effective debt management processes were not being employed. This included late write off of debt, unallocated receipts and use of credit memos to cancel debt with a view to new invoices being issued that were subsequently not issued. **Risk** There is a risk that the recovery of debts is ineffective and that the receivables balance in the accounts is misstated.	Government review its debt management processes to ensure they are effective.	Responsible officer Agreed date
52	**6. National Fraud Initiative** There should be more of a joined up approach to NFI across the Scottish Government. The NFI exercise is effective in detecting fraud and error in public sector organisations. In addition, it can help strengthen internal controls to protect against fraud and error. **Risk** Without a joined up approach and central NFI contact there is a risk that potential fraud is undetected.	The Scottish Government should consider a more joined up approach with a central NFI contact responsible for co-ordinating match investigation work and ensuring that results are reported and disseminated across the Scottish Government.	Narrative on agreed action Responsible officer Agreed date
113	**7. Publication of register of interests** The Scottish Government does not currently make the Register of Interests for its board members available on its website. Publishing the register is good practice and in line with guidance issued by the Scottish Government to public bodies and would support the Government in its commitments through the Open Government	We recommend that the Scottish Government makes available its register of interests on its website by October 2017.	Narrative on agreed action Responsible officer Agreed date

Paragraph no.	Issue/risk	Recommendation	Agreed management action/timing
	Partnership to increase transparency. **Risk** There is a risk that the Scottish Government is not compliant with good practice guidance.		

Appendix 2

Significant audit risks identified during planning

The table below sets out the audit risks we identified during our planning of the audit and how we addressed each risk in arriving at our conclusion. The risks are categorised between those where there is a risk of material misstatement in the annual report and accounts and those relating our wider responsibility under the *Code of Audit Practice 2016*.

Audit Risk	Assurance procedure	Results and conclusions
Risks of material misstatement in the financial statements		
1 EU funding There are material balances and transactions in the consolidated accounts relating to EU funding: • European Structural Funds 2014-20 programme: the Scottish Government intends to make payments to lead partners in 2016/17. • Expenditure and income of £445 million relating to European Agricultural Fund schemes. This audit risk requires us to ensure that EU funding balances and transactions are reflected appropriately in the accounts.	Test expenditure and accrued income balances at the year end for structural funds. Engage with local auditors to join up information and analysis on structural funds. Engage with internal audit (as the audit authority for structural funds) and seek assurances where possible. Seek assurances from the auditors of the European Agricultural Fund on the control environment and supplement with targeted substantive testing. Test accrued expenditure and income balances at the year end for European Agricultural funding.	Payments to lead partners totalled £2 million during 2016/17 as the Scottish Government prioritised its closure work relating to the 2007-13 programmes. Therefore there was no material balance or transactions to test during the audit.
2 EU structural funds: potential losses and penalties The 2015/16 consolidated accounts included a provision for a loss of income of £14 million in relation to the 2007-13 structural fund programmes. This amount may change as the audit authority (internal audit) reviews and reports on closure reconciliations, due to be completed by 31 March 2017. This audit risk requires us to ensure that the provisions and balance appropriately reflect the	Test a sample of closure reconciliations and the calculation of any related provisions for penalties for accuracy and completeness. Review the extent of recoveries where projects are withdrawn or de-committed and consider if there are any state aid implications. Review internal audit's reports and supporting work on the closure process and consider whether the accounting and disclosures in the accounts (including the governance	We engaged with Internal Audit and reviewed their findings that supported their Final Audit Report to the European Commission. We placed reliance on their work with regard to their Article 62b verification work and the error rates arising from this work. The provision of £14 million crystallised to a liability of £31 million. We substantively tested the substance of transactions and working papers which informed this position and the

	Audit Risk	Assurance procedure	Results and conclusions
	associated liability.	statement) are appropriate.	accounting for it. The consolidated accounts also include an unquantifiable contingent asset for amounts owed to the Scottish Government by project sponsors. The Scottish Government has not decided whether to recover all of this debt. State aid risks therefore remain and will be followed up in 2017/18. Disclosures in the accounts are considered adequate.
3	**Common Agricultural Policy (CAP) Futures** The Common Agricultural Policy Futures programme is a five-year business change and IT programme to deliver CAP reform. This programme has proved significantly more complex and challenging than the Scottish Government anticipated. Two CAP Basic Payment loan schemes were launched during 2016/17. The loan schemes are an interim measure until the control environment and CAP Futures IT system are established. This audit risk requires us to ensure that the loans and EU payments are accounted for appropriately.	Analyse cost information and SEAS transactions. Substantive testing of loan advances and repayments. Targeted substantive testing and cut-off testing of debtors and creditors to verify timing of transactions and associated accounting. Consider the completeness and accuracy of the accounting for loan transactions. Engage with CAP Futures performance audit work and consider the findings from the upcoming Section 23 report on CAP Futures.	No issues were identified from our detailed testing of loan advances and repayments. Our testing of debtors and creditors confirmed timing and accounting for the CAP payments and associated EU funding was appropriate.
4	**Estimation and judgements** There are significant degrees of management estimation in the measurement, valuation and disclosures of the material account areas of student loans and contingent liabilities, including the valuation and completeness of financial guarantees provided by the Scottish Government. This audit risk requires us to ensure amounts and disclosures in the accounts are appropriate.	Further review of the student loans model (assumptions and application). Focused substantive testing. Review the identification of and record of contingent liabilities, guarantees, indemnities and letters of comfort. Test assumptions in contingent liability financial modelling. Review the disclosure of contingent liabilities, guarantees etc.	From our work on estimation and judgements the following points were noted: • The Scottish Government changed the model used for student loans in 2016/17. The new model is consistent with all four devolved nations and the assumptions are based on information provided by the Office for Budget Responsibility (OBR). We reviewed the assumptions and application of the model. We queried the discount rate applied in the model of 2.2% and the Scottish Government confirmed that the 0.7% was the HM Treasury rate to use and the consolidated accounts

Audit Risk	Assurance procedure	Results and conclusions
		were updated to reflect this. We concluded our work on the accounting for the Rio Tinto Smelter guarantee and confirmed the accounting treatment is correct. Our work included a review of the model developed by Ernest and Young which made a series of accounting suggestions to Scottish Government.
5 **Risk of management override of controls** ISA 240 requires that auditors consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements.	Detailed testing of journal entries. Review of accounting estimates. Focused testing of accruals and prepayments. Evaluation of significant transactions that are outside the normal course of business. Review of internal audit reports. Consider the results of controls testing.	We carried out testing of internal controls and journal entries and reviewed accounting estimates and unusual transactions. We reviewed internal audit reports. We tested a focused sample of accruals and prepayments. The results of this audit work were satisfactory.
6 **Risk of expenditure recognition** ISA 240 presumes a risk of fraud in regard to revenue recognition in the financial statements in any audit. This can be extended to include expenditure recognition in some public sector bodies.	Test key internal controls. Test significant transactions, particularly around the financial year-end. Carry out analytical procedures. Monitor budgetary process and reporting. Review of counter fraud arrangements. Consider internal audit findings.	We tested controls in this area and tested transactions around the financial year end. The result of this audit work was satisfactory as we did not identify any issues.
Risks identified from the auditor's wider responsibility under the Code of Audit Practice		
Financial sustainability 7 **Office for National Statistics (ONS) classification** The Office for National Statistics (ONS) assesses transactions to decide how they should be treated in the National Accounts. ONS decisions on certain capital projects do not change the	Keep up to date with developments as part of our wider code of practice responsibilities to consider financial management and sustainability. Review Scottish Government reporting on the capital budget, including disclosures	We reviewed developments in year with regard to the Office for National Statistics (ONS) work plan and decisions. There are no recent decisions which affect the Scottish Government's financial position in 2016/17. The classification with regard to

	Audit Risk	Assurance procedure	Results and conclusions
	accounting treatment but do affect the capital budget. The expected impact on the capital DEL budget in 2016/17 is estimated as £398 million. The Scottish Government is managing its capital budget charges in the context of its overall capital programme. This audit risk requires us to review how the Scottish Government delivers the capital programme and how transparently the impact of the ONS decisions are reported.	in the consolidated accounts. Review other ONS decisions that may affect the Scottish Government's financial position in 2016/17 and beyond.	housing associations capital projects is likely to be addressed with new legislation in future years.
8	**Workforce capacity** Financial devolution under the 2012 and 2016 Scotland Acts brings increased responsibility for financial management at a time of increasing pressures on resources. This audit risk requires us to review actions taken by Scottish Government to ensure it has sufficient capacity and resources to effectively manage its increased financial responsibilities and implement the new financial powers, alongside business as usual.	Our performance audit report on Managing New Financial Powers (spring 2017) will provide an assessment of the steps the Scottish Government is taking to manage pressures on capacity, including in the finance function and the potential impact on financial management and reporting. Review of overtime expenditure, payments in lieu of holidays and use of contractors/agency staff.	Our review of overtime expenditure, payments in lieu of holidays and use of contractors/agency staff did not identify any significant issues. The Scottish Government has started to reallocate existing staff and recruit new people to meet immediate pressures. The Scottish Government now needs to implement longer-term solutions to ensure it has the staff and skills in place to deliver its current priorities and new responsibilities. It will be important that it integrates new approaches to workforce planning, developed through SG2020, into its processes at all levels of the organisation.
9	**CAP Futures** The loan scheme for farmers involves around £285 million. It is funded from the financial transactions (FT) budget (£80 million) and budgeted loan recovery (£205 million). The Scottish Government's overall FT budget for 2016/17 is £327 million. The EU payments due to farmers will not start until February 2017 at the earliest and may impact on the repayment of loans. This audit risk requires us to consider the implications for the FT budget and any related impact on the Scottish Government budget overall.	Review of cash flow management procedures and controls. Review and analysis of financial transaction budget and reporting of loans and other FT transactions. Review the impact of these developments on the FT budget and other loan schemes planned. Review of internal audit work. Update to the CAP Futures performance audit report will be published before the Scottish Parliament's 2017 summer recess.	The Scottish Government drew down cash from the consolidated fund based on forecasts. The actual cash flow did not reflect the forecast and this meant the Scottish Government had a closing cash balance of £625 million.

Audit Risk	Assurance procedure	Results and conclusions
10 Financial Management **National Fraud Initiative** The Scottish Government's payroll recommended matches from the 2014/15 NFI exercise were not timeously investigated. This audit risk requires us to assess the potential for undetected fraud or error in payroll records.	Completion of 2016/17 NFI questionnaire.	2016/17 NFI checklist has been completed by audit team. Good progress had been made investigating the accounts payable matches with slower progress in investigating recommended payroll matches due to resourcing pressures. No progress had been made on investigating the procurement matches at the time our review was undertaken (June 2017). The Scottish Government should consider a more joined up approach with a central NFI contact responsible for co-ordinating match investigation work and ensuring that results are reported and disseminated.
Governance and Transparency **11 New governance structure** The Scottish Government implemented new governance arrangements during 2016/17 designed to better support the assurance requirements of the Principal Accountable Officer. This involved significant changes to governance structures and new ways of working, including internal assurance processes. This audit risk requires us to review the revised governance arrangements and assess whether they provide effective oversight and assurances.	Attend meetings, review of papers and discussions with staff and non-executive directors. Follow up of the principles contained in national 'Role of Boards' report (published in 2010). Consider the findings of the planned review of governance arrangements.	We attended all Scottish Government Assurance and Audit Committee meetings and at least one meeting for each DG assurance meeting under the new arrangements. An independent review of the governance arrangements led by the Crown Agent, a Non-Executive Director and Director of Internal Audit was underway in June 2017 with a view to reporting findings in October 2017. We were interviewed as part of this review. We consider this review a positive step and evidence of good practice but how it will now inform future revisions of governance arrangements is unclear at this stage.
12 Developing financial reporting Significant changes were made to the presentation of the consolidated accounts in 2015/16 with further changes planned in 2016/17. This is part of the Scottish Government’s programme of work to review and broaden its financial reporting in the context of new financial powers. The Permanent Secretary confirmed in a response to the Scottish Parliament's Public Audit and Post-legislative Scrutiny Committee in November 2016	Review preparations and progress against proposed timetable. Continue to report on the progress as part of the 2016/17 audit.	Further presentational changes were made to the consolidated accounts which improved the accounts for the reader. The Scottish Government plan to report the Scottish Administration outturn by 30 September 2017. The Scottish Government have designated 2016/17 as a 'shadow-year' with a view to publishing a consolidated public account during 2018. This is a welcome development and should aim to allow for the Parliament and others to see a

Audit Risk	Assurance procedure	Results and conclusions
that the Scottish Government is also planning to produce a 'tailored-for-Scotland' 2016/17 consolidated accounts. This audit risk requires us to assess progress in this area.		comprehensive picture of the financial health of the public sector in Scotland.
Value for money 13 **Following the public pound** The Scottish Government provides many different forms of funding streams and grants to a wide range of third parties. This audit risk requires us to consider the Scottish Government's arrangements and the steps it takes to ensure that public money is used for the purposes intended.	As part of our substantive testing, we will confirm on a sample basis, evidence of monitoring by the Scottish Government to ensure funds are used for the purposes intended. Follow up of conclusions from our 'T in the Park' work conducted in 2015/16. Review of the newly created Attainment Fund, including review of the controls, oversight and accountability arrangements between the Scottish Government and local authorities/schools.	We reviewed a sample of grant payments as well as reviewing the arrangements in place to monitor grants. We did not identify any significant issues. We followed up our 2015/16 work and found that grant conditions had been complied with as expected. We reviewed the high-level controls in place and the oversight and accountability arrangements between the Scottish Government and local authorities/schools. No issues were identified from this work.

Appendix 3

Summary of unadjusted misstatements

We report all uncorrected misstatements that are individually greater than our reporting threshold of £0.1 million.

Misstatements were noted during our audit testing were not corrected in the financial statements. Cumulatively these errors are below our performance materiality level as explained in Exhibit 2 (page 8). We are satisfied that these errors do not have a material impact on the financial statements.

No.	Account areas	Comprehensive income and expenditure statement		Statement of Financial Position	
		Dr £m	Cr £m	Dr £m	Cr £m
Scottish Government Core					
1	Credit balance on suspense account resulting in receivables being understated.			2.71	(2.71)
2	Property plant and equipment addition of £0.359m was capitalised twice.			0.36	(0.36)
3	No current intangible asset recognised for the carbon reduction commitment.			0.26	(0.26)
Gross impact					**3.33**
NHS boards					
4	Gross adjustment of all unadjusted misstatements reported for NHS boards	4.92	(12.42)	14.83	(7.33)
Gross impact					**19.75**
Executive agencies					

No.	Account areas	Comprehensive income and expenditure statement		Statement of Financial Position	
5	No unadjusted misstatements in excess of £0.1m to report.				
Gross impact		**4.92**	**(12.42)**	**18.16**	**(10.66)**
Net impact			**(7.5)**	**7.5**	
Total gross impact					**23.08**

Appendix 4

Summary of national performance reports 2016/17

2016/17 Reports

Month	Reports		
Apr			
May	Common Agricultural Policy Futures programme: an update		
Jun	South Ayrshire Council: Best Value audit report	The National Fraud Initiative in Scotland	
Jul	Audit of higher education in Scottish universities	Supporting Scotland's economic growth	
Aug	Maintaining Scotland's roads: a follow-up report	Superfast broadband for Scotland: a progress update	Scotland's colleges 2016
Sept	Social work in Scotland	Scotland's new financial powers	
Oct	Angus Council: Best Value audit report	NHS in Scotland 2016	
Nov	How councils work – Roles and working relationships in councils	Local government in Scotland: Financial overview 2015/16	
Dec	Falkirk Council: Best Value audit report	East Dunbartonshire Council: Best Value audit report	
Jan			
Feb	Scotland's NHS workforce		
Mar	Local government in Scotland: Performance and challenges 2017	i6: a review	Managing new financial powers: an update

Central Government relevant reports

Common Agricultural Policy Futures programme: an update – May 2016

The National Fraud Initiative in Scotland – June 2016

Audit of higher education in Scottish universities – July 2016

Supporting Scotland's economic growth – July 2016

Maintaining Scotland's roads: a follow-up report – August 2016

Superfast broadband for Scotland: a progress update – August 2016

Scotland's colleges 2016 – August 2016

Social work in Scotland – September 2016

Scotland's new financial powers – September 2016

i6: a review – March 2017

Managing new financial powers: an update – March 2017

Scottish Government

2016/17 Annual Audit Report

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AUDIT SCOTLAND

Ms Alyson Stafford
Director General of Finance
Scottish Government
Area 3-B99
Victoria Quay
Edinburgh
EH6 6QQ

27 September 2017

Dear Ms Stafford

Scottish Government Consolidated Accounts
Audit for the year ended 31 March 2017

Please find enclosed the audited Scottish Government Consolidated Accounts for the 12 months ended 31 March 2017. These also incorporate the auditor's report. I also enclose a copy of my report on the accounts prepared under section 22(3) of the Act.

Section 22(5) of the Public Finance and Accountability (Scotland) Act 2000 requires Scottish Ministers to lay a copy of the accounts and the auditor's report before the Parliament and to publish the accounts and auditor's report. The legislation also requires the accounts and auditor's report to be laid by no later than 31 December 2017. I would be grateful if you could make the necessary arrangements for this to take place.

If you have any questions regarding this letter, please contact Michael Oliphant, Senior Audit Manager (0131 625 1731).

Yours sincerely

Caroline Gardner

Caroline Gardner
Auditor General for Scotland

Enc

The 2016/17 audit of the Scottish Government Consolidated Accounts

AUDITOR GENERAL

Prepared for the Public Audit and Post-legislative Scrutiny Committee
Made under section 22 of the Public Finance and Accountability (Scotland) Act 2000
September 2017

Auditor General for Scotland

The Auditor General's role is to:

- appoint auditors to Scotland's central government and NHS bodies
- examine how public bodies spend public money
- help them to manage their finances to the highest standards
- check whether they achieve value for money.

The Auditor General is independent and reports to the Scottish Parliament on the performance of:

- directorates of the Scottish Government
- government agencies, eg the Scottish Prison Service, Historic Environment Scotland
- NHS bodies
- further education colleges
- Scottish Water
- NDPBs and others, eg Scottish Police Authority, Scottish Fire and Rescue Service.

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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.

Contents

Introduction

1. The Scottish Parliament's new financial powers are coming into effect at a time of ongoing pressures on public finances and uncertainty about the implications of the UK vote to leave the European Union. The Scotland Acts of 2012 and 2016 have introduced new responsibilities for tax and spending that enhance the Scottish Government's ability to manage and control its spending but also introduce a greater element of financial risk. Comprehensive, transparent and timely reporting of the Scottish Government's budget and financial performance is essential in supporting the Parliament in its important scrutiny role.

2. In December 2015, the Scottish Government published its draft 2016/17 Scottish Budget which set out its spending priorities and plans for the year. The Scottish Government's Consolidated Accounts for 2016/17 provides information on how this budget was managed, how the money was spent and what was achieved.

3. The Consolidated Accounts are a key component of the Scottish Government's accountability to the Scottish Parliament and the public. The accounts reflect the areas for which it has direct responsibility and accountability, including the core portfolios and supporting administration, the executive agencies and NHS bodies. The Consolidated Accounts:
   - cover around 90 per cent of the spending approved by the Scottish Parliament
   - report the amounts the Scottish Government spent against each main budget heading, and the reasons for any significant differences
   - show the amounts distributed to other public bodies including local government
   - report the assets, liabilities and other financial commitments carried forward to future years
   - contain a performance report, in which the Government gives a high-level account of its performance during the year.

4. My independent audit opinion on the 2016/17 Consolidated Accounts is unqualified. This means that I am content they show a true and fair view, follow accounting standards and that the income and expenditure for the year is lawful. My audit opinion is set out at page 46 of the accounts.

5. This report highlights key information in the Consolidated Accounts. It explains what they show about the Scottish Government's management of its budget. The report also provides other information about the budget, and about governance and performance. I also set out significant audit findings and identify matters relating to financial and performance management and report where further action is required.

6. As with previous years, I provide this report on the 2016/17 Consolidated Accounts to support the Scottish Parliament in its important scrutiny role of public finances in Scotland.

Key messages

- **The Scottish Government has published a sound financial report in its Consolidated Accounts for 2016/17 and my opinion on them is unqualified. The accounts show that total net expenditure during 2016/17 was £33,870 million, £85 million less than budget. Budget management during the year was effective in managing total spending against the limit set.**
- **The amount raised from Land and Buildings Transactions Tax and Scottish Landfill Tax in 2016/17 was £633 million, £38 million less than the December 2015 forecast of £671 million included as part of the budget. As with any forecast, actual amounts are likely to differ from those predicted. The Scottish Government managed this shortfall through underspends in its overall budget.**
- **The implementation of new financial powers and changes that will arise from the UK's decision to leave the European Union, mean it is critical that the Scottish Government continues to strengthen its approach to public financial management and reporting. Priorities for the Scottish Government should be to:**
    - **publish a public sector consolidated account for the whole public sector**
    - **introduce a medium-term financial strategy covering the next five years**
    - **finalise policies and principles for borrowing and reserves.**
- **In June 2017, the Budget Process Review Group established by the Finance and Constitution Committee, recommended a revised framework for a new budget process centred on a full-year approach with continuous scrutiny. The Group consisted of parliamentary and government officials alongside external experts. The Group's recommendations provide a real opportunity for the Scottish Government to significantly strengthen its financial reporting and support Parliamentary and public scrutiny as we enter a new environment for public financial management in Scotland.**
- **During 2016/17, the Scottish Government implemented new governance arrangements with the aim that they better reflect the demands created by new financial powers and constitutional change. The success of the new arrangements will be determined by how they operate in practice. Central to this will be the culture and behaviours adopted by those involved to ensure scrutiny and challenge are effective and transparency is exercised**.

Financial management

7. For the second year, the Scottish budget included new tax and borrowing powers set out in the Scotland Act 2012. This meant that the total amount it could spend was affected by amounts raised through devolved taxes and any capital borrowing decisions, as well as the Scottish Block Grant and other funding sources including Non-Domestic Rates (NDR) income and European programmes of financial assistance.

8. The Block Grant was the largest part of the budget. It was adjusted to reflect the devolution of Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) as well as the introduction of the Scottish Rate of Income Tax (SRIT) for the first time in 2016/17. The UK Parliament votes the necessary provision to the Secretary of State for Scotland, who makes grant payments to the Scottish Government into the Scottish Consolidated Fund (SCF). Receipts from devolved tax powers and any borrowing are also paid into the Fund.

9. Each year the Scottish Government has to manage its spending within two budgets:

- **Scottish budget:** approved by the Scottish Parliament each year and used to cover spending by the Scottish Administration and other bodies funded directly out of the Scottish Consolidated Fund.
- **HM Treasury budget:** used by the UK government to manage its spending on the Scottish Block grant. This is different from the Scottish Parliament's budget largely for technical reasons reflecting differences between accounting rules and UK budget rules.

Scottish budget

10. The final budget approved by the Scottish Parliament for 2016/17 permitted total expenditure of £37,580 million for the financial year. This reflects two revisions made to the original budget during autumn 2016 and spring 2017, which added a total of £631 million to the budget. Additions were mainly due to a combination of Barnett consequentials[1] arising from changes to UK spending programmes and technical accounting adjustments.

11. The majority of the budget (90 per cent or £33,955 million) relates to spending programmes and administration costs covered by the Scottish Government Consolidated Accounts. The accounts are an important part of a number of different financial reports laid in Parliament that sets out how the Scottish budget has been used. They reflect the areas that the Scottish Government is directly responsible and accountable for:

- core portfolios and related administration (such as staff costs)
- executive agencies (such as Scottish Prison Service and Transport Scotland)
- NHS bodies (both territorial and national boards)
- Crown Office and Procurator Fiscal Service

[1] Barnett consequentials are changes to funding to a devolved administration as a result of changes to comparable UK spending programmes.

- Mental Welfare Commission.

Further details of the bodies included as part of the Consolidated Accounts are included at page 12 of the accounts.

12. Amounts are also allocated to other parts of the Scottish Administration (£3,460 million) such as NHS and Teachers' Pension Schemes and also to directly funded bodies (£165 million) such as the Scottish Parliamentary Corporate Body. Details of outturn against budget for the bodies not included in the Consolidated Accounts are included at Appendix 1.

13. Separate accounts are also published by individual agencies and bodies whether part of the Scottish Administration, sponsored by the Scottish Government or directly funded bodies. These reflect the accountability each has to the Scottish Parliament. Audit reports relating to these separate accounts are available on Audit Scotland's website.[2]

14. The Scottish Government also publishes the audited accounts of the Scottish Consolidated Fund (SCF) and the Non-Domestic Rating (NDR) Account. The SCF account reports the cash paid in and out of the Fund and the NDR account shows the amounts collected by, and paid out to, local government in relation to non-domestic rates. The Devolved Taxes accounts are produced by Revenue Scotland. The Scottish Ministers also report a Final Outturn statement for the preceding financial year against the final Budget for the Scottish Administration as a whole. This is an important part of the Government’s accountability to the Scottish Parliament.

Scottish budget performance 2016/17

15. The Consolidated Accounts show that total net expenditure during 2016/17 was £33,870 million, £85 million less than budget (Exhibit 1). The resource budget was underspent by £28 million (0.1 per cent) against a budget of £31,890 million and capital by £57 million (2.8 per cent) against a budget of £2,065 million. Budget management during the year was effective in managing total spending against the limit set.

Exhibit 1

Total expenditure (resource and capital) against the Scottish Budget approved by the Scottish Parliament

The Scottish Government consolidated total was £85 million under budget in 2016/17.

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Finance and the Constitution	91	104	(13)
Health and Sport	13,353	13,241	112
Education and Skills	3,146	3,190	(44)
Economy, Jobs and Fair Work	320	339	(19)

[2] www.audit-scotland.gov.uk/report/search

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Justice	2,405	2,415	(10)
Communities, Social Security and Equalities	10,959	11,021	(62)
Environment, Climate Change and Land Reform	203	223	(20)
Culture, Tourism and External Affairs	264	272	(8)
Rural Economy and Connectivity	2,835	2,839	(4)
Crown Office and Procurator Fiscal Service	113	115	(2)
Administration	181	196	(15)
Scottish Government consolidated total	**33,870**	**33,955**	**(85)**
Other Scottish Administration	3,442	3,460	(18)
Total Scottish Administration	**37,312**	**37,415**	**(103)**
Directly-funded bodies	160	165	(5)
Total Scottish Budget	**37,472**	**37,580**	**(108)**

Source: Information drawn from the Scottish Government Consolidated Accounts 2016/17 (page 50) and accounts of other bodies, some of which are unaudited at the time of writing. Information on actual against budget performance for bodies not included in the Consolidated Accounts is included at Appendix 1. Further information of individual portfolio spending performance can be found in pages 51 to 61 in the Consolidated Accounts.

16. The Scottish Government manages variations in each portfolio to ensure overall spending remains within budget. The main differences between actual and budgeted spend reported by the Scottish Government were:

- Health and Sport: An overspend of £112 million which mainly related to an increase of £160 million to the provision used to assess legal claims against health boards. The increase was as a result of a technical change in how the claims are assessed. The increase in the provision was partly offset by lower than anticipated charges for property impairments.
- Education and Skills: The underspend within Education and Skills was due to a combination of issues including:
  - Later than anticipated implementation by schools and local authorities of all elements within the Scottish Attainment Challenge programme.
  - Additional income from Disclosure Scotland as a result of retaining English and Welsh disclosure check business longer than planned.

– Re-profiling of Baby Boxes spending to 2017/18.

– Higher than expected income from repayments of Student Loans offset against portfolio spending.

- Communities, Social Security and Equalities: The underspend primarily related to capital spending in housing. Higher than expected levels of capital receipts were received which were offset against spending. In addition, spending on the Infrastructure Loan Fund established in 2016/17 was lower than planned as it relies upon sites becoming available from councils and private developers.

17. High-level reasons for significant variances between actual and budgeted spend are included in the Consolidated Accounts (pages 51 to 61). Further information is given in the accounts of other bodies.

HM Treasury budget

18. Total Managed Expenditure (TME) is the total HM Treasury budget for the year. TME is categorised as either Annually Managed Expenditure (AME) or Departmental Expenditure Limit (DEL). AME is not subject to firm multi-year limits and does not affect the Scottish Government's spending power. DEL is subject to greater control, with a particular focus on fiscal DEL as a measure of real spending power. Fiscal DEL excludes capital charges that reflect the consumption of physical assets and other technical accounting non-cash items. The differences between HM Treasury and Scottish budgets are outlined in Exhibit 2.

Exhibit 2

Reconciliation between the Scottish budget and HM Treasury budget 2016/17 (£m)

The main difference between the two budgets is largely due to technical differences between accounting rules and UK budget rules.

	£m
Scottish budget approved	37,580
Add: HMT funding for DEL not in Spring Budget Revision	37
Add: HMT funding for AME not in Spring Budget Revision	254
Add: Judicial salaries	30
Less: Net technical adjustments	(162)
HM Treasury budget	**37,739**

Source: Audit Scotland based on Note 21 in the Consolidated Accounts 2016/17 (page 118)

19. Financial decisions taken by the Scottish Government within the extent of its available powers affect both TME and Scottish budget limits. For example, devolved tax revenues will be affected by tax policies for LBTT, SLfT and NDR. Decisions on the use of borrowing and reserve powers, and the amounts carried forward between years will also affect the aggregate amount of resources available during a particular year.

Performance against HM Treasury budget 2016/17

20. In June 2017, the Cabinet Secretary for Finance and the Constitution announced the provisional outturn figures for 2016/17 showed an underspend of £191 million against the HM Treasury DEL budget of £24,041 million. This included underspends of £138 million against the fiscal DEL budget (£98 million resource, £40 million capital) and £53 million against the financial transactions budget (used to make loans or equity investments into the private sector). The Scottish Government is able to carry forward the full amount of these underspends into 2017/18 using the Budget Exchange Scheme agreed with HM Treasury (Exhibit 3). Non-cash underspends of £108 million are not carried forward into the following year but as these reflect accounting adjustments such as depreciation and impairments, they do not represent a loss of spending power.

Exhibit 3
Provisional HM Treasury budget performance 2016/17

	Provisional outturn (£m)	HM Treasury budget (£m)	Over/(under) (£m)
HM Treasury Departmental Expenditure Limit (DEL)			
Gross Resource DEL	26,108	26,206	(98)
Block grant adjustment for devolved taxes	(5,500)	(5,500)	-
Net Resource DEL	**20,608**	**20,706**	**(98)**
Capital DEL - general	2,927	2,967	(40)
Capital DEL - financial transactions	315	368	(53)
Cash DEL	**23,850**	**24,041**	**(191)**
Non-cash DEL	784	892	(108)
Net block grant	**24,634**	**24,933**	**(299)**
Devolved tax powers revenue	5,533	5,571	(38)
Of which:			
LBTT	*484*	*538*	*(54)*
SLfT	*149*	*133*	*16*
SRIT	*4,900*	*4,900*	-
Capital borrowing facility	333	333	-

	Provisional outturn (£m)	HM Treasury budget (£m)	Over/(under) (£m)
HM Treasury Annually Managed Expenditure (AME)			
Non-domestic rates	2,769	2,769	-
Other AME	4,180	4,133	(47)
Total AME (not carried forward)	**6,949**	**6,902**	**(47)**

Note: HM Treasury outturn figures are provisional. The differences between budget and outturn in non-cash DEL and in AME do not represent a loss in spending power.

Source: Audit Scotland, based on Scotland Office and Office of Advocate General Annual Report & Accounts 2016/17 and provisional outturn statement by Cabinet Secretary for Finance and the Constitution.

Devolved tax powers from Scotland Act 2012

21. The 2016/17 financial year was the first year that all three devolved tax powers from the Scotland Act 2012 were fully implemented. The Scottish Government prepared forecasts for Land and Buildings Transactions Tax (LBTT) and Scottish Landfill Tax (SLfT) revenues for inclusion in the draft budget, while a Scottish Rate of Income Tax (SRIT) of 10 pence was set for the first time.

22. The Scottish Fiscal Commission (SFC) was responsible for providing independent scrutiny of the Scottish Government's tax forecasts. For 2016/17, the SFC assessed the forecasts for LBTT and SLfT as reasonable based on the data available. The amounts raised from LBTT and SLfT in 2016/17 were £484 million and £149 million respectively. This was £38 million less than the total £671 million forecast as part of the 2016/17 budget (Exhibit 4). The SFC reported[3] that variances were due to overestimating the house price forecast within the LBTT forecast; and for SLfT underestimating the level of standard rated waste which led to higher receipts than forecast.

23. More details of devolved tax revenues are reported in the Devolved Taxes Account published by Revenue Scotland.

[3] Scottish Fiscal Commission Forecast Evaluation Report September 2017

Exhibit 4

Devolved taxes collected

	2016/17 Revenue collected (£m)	2016/17 Budget Act Estimates (£m)	2016/17 Higher than forecast/ (shortfall)	2015/16 Revenue collected (£m)	2015/16 Budget Act Estimates (£m)	2015/16 Higher than forecast/ (shortfall)
Land and Buildings Transactions Tax	484	538	(54)	425	381	44
Scottish Landfill Tax	149	133	16	147	117	30
Total	**633**	**671**	**(38)**	**572**	**498**	**74**

Source: Revenue Scotland devolved taxes accounts 2015/16 and 2016/17.

24. As with any forecast, actual amounts are likely to differ from those predicted. For example, in 2015/16, tax receipts from LBTT and SLfT were £74 million higher than forecast. This additional income was transferred to a cash reserve designed to help offset any future shortfalls between forecast amounts and income received. In 2016/17, the Scottish Government managed its £38 million shortfall from LBTT and SLfT through underspends in its overall budget, therefore the cash reserve balance remains at £74 million. In 2017/18, this balance will transfer to a new Scotland Reserve at the same time as the aforementioned Budget Exchange Scheme closes. This is one of the new mechanisms available to the Scottish Government, along with increased revenue borrowing powers, to help it manage the increased risk and volatility its budget is now exposed to. As I reported in March 2017, the Scottish Government urgently needs to finalise policies and principles for borrowing and reserves, and further develop its longer-term financial scenario planning.[4] Making these publicly available will enhance financial transparency and help demonstrate good public financial management.

25. The Office for Budget Responsibility forecast that the SRIT would raise £4,900 million in 2016/17. This was the amount removed from the Scottish block grant and added back to reflect forecast tax income collected by HMRC from Scottish taxpayers. No adjustments will be made to future Scottish budgets should the actual tax received in 2016/17 differ from this forecast. Final outturn figures for 2016/17 will be known in summer 2018. This arrangement was part of the fiscal framework agreement between the UK Government and the Scottish Government in February 2016. From April 2017, SRIT was replaced by non-savings non-dividend income tax. Adjustments will be made in the summer of 2019.

[4] *Managing new financial powers: an update*, Audit Scotland, March 2017.

Capital borrowing

26. The treatment of Private Finance Initiative, Public Private Partnership and Non-Profit Distributing (NPD) investment projects in the Consolidated Accounts is based on accounting standards. Such projects are generally treated as 'on-balance sheet' capital investment in the accounts and the Scottish Government has applied the correct accounting treatment.

27. In July 2015, the Office for National Statistics (ONS) decided that the Aberdeen Western Peripheral Route (AWPR), which was a Scottish NPD investment project, should be classified as a public sector project in the National Accounts. In accordance with HM Treasury Consolidated Budgeting Guidance, budget treatment of these projects is determined by their position in the National Accounts. In November 2016, the ONS confirmed a similar classification for three further projects (Edinburgh Sick Kids Hospital, Dumfries & Galloway Royal Infirmary and the National Blood Centre). This classification means that capital budget cover is required at the point of initial investment, rather than revenue budget cover for the annual payments over the lifetime of the contract.

28. This resulted in charges against fiscal DEL budgets which required to be managed within budget limits. This meant that spending plans had to accommodate NPD expenditure within overall annual budget limits. In both 2015/16 and 2016/17, the Scottish Government agreed with HM Treasury that it could record these amounts against its capital borrowing limit. In 2016/17, the Scottish Government used its total capital borrowing limit of £333 million for this purpose. Although this did not result in actual borrowing, it removed the Scottish Government's power to borrow for capital purposes in 2016/17.

29. Looking ahead the draft Scottish budget estimates further capital spending of £190 million for these four projects in 2017/18. In March 2017, following discussions with officials, HM Treasury confirmed to the Scottish Government that any capital pressures arising from NPD projects as a result of the ONS classification would have to be absorbed within capital DEL limits with capital borrowing powers to be used as intended. The additional capital borrowing powers introduced in 2017/18 from the Scotland Act 2016 provides the Scottish Government with more flexibility in responding to spending pressures across its capital programme.

Overall financial position

30. The Consolidated Statement of Financial Position (previously known as the balance sheet) (page 62) is one of the primary financial statements in the Consolidated Accounts. It summarises what is owned and owed by the Scottish Government. This shows taxpayers' equity – an accounting measurement of the amount of taxpayers' money applied that has continuing public benefit. It shows how much of this has arisen from the application of revenues (including the Scottish Block Grant and devolved taxes) and that which has resulted through changes over time in the value of physical assets.

31. In public finances, the annual position of spending against budget is helpful but the most valuable insight comes from an analysis of trends in assets and liabilities over time. This provides important information about the impact of past decisions on future budgets and in turn highlights potential risks to financial sustainability. It is important that the Scottish

Government can demonstrate how it is managing its overall financial position. The key items in the Statement of Financial Position over the last five financial years are summarised in Exhibit 5.

Exhibit 5

Scottish Government's year end financial position, 2013 to 2017.

	As at 31/3/2017 (£m)	As at 31/3/2016 (£m)	As at 31/3/2015 (£m)	As at 31/3/2014 (£m)	As at 31/3/2013 (£m)
Physical assets	28,852	27,596	26,698	26,153	25,887
Financial assets	8,726	7,484	6,775	6,228	5,775
Receivables	1,277	1,379	1,098	973	921
Total assets	**38,855**	**36,459**	**34,571**	**33,354**	**32,583**
Payables	(6,063)	(4,882)	(4,416)	(4,572)	(4,527)
Financial liabilities	(673)	(679)	(693)	(698)	(705)
Provisions	(948)	(717)	(778)	(636)	(720)
Total liabilities	**(7,684)**	**(6,278)**	**(5,887)**	**(5,906)**	**(5,952)**
Net assets	**31,171**	**30,181**	**28,684**	**27,448**	**26,631**
General fund	21,064	20,623	18,843	17,397	16,468
Revaluation reserve	10,107	9,558	9,841	10,051	10,163
Taxpayers' Equity	**31,171**	**30,181**	**28,684**	**27,448**	**26,631**

Source: Audit Scotland from Consolidated Accounts 2012/13 to 2016/17.

32. The accounts also provide information about some categories of asset, debt or financing activity not shown on the statement of financial position, largely because of the high level of uncertainty involved. This includes potential liabilities, contingent assets and liabilities and government guarantees. A contingent asset is a possible asset and a contingent liability is a possible obligation, whose existence will be confirmed only by uncertain future events not wholly within the Scottish Government’s control.

33. The Scottish Government has reported various contingent assets and liabilities in the Consolidated Accounts. Only some of the liabilities can be quantified, with amounts totalling an estimated £429 million. Some of these amounts may need to be funded from future budgets, but this is by no means certain. Similarly, the Scottish Government has a number of

financial guarantees where the likelihood of settlement is more remote and therefore is not classed as a contingent asset or liability. For example, in December 2016 the Scottish Government entered into a guarantee relating to the hydro plant and aluminium smelter at Lochaber in relation to a power purchase agreement. In 2016/17 this guarantee was valued at £21.4 million. Although settlement is remote, this reflects the Scottish Government's increasing activity and risk appetite in providing financial support and guarantees to support policy objectives.

34. As detailed in Exhibit 5, taxpayers' equity has increased in each of the last five years. This increase is due largely to an increase in physical assets and financial assets. It is important to note that whilst taxpayers' equity as reported in the Scottish Government Consolidated Accounts is increasing, the position does not reflect all the assets and liabilities of the Scottish public sector. For example, key liabilities over and above those detailed in the consolidated accounts including local government borrowing or all public sector pension liabilities funded from the Scottish budget. As detailed in paragraph 39 of this report, publication of a consolidated account for the whole of the public sector in Scotland will give a more comprehensive view of the assets and liabilities of the public sector as a whole.

35. The Consolidated Accounts provides some narrative on the components of the Statement of Financial Position. This is largely in line with improvements noted last year. There remains scope for the Scottish Government to build on these improvements by outlining the opportunities and risks over potential future assets and liabilities and their impact on annual budgets and the overall financial position. This would strengthen transparency and help support the Parliament in their scrutiny of the potential impact of Scottish Government's budget plans and policy choices.

Financial and performance reporting

Financial reporting

36. The Scottish Parliament has seen its financial powers increase substantially, with new responsibilities for taxes, social security and management of finances flowing from the 2012 and 2016 Scotland Acts. These changes have significant implications for public financial management in Scotland and how public finances are reported. A more strategic approach is required that is underpinned by a strong understanding of the economic context at both Scottish and UK levels. This requires comprehensive information to be available that links economic performance with financial information covering income, borrowing and spending.

37. In March this year, I reported that the Scottish Government is taking steps to enhance financial reporting of Scotland's public finances, but more work is required to provide a clear overall picture.[5] The increasingly complex nature of Scotland's public finances means there is an expectation and responsibility on the Scottish Government to provide clear and consistent budget and financial reporting. It is important that information is presented in such a way that

[5] *Managing new financial powers: an update*, Audit Scotland, March 2017.

is easy to understand and navigate. This will encourage greater public engagement and help the Parliament to build a comprehensive picture of Scotland's public finances. This allows the potential consequences of policy choices and decisions on long-term financial sustainability to be better understood and contribute to public trust and confidence in Government.

38. The Scottish Government reports financial information in a variety of documents including the Consolidated Accounts. The Scottish Government has made some improvements to the presentation of this year's consolidated statements, which should help the reader's understanding of individual Scottish Government portfolios' financial performance. I welcome this but there is scope to go further to make the accounts more accessible to the public and Parliament.

39. The Scottish Government has established a programme of work to develop its public financial reporting. As part of this, it has committed to producing a consolidated account to cover the whole public sector in Scotland including local government borrowing and public sector pension liabilities. It is expected this will provide information on total assets, liabilities, borrowing and investments across the Scottish public sector. The Scottish Government has designated 2016/17 as a 'shadow-year' with a view to publishing the account during 2018. This is a welcome development and should aim to allow for the Parliament and others to see a comprehensive picture of the financial health of the public sector in Scotland.

40. In December 2016, the Scottish Government published its first Open Government National Plan.[6] The plan aims to give the public a better understanding of how government works so that they can have more influence in holding them to account. One of the commitments in the plan aims to clearly explain how public finances work, so people can understand how money flows into and out of the Scottish Government, to support public spending in Scotland. By April 2018, it aims to have undertaken a review of the content and format of the information that it currently publishes on its website to then allow greater clarity and wider access to the information that is published. In addition, the Scottish Government has committed to consider what new financial reporting information it needs to publish to reflect a more open approach to public finances alongside the introduction of new financial powers. It aims to make any changes in 2018/19.

41. In 2016, the Finance and Constitution Committee established a Budget Process Review Group to carry out a fundamental review of the budget process in light of the Scottish Parliament's new financial powers. The Group consisted of parliamentary and government officials alongside a panel of external experts including me as Auditor General. The Group published its final report in June 2017, making detailed recommendations to significantly change the existing budget process.[7] This included a recommendation that the revised process should:

- have a greater influence on the formulation of the Scottish Government’s budget proposals;

[6] *Open Government Partnership Scottish Action Plan*, Scottish Government, December 2016.
[7] *Budget Process Review Group, Final Report*, June 2017.

- improve transparency and raise public understanding and awareness of the budget;
- respond effectively to new fiscal and wider policy challenges;
- lead to better outputs and outcomes as measured against benchmarks and stated objectives.

42. The Group recommended a revised framework for the Scottish Parliament and Government to agree a new budget process. This centres on a full-year approach with continuous scrutiny allowing for a better understanding of the impact of decisions over a number of years. It also recommends there should be a greater focus on outcomes and the interdependencies and prioritisation of policies considering both financial constraints and an increased demand for public services.

43. To support improvements to the budget process, the Group's recommendations include some significant changes to the Scottish Government's financial reporting. These include:

- The introduction of an annual Fiscal Framework Outturn Report. This is to support scrutiny of the operation of the Fiscal Framework agreed between the UK and Scottish governments in relation to the arrangements for new tax and social security powers and how this affects the Scottish budget. The report should include details on the reconciliation process between forecasts and outturn, use of Scotland Reserve and borrowing powers.
- The introduction of a Medium-Term Financial Strategy to outline the Scottish Government's high-level financial plans and projections for at least five years. The strategy should be published on an annual, rolling basis to help inform detailed budget proposals in each year.
- A presumption that the Scottish Government returns to publishing multi-year spending reviews following the equivalent publication at UK level. This would provide support to public bodies in developing and setting medium-term priorities and plans.
- The introduction of a mid-year report to Parliament on revenue and spending up to the end of December of the current financial year to accompany any proposed budget amendments in the Spring Budget Revision.

44. I welcome and support the Group's findings and recommendations, which are consistent with themes I have reported to Parliament in recent years. A key aspect is that the scrutiny of public finances moves towards a whole-cycle approach rather than its current annual focus that follows the publication of the draft budget. This would provide more space and time for year-round scrutiny of value for money decisions and inform future spending proposals. Longer-term planning and a clear financial strategy are fundamental elements for effective policy decision making. The principles of financial sustainability, transparency and accountability should be demonstrated in the Government's financial reporting on the current financial position, future forecasts and its plans to address any emerging pressures. This is necessary to enable the Parliament to take a broader perspective to hold Government to account for its approach to spending and tax-raising and its overall management of public finances.

45. Relevant recommendations are to be reflected in a revised Written Agreement between the Scottish Government and the Finance Committee.

46. The recommendations together with the need to finalise policies for borrowing and reserves, and the Scottish Government's plans to develop a whole public sector consolidated account, provide a real opportunity for the Scottish Government to significantly strengthen its financial reporting. This will help support both Parliamentary and public scrutiny as we enter a new environment for public financial management in Scotland. I will continue to examine and report on the Government's progress in this area.

Performance reporting

47. The Consolidated Accounts are required to comply with the accounting principles and disclosure requirements of the Government Financial Reporting Manual (FReM).[8] A direction by the Scottish ministers to that effect is set out in the Consolidated Accounts (page 120). In Scotland, the form and content of the annual report and accounts is a matter for the Scottish Parliament, which in practice involves an agreement between the Scottish ministers and the Public Audit and Post-Legislative Scrutiny Committee on a format based on the principles contained in the FReM.

48. The 2016/17 Consolidated Accounts comply with the principles of the FReM, including a performance report and an accountability report. The performance report (pages 6 to 21) summarises financial performance for the year, with particular emphasis on performance against budget. It also contains some specific performance information which is required by current guidance on supplier payment performance compared with policy targets and signposts where more information is available on sustainability and environmental performance. For information on the Scottish Government's progress towards its overall aims and objectives, users of the accounts are directed to the National Performance Framework (NPF). The NPF sets out the purpose, objectives and national outcomes which describe in more detail what the Scottish Government aims to achieve. The report provides a link to the Scotland Performs website where progress against the measures set out in the NPF is regularly updated.

49. Consequently, while the performance report provides analysis of some key aspects of financial performance, the Consolidated Accounts focus on the Government's finances. They do not report on the performance of individual portfolios or the Scottish Government as a whole, limiting the reader's ability to see the Government's own contribution to national outcomes.

50. As Scotland's fiscal responsibilities continue to grow, expectations are increasing for the Scottish Government to produce more detailed and transparent performance reporting, that better links spending with outcomes. The Budget Process Review Group recommended that the Scottish Government strengthens their performance planning and reporting to provide a greater focus on the delivery of outcomes. This includes providing better information about

[8] *Government Financial Reporting Manual 2016/17*, HM Treasury.

what activity public spending will support, its aims, and the contribution it expects to make to national outcomes.

51. Greater transparency around the Scottish Government's own performance towards meeting its strategic objectives would provide greater accountability for the use of financial resources outlined in the Consolidated Accounts. This would provide a more rounded account of the Scottish Government's overall performance and would enhance reporting to the Scottish Parliament and the public, and help strengthen accountability and scrutiny.

Governance

52. A Governance Statement (pages 23 to 30) prepared by the Permanent Secretary is a key feature of the Consolidated Accounts. It forms part of a wider accountability report and summarises how the core Scottish Government organisation is controlled and directed. The statement reports that it complies with relevant guidance on corporate governance. It also highlights some of the main risks and opportunities for the organisation and any significant internal control issues in 2016/17. I am content that the Governance Statement is consistent with the financial statements and has been prepared in accordance with guidance on this issued by the Scottish Ministers.

53. In October 2016, the Scottish Government implemented new governance arrangements with the aim that they better reflect the demands created by new financial powers and constitutional change. This followed a review undertaken by the Permanent Secretary to explore options for streamlining arrangements while ensuring the principles of effectiveness and transparency are maintained. In July 2017, further changes were made at executive team level including the creation of a Director General role to better reflect Scotland's new fiscal responsibilities and a Chief Financial Officer role to cover in-year financial management and operations. The changes provide an opportunity for the Scottish Government to strengthen oversight of public financial management during a period of significant change for Scotland's public finances.

54. In June 2017, an independent review of the governance arrangements commenced led by the Director of Internal Audit, supported by the Crown Agent and a former non-executive director. The review aims to assess whether the design principles and governance tests of the new arrangements are being met or if any further measures are required. It is good practice to undertake an early review of new arrangements in order to address any concerns or to identify any lessons learned can be identified. The review is due to be reported to the Scottish Government in October 2017.

55. The success of the new arrangements will be determined by how they operate in practice. Central to this will be the culture and behaviours adopted by those involved including the contributions made by non-executive directors to ensure scrutiny and challenge are effective and transparency is exercised. It is important that non-executive directors are able to provide an appropriate balance of support and challenge and their level of engagement should reflect this independent role. I will keep the revised governance arrangements under review as part of our continuing work and engagement with the Scottish Government.

56. In implementing these new arrangements it is also important to recognise the Scottish Government's leadership role for other bodies. In my view, the new approach must remain, and be seen to remain, aligned with what it expects of other public bodies and that in developing its new arrangements it demonstrates the culture and behaviours that support the principles of good governance including transparency.

Other significant audit matters

European Funding - CAP Futures

57. The Scottish Government provides financial support to farmers and other rural businesses as part of the Common Agricultural Policy (CAP). The 2016/17 Consolidated Accounts include resource expenditure of £10.6 million on the CAP Futures programme, an IT-enabled change programme to implement the CAP reforms in Scotland. Capital spending was £29.4 million.

58. In June 2017, I reported that the CAP Futures programme closed as planned on 31 March 2017.[9] Significant parts of the system continue to be delivered by the Agriculture and Rural Economy directorate. The directorate expects to deliver the minimum required scope to comply with European Commission (EC) regulations within the £178 million budget.

59. The Governance Statement in the Consolidated Accounts notes that delivering the CAP payments remains extremely challenging and that there remains a significant risk to meeting EC regulatory requirements. In my June 2017 report I estimated potential financial penalties of up to £60 million, but I highlighted that the Scottish Government had not undertaken a detailed analysis of potential financial penalties. My estimate was based on a combination of the financial impact of findings from the 2015/16 audit of European Agricultual Funds Accounts, penalties relating to the late payment of 2015 single application form claims and the failure to meet other deadlines. The Consolidated Accounts show provisions and contingent liabilities relating to potential penalties from the European Commission. Note 12 of the Consolidated Accounts (page 94) includes a provision of £2.5 million in relation to penalties. An unquantifiable contingent liability in respect of potential future liabilities is also included in Note 17 (page 108). The relevant amounts are appropriately disclosed in the Consolidated Accounts. A provision is a liability of uncertain timing or amount where there is an obligation based on a past event, it is probable it will mean a payment to settle the obligation and the amount is based on a reliable estimate. A contingent liability is more uncertain in both timing and amount, and is dependent on a future event to confirm its existence; or no reliable estimate can be made for it.

60. The Consolidated Accounts also show an unquantifiable contingent liability for the potential penalty from the missed extended payment deadline for 2015 payments. There is an accrual of £1 million in relation to this missed deadline as well as a contingent liability for the potential penalty that is to be negotiated. The liability is probable, however a reliable estimate cannot be made and therefore we accepted the treatment as a contingent liability.

[9] *Common Agricultural Policy Futures programme: further update*, Audit Scotland, June 2017.

61. There is also a contingent liability disclosure for a number of European Commission audits which may result in disallowance of grant or penalties, but these cannot be quantified because of the uncertainty in timing and estimates as they can change through negotiations with the European Commission. Negotiations on disallowance with the European Commission can last for many months and the agreed disallowance or penalty can sometimes be significantly different from initial notification of potential penalty. Consequently, the £60 million estimate of potential financial penalties does not appear in the Consolidated Accounts.

62. Exhibit 6 below shows the time it takes for a potential liability to crystallise to a payment.

Exhibit 6

Time lag between CAP scheme year and repayment to the European Commission

Source: Audit Scotland

63. The Scottish Government established two loan schemes during 2016/17 to help farmers and rural businesses receive money more quickly. These included funding from the Scottish Government's financial transactions budget which supports loan schemes that go beyond the public sector. Note 9 (page 87) of the Consolidated Accounts discloses that loan payments of £370 million were made in 2016/17, with £239 million recovered by 31 March 2017. The Scottish Government managed in-year loan funding to minimise the risk of overspending its 2016/17 capital budget. At the same time, the Government ensured any underspend did not exceed its budget exchange limit which would have reduced the level of carry forward available in 2017/18.

64. Due to the continued delays developing the software for 2016 Less Favoured Area Support Scheme payments, the Cabinet Secretary for Rural Economy and Connectivity announced a £50 million loan scheme in April 2017. In addition, a further loan scheme in relation to the 2017 Basic Payment Scheme (BPS) was announced in September 2017.

European Structural Funds

65. The Scottish Government manages four European structural fund programmes (two programmes funded by the European Social Fund and two funded by the European Regional Development Fund). These programmes provide financial assistance to, for example, help improve transport links, support business growth and improve skills.

66. In my report last year on the 2015/16 Consolidated Accounts, I highlighted that the European Commission had lifted the suspensions and interruption imposed on the 2007-13 programmes. While the suspensions and interruptions remained in place, amounts due from the EC accumulated. Following their removal, £165 million receipts were received during 2016/17. The 2016/17 Consolidated Accounts show that the £14 million provision created in 2015/16 crystallised into a liability of £31 million as a result of the 2007-13 programme closure representing grant payments received over and above expenditure declared to the EC. Taking into account all receipts in year, the net cost to the Scottish Government is £21 million, subject to final EC checks.

67. Closure of the 2007-13 programmes also identified that the Scottish Government overpaid project sponsors a total of £16 million as a result of errors identified by Internal Audit and the subsequent application of penalties. The Scottish Government has started to raise invoices for these amounts owed to them by sponsors. The Consolidated Accounts include an unquantified contingent asset as there remains uncertainty over whether the amounts will be recovered as they may be subject to appeal.

Conclusion

68. The Scottish Government has published a sound financial report in its Consolidated Accounts for 2016/17. It covers spending against budget for the financial year and sets out what it owns and owes as at 31 March 2017. The accounts are prepared from the perspective of the Scottish Government's role in managing the budget it directly controls and covers the majority of public spending in the Scottish budget. This is a critical component of the Scottish Government's accountability to the Parliament and the public.

69. The Scottish Government has a good record of financial management and reporting. In 2016/17 improvements were made to the Consolidated Accounts in its presentation and narrative. Governance arrangements continue to evolve and the National Performance Framework provides details on what the Government aims to achieve and performance against national outcomes. My audit work has highlighted a number of areas for further improvement to help support the Parliament and the public in their scrutiny of public finances. Priorities for the Scottish Government should be to:

- publish a public sector consolidated account for the whole public sector to outline total assets, liabilities, borrowing and investments;
- introduce a medium-term financial strategy to outline high-level financial plans for the next five years; and
- finalise policies and principles for borrowing and reserves.

70. The implementation of new financial powers and changes that will arise from the UK's decision to leave the European Union, mean it is critical that the Scottish Government continues to strengthen its approach to public financial management and reporting. These challenges provide a unique opportunity for the Scottish Government to engage with both the Parliament and the public about the risks and opportunities facing Scotland's public finances. The increasingly complex nature of public finances means there is a growing expectation and responsibility on the Scottish Government to provide clear and consistent budget and financial reporting. This will help support the Parliament, as it implements its new budget process, to build a comprehensive picture of Scotland's public finances and will help foster greater public trust and confidence in Government.

71. Working with Audit Scotland and the Accounts Commission, I will continue to support the independent scrutiny of Scotland's public finances through all of our audit work.

Appendix 1

Scottish budget 2016/17: outturn against budget for bodies not included in the Consolidated Accounts.

Entity	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Scottish Government Consolidated Accounts	33,870	33,955	(85)
National Records of Scotland	25	26	(1)
Teachers' and NHS Pension Schemes	3,282	3,300	(18)
Office of the Scottish Charity Regulator	3	3	-
Scottish Courts and Tribunal Service	108	107	1
Scottish Housing Regulator	4	4	-
Revenue Scotland	5	5	-
Food Standards Scotland	15	15	-
Total Scottish Administration	**37,312**	**37,415**	**(103)**
Forestry Commission	54	57	(3)
Scottish Parliamentary Corporate Body	98	100	(2)
Audit Scotland	8	8	-
Total Scottish Budget	**37,472**	**37,580**	**(108)**

Source: Audit Scotland based on 2016/17 audited accounts where available at the time of writing.

The 2016/17 audit of the Scottish Government Consolidated Accounts

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The 2016/17 audit of the Scottish Government Consolidated Accounts

DRAFT

AUDITOR GENERAL

Prepared for the Public Audit and Post-legislative Scrutiny Committee
Made under section 22 of the Public Finance and Accountability (Scotland) Act 2000
September 2017

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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Introduction

1. The Scottish Parliament's new financial powers are coming into effect at a time of ongoing pressures on public finances and uncertainty about the implications of the UK vote to leave the European Union. The Scotland Acts of 2012 and 2016 have introduced new responsibilities for tax and spending that enhance the Scottish Government's ability to manage and control its spending but also introduce a greater element of financial risk. Comprehensive, transparent and timely reporting of the Scottish Government's budget and financial performance is essential in supporting the Parliament in its important scrutiny role.

2. In December 2015, the Scottish Government published its draft 2016/17 Scottish Budget which set out its spending priorities and plans for the year. The Scottish Government's Consolidated Accounts for 2016/17 provides information on how this budget was managed, how the money was spent and what was achieved.

3. The Consolidated Accounts are a key component of the Scottish Government's accountability to the Scottish Parliament and the public. The accounts reflect the areas for which it has direct responsibility and accountability, including the core portfolios and supporting administration, the executive agencies and NHS bodies. The Consolidated Accounts:
   - cover around 90 per cent of the spending approved by the Scottish Parliament
   - report the amounts the Scottish Government spent against each main budget heading, and the reasons for any significant differences
   - show the amounts distributed to other public bodies including local government
   - report the assets, liabilities and other financial commitments carried forward to future years
   - contain a performance report, in which the Government gives a high-level account of its performance during the year.

4. My independent audit opinion on the 2016/17 Consolidated Accounts is unqualified. This means that I am content they show a true and fair view, follow accounting standards and that the income and expenditure for the year is lawful. My audit opinion is set out at page 50 of the accounts.

5. This report highlights key information in the Consolidated Accounts. It explains what they show about the Scottish Government’s management of its budget. The report also provides other information about the budget, and about governance and performance. I also set out significant audit findings and identify matters relating to financial and performance management and report where further action is required.

6. As with previous years, I provide this report on the 2016/17 Consolidated Accounts to support the Scottish Parliament in its important scrutiny role of public finances in Scotland.

Key messages

- **The Scottish Government has published a sound financial report in its Consolidated Accounts for 2016/17 and my opinion on them is unqualified. The accounts show that total net expenditure during 2016/17 was £33,870 million, £85 million less than budget. Budget management during the year was effective in managing total spending against the limit set.**
- **The amount raised from Land and Buildings Transactions Tax and Scottish Landfill Tax in 2016/17 was £633 million, £38 million less than the December 2105 forecast of £671 million included as part of the budget. As with any forecast, actual amounts are likely to differ from those predicted. The Scottish Government managed this shortfall through underspends in its overall budget.**
- **The implementation of new financial powers and changes that will arise from the UK's decision to leave the European Union, mean it is critical that the Scottish Government continues to strengthen its approach to public financial management and reporting. Priorities for the Scottish Government should be to:**
  - **publish a public sector consolidated account for the whole public sector**
  - **introduce a medium-term financial strategy covering the next five years**
  - **finalise policies and principles for borrowing and reserves.**
- **In June 2017, the Budget Process Review Group established by the Finance and Constitution Committee, recommended a revised framework for a new budget process centred on a full-year approach with continuous scrutiny. The Group consisted of parliamentary and government officials alongside external experts. The Group's recommendations provide a real opportunity for the Scottish Government to significantly strengthen its financial reporting and support Parliamentary and public scrutiny as we enter a new environment for public financial management in Scotland.**
- **During 2016/17, the Scottish Government implemented new governance arrangements with the aim that they better reflect the demands created by new financial powers and constitutional change. The success of the new arrangements will be determined by how they operate in practice. Central to this will be the culture and behaviours adopted by those involved to ensure scrutiny and challenge are effective and transparency is exercised.**

Financial management

7. For the second year, the Scottish budget included new tax and borrowing powers set out in the Scotland Act 2012. This meant that the total amount it could spend was affected by amounts raised through devolved taxes and any capital borrowing decisions, as well as the Scottish Block Grant and other funding sources including Non-Domestic Rates (NDR) income and European programmes of financial assistance.

8. The Block Grant was the largest part of the budget. It was adjusted to reflect the devolution of Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) as well as the introduction of the Scottish Rate of Income Tax (SRIT) for the first time in 2016/17. The UK Parliament votes the necessary provision to the Secretary of State for Scotland, who makes grant payments to the Scottish Government into the Scottish Consolidated Fund (SCF). Receipts from devolved tax powers and any borrowing are also paid into the Fund.

9. Each year the Scottish Government has to manage its spending within two budgets:

- **Scottish budget:** approved by the Scottish Parliament each year and used to cover spending by the Scottish Administration and other bodies funded directly out of the Scottish Consolidated Fund.
- **HM Treasury budget:** used by the UK government to manage its spending on the Scottish Block grant. This is different from the Scottish Parliament's budget largely for technical reasons reflecting differences between accounting rules and UK budget rules.

Scottish budget

10. The final budget approved by the Scottish Parliament for 2016/17 permitted total expenditure of £37,580 million for the financial year. This reflects two revisions made to the original budget during autumn 2016 and spring 2017, which added a total of £631 million to the budget. Additions were mainly due to a combination of Barnett consequentials[1] arising from changes to UK spending programmes and technical accounting adjustments.

11. The majority of the budget (90 per cent or £33,955 million) relates to spending programmes and administration costs covered by the Scottish Government Consolidated Accounts. The accounts are an important part of a number of different financial reports laid in Parliament that sets out how the Scottish budget has been used. They reflect the areas that the Scottish Government is directly responsible and accountable for:

- core portfolios and related administration (such as staff costs)
- executive agencies (such as Scottish Prison Service and Transport Scotland)
- NHS bodies (both territorial and national boards)
- Crown Office and Procurator Fiscal Service
- Mental Welfare Commission.

[1] Barnett consequentials are changes to funding to a devolved administration as a result of changes to comparable UK spending programmes.

Further details of the bodies included as part of the Consolidated Accounts are included at page 13 of the accounts.

12. Amounts are also allocated to other parts of the Scottish Administration (£3,460 million) such as NHS and Teachers' Pension Schemes and also to directly funded bodies (£165 million) such as the Scottish Parliamentary Corporate Body. Details of outturn against budget for the bodies not included in the Consolidated Accounts are included at Appendix 1.

13. Separate accounts are also published by individual agencies and bodies whether part of the Scottish Administration, sponsored by the Scottish Government or directly funded bodies. These reflect the accountability each has to the Scottish Parliament. Audit reports relating to these separate accounts are available on Audit Scotland's website.[2]

14. The Scottish Government also publishes the audited accounts of the Scottish Consolidated Fund (SCF) and the Non-Domestic Rating Account. The SCF account reports the cash paid in and out of the Fund and the NDR account shows the amounts collected by, and paid out to, local government in relation to non-domestic rates. The Devolved Taxes accounts are produced by Revenue Scotland. The Scottish Ministers also report a Final Outturn statement for the preceding financial year against the final Budget for the Scottish Administration as a whole. This is an important part of the Government's accountability to the Scottish Parliament.

Scottish budget performance 2016/17

15. The Consolidated Accounts show that total net expenditure during 2016/17 was £33,870 million, £85 million less than budget (Exhibit 1). The resource budget was underspent by £28 million (0.1 per cent) against a budget of £31,890 million and capital by £57 million (2.8 per cent) against a budget of £2,065 million. Budget management during the year was effective in managing total spending against the limit set.

Exhibit 1

Total expenditure (resource and capital) against the Scottish Budget approved by the Scottish Parliament

The Scottish Government consolidated total was £85 million under budget in 2016/17.

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Finance and the Constitution	91	104	(13)
Health and Sport	13,353	13,241	112
Education and Skills	3,146	3,190	(44)
Economy, Jobs and Fair Work	320	339	(19)
Justice	2,405	2,415	(10)

[2] www.audit-scotland.gov.uk/report/search

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Communities, Social Security and Equalities	10,959	11,021	(62)
Environment, Climate Change and Land Reform	203	223	(20)
Culture, Tourism and External Affairs	264	272	(8)
Rural Economy and Connectivity	2,835	2,839	(4)
Crown Office and Procurator Fiscal Service	113	115	(2)
Administration	181	196	(15)
Scottish Government consolidated total	**33,870**	**33,955**	**(85)**
Other Scottish Administration	3,442	3,460	(18)
Total Scottish Administration	**37,312**	**37,415**	**(103)**
Directly-funded bodies	160	165	(5)
Total Scottish Budget	**37,472**	**37,580**	**(108)**

Source: Information drawn from the Scottish Government Consolidated Accounts 2016/17 (page 54) and accounts of other bodies, some of which are unaudited at the time of writing. Information on actual against budget performance for bodies not included in the Consolidated Accounts is included at Appendix 1. Further information of individual portfolio spending performance can be found in pages 55 to 65 in the Consolidated Accounts.

16. The Scottish Government manages variations in each portfolio to ensure overall spending remains within budget. The main differences between actual and budgeted spend reported by the Scottish Government were:

- Health and Sport: An overspend of £112 million which mainly related to an increase of £160 million to the provision used to assess legal claims against health boards. The increase was as a result of a technical change in how the claims are assessed. The increase in the provision was partly offset by lower than anticipated charges for property impairments.
- Education and Skills: The underspend within Education and Skills was due to a combination of issues including:
  - Later than anticipated implementation by schools and local authorities of all elements within the Scottish Attainment Challenge programme.
  - Additional income from Disclosure Scotland as a result of retaining English and Welsh disclosure check business longer than planned.
  - Re-profiling of Baby Boxes spending to 2017/18.

- Higher than expected income from repayments of Student Loans offset against portfolio spending.

- Communities, Social Security and Equalities: The underspend primarily related to capital spending in housing. Higher than expected levels of capital receipts were received which were offset against spending. In addition, spending on the Infrastructure Loan Fund established in 2016/17 was lower than planned as it relies upon sites becoming available from councils and private developers.

17. High-level reasons for significant variances between actual and budgeted spend are included in the Consolidated Accounts (pages 55 to 65). Further information is given in the accounts of other bodies.

HM Treasury budget

18. Total Managed Expenditure (TME) is the total HM Treasury budget for the year. TME is categorised as either Annually Managed Expenditure (AME) or Departmental Expenditure Limit (DEL). AME is not subject to firm multi-year limits and does not affect the Scottish Government's spending power. DEL is subject to greater control, with a particular focus on fiscal DEL as a measure of real spending power. Fiscal DEL excludes capital charges that reflect the consumption of physical assets and other technical accounting non-cash items. The differences between HM Treasury and Scottish budgets are outlined in Exhibit 2.

Exhibit 2

Reconciliation between the Scottish budget and HM Treasury budget 2016/17 (£m)

The main difference between the two budgets is largely due to technical differences between accounting rules and UK budget rules.

	£m
Scottish budget approved	37,580
Add: HMT funding for DEL not in Spring Budget Revision	37
Add: HMT funding for AME not in Spring Budget Revision	254
Add: Judicial salaries	30
Less: Net technical adjustments	(162)
HM Treasury budget	**37,739**

Source: Audit Scotland based on Note 21 in the Consolidated Accounts 2016/17 (page 122)

19. Financial decisions taken by the Scottish Government within the extent of its available powers affect both TME and Scottish budget limits. For example, devolved tax revenues will be affected by tax policies for LBTT, SLfT and NDR. Decisions on the use of borrowing and reserve powers, and the amounts carried forward between years will also affect the aggregate amount of resources available during a particular year.

Performance against HM Treasury budget 2016/17

20. In June 2017, the Cabinet Secretary for Finance and the Constitution announced the provisional outturn figures for 2016/17 showed an underspend of £191 million against the HM Treasury DEL budget of £24,041 million. This included underspends of £138 million against the fiscal DEL budget (£98 million resource, £40 million capital) and £53 million against the financial transactions budget (used to make loans or equity investments into the private sector). The Scottish Government is able to carry forward the full amount of these underspends into 2017/18 using the Budget Exchange Scheme agreed with HM Treasury (Exhibit 3). Non-cash underspends of £108 million are not carried forward into the following year but as these reflect accounting adjustments such as depreciation and impairments, they do not represent a loss of spending power.

Exhibit 3

Provisional HM Treasury budget performance 2016/17

	Provisional outturn (£m)	HM Treasury budget (£m)	Over/(under) (£m)
HM Treasury Departmental Expenditure Limit (DEL)			
Gross Resource DEL	26,108	26,206	(98)
Block grant adjustment for devolved taxes	(5,500)	(5,500)	-
Net Resource DEL	**20,608**	**20,706**	**(98)**
Capital DEL - general	2,927	2,967	(40)
Capital DEL - financial transactions	315	368	(53)
Cash DEL	**23,850**	**24,041**	**(191)**
Non-cash DEL	784	892	(108)
Net block grant	**24,634**	**24,933**	**(299)**
Devolved tax powers revenue	5,533	5,571	(38)
Of which:			
LBTT	*484*	*538*	*(54)*
SLfT	*149*	*133*	*16*
SRIT	*4,900*	*4,900*	-
Capital borrowing facility	333	333	-

	Provisional outturn (£m)	HM Treasury budget (£m)	Over/(under) (£m)
HM Treasury Annually Managed Expenditure (AME)			
Non-domestic rates	2,769	2,769	-
Other AME	4,180	4,133	(47)
Total AME (not carried forward)	**6,949**	**6,902**	**(47)**

Note: HM Treasury outturn figures are provisional. The differences between budget and outturn in non-cash DEL and in AME do not represent a loss in spending power.

Source: Audit Scotland, based on Scotland Office and Office of Advocate General Annual Report & Accounts 2016/17 and provisional outturn statement by Cabinet Secretary for Finance and the Constitution.

Devolved tax powers from Scotland Act 2012

21. The 2016/17 financial year was the first year that all three devolved tax powers from the Scotland Act 2012 were fully implemented. The Scottish Government prepared forecasts for Land and Buildings Transactions Tax (LBTT) and Scottish Landfill Tax (SLfT) revenues for inclusion in the draft budget, while a Scottish Rate of Income Tax (SRIT) of 10 pence was set for the first time.

22. The Scottish Fiscal Commission (SFC) was responsible for providing independent scrutiny of the Scottish Government's tax forecasts. For 2016/17, the SFC assessed the forecasts for LBTT and SLfT as reasonable based on the data available. The amounts raised from LBTT and SLfT in 2016/17 were £484 million and £149 million respectively. This was £38 million less than the total £671 million forecast as part of the 2016/17 budget (Exhibit 4). The SFC reported[3] that variances were due to overestimating the house price forecast within the LBTT forecast; and for SLfT underestimating the level of standard rated waste which led to higher receipts than forecast.

23. More details of devolved tax revenues are reported in the Devolved Taxes Account published by Revenue Scotland.

Exhibit 4

Devolved taxes collected

	2016/17 Revenue collected (£m)	2016/17 Budget Act Estimates (£m)	2016/17 Higher than forecast/ (shortfall)	2015/16 Revenue collected (£m)	2015/16 Budget Act Estimates (£m)	2015/16 Higher than forecast/ (shortfall)

[3] Scottish Fiscal Commission Forecast Evaluation Report September 2017

	2016/17 Revenue collected (£m)	2016/17 Budget Act Estimates (£m)	2016/17 Higher than forecast/ (shortfall)	2015/16 Revenue collected (£m)	2015/16 Budget Act Estimates (£m)	2015/16 Higher than forecast/ (shortfall)
Land and Buildings Transactions Tax	484	538	(54)	425	381	44
Scottish Landfill Tax	149	133	16	147	117	30
Total	**633**	**671**	**(38)**	**572**	**498**	**74**

Source: Revenue Scotland devolved taxes accounts 2015/16 and 2016/17.

24. As with any forecast, actual amounts are likely to differ from those predicted. For example, in 2015/16, tax receipts from LBTT and SLfT were £74 million higher than forecast. This additional income was transferred to a cash reserve designed to help offset any future shortfalls between forecast amounts and income received. In 2016/17, the Scottish Government managed its £38 million shortfall from LBTT and SLfT through underspends in its overall budget, therefore the cash reserve balance remains at £74 million. In 2017/18, this balance will transfer to a new Scotland Reserve at the same time as the aforementioned Budget Exchange Scheme closes. This is one of the new mechanisms available to the Scottish Government, along with increased revenue borrowing powers, to help it manage the increased risk and volatility its budget is now exposed to. As I reported in March 2017, the Scottish Government urgently needs to finalise policies and principles for borrowing and reserves, and further develop its longer-term financial scenario planning.[4] Making these publicly available will enhance financial transparency and help demonstrate good public financial management.

25. The Office for Budget Responsibility forecast that the SRIT would raise £4,900 million in 2016/17. This was the amount removed from the Scottish Government's block grant and added back to reflect forecast tax income collected by HMRC from Scottish taxpayers. No adjustments will be made to future Scottish budgets should the actual tax received in 2016/17 differ from this forecast. Final outturn figures for 2016/17 will be known in summer 2018. This arrangement was part of the fiscal framework agreement between the UK Government and the Scottish Government in February 2016. From April 2017, SRIT was replaced by non-savings non-dividend income tax. Adjustments will be made in the summer of 2019.

[4] *Managing new financial powers: an update*, Audit Scotland, March 2017.

Capital borrowing

26. The treatment of Private Finance Initiative, Public Private Partnership and Non-Profit Distributing (NPD) investment projects in the Consolidated Accounts is based on accounting standards. Such projects are generally treated as 'on-balance sheet' capital investment in the accounts and the Scottish Government has applied the correct accounting treatment.

27. In July 2015, the Office for National Statistics (ONS) decided that the Aberdeen Western Peripheral Route (AWPR), which was a Scottish NPD investment project, should be classified as a public sector project in the National Accounts. In accordance with HM Treasury Consolidated Budgeting Guidance, budget treatment of these projects is determined by their position in the National Accounts. In November 2016, the ONS confirmed a similar classification for three further projects (Edinburgh Sick Kids Hospital, Dumfries & Galloway Royal Infirmary and the National Blood Centre). This classification means that capital budget cover is required at the point of initial investment, rather than revenue budget cover for the annual payments over the lifetime of the contract.

28. This resulted in charges against fiscal DEL budgets which required to be managed within budget limits. This meant that spending plans had to accommodate NPD expenditure within overall annual budget limits. In both 2015/16 and 2016/17, the Scottish Government agreed with HM Treasury that it could record these amounts against its capital borrowing limit. In 2016/17, the Scottish Government used its total capital borrowing limit of £333 million for this purpose. Although this did not result in actual borrowing, it removed the Scottish Government's power to borrow for capital purposes in 2016/17.

29. Looking ahead the draft Scottish budget estimates further capital spending of £190 million for these four projects in 2017/18. In March 2017, following discussions with officials, HM Treasury confirmed to the Scottish Government that any capital pressures arising from NPD projects as a result of the ONS classification would have to be absorbed within capital DEL limits with capital borrowing powers to be used as intended. The additional capital borrowing powers introduced in 2017/18 from the Scotland Act 2016 provides the Scottish Government with more flexibility in responding to spending pressures across its capital programme.

Overall financial position

30. The Consolidated Statement of Financial Position (previously known as the balance sheet) (page 66) is one of the primary financial statements in the Consolidated Accounts. It summarises what is owned and owed by the Scottish Government. This shows taxpayers' equity – an accounting measurement of the amount of taxpayers' money applied that has continuing public benefit. It shows how much of this has arisen from the application of revenues (including the Scottish Block Grant and devolved taxes) and that which has resulted through changes over time in the value of physical assets.

31. In public finances, the annual position of spending against budget is helpful but the most valuable insight comes from an analysis of trends in assets and liabilities over time. This provides important information about the impact of past decisions on future budgets and in turn highlights potential risks to financial sustainability. It is important that the Scottish

Government can demonstrate how it is managing its overall financial position. The key items in the Statement of Financial Position over the last five financial years are summarised in Exhibit 5.

Exhibit 5

Scottish Government's year end financial position, 2013 to 2017.

	As at 31/3/2017	As at 31/3/2016	As at 31/3/2015	As at 31/3/2014	As at 31/3/2013
Physical assets	28,852	27,596	26,698	26,153	25,887
Financial assets	8,726	7,484	6,775	6,228	5,775
Receivables	1,277	1,379	1,098	973	921
Total assets	**38,855**	**36,459**	**34,571**	**33,354**	**32,583**
Payables	(6,063)	(4,882)	(4,416)	(4,572)	(4,527)
Financial liabilities	(673)	(679)	(693)	(698)	(705)
Provisions	(948)	(717)	(778)	(636)	(720)
Total liabilities	**(7,684)**	**(6,278)**	**(5,887)**	**(5,906)**	**(5,952)**
Net assets	**31,171**	**30,181**	**28,684**	**27,448**	**26,631**
General fund	21,064	20,623	18,843	17,397	16,468
Revaluation reserve	10,107	9,558	9,841	10,051	10,163
Taxpayers' Equity	**31,171**	**30,181**	**28,684**	**27,448**	**26,631**

Source: Audit Scotland from Consolidated Accounts 2012/13 to 2016/17.

32. The accounts also provide information about some categories of asset, debt or financing activity not shown on the statement of financial position, largely because of the high level of uncertainty involved. This includes potential liabilities, contingent assets and liabilities and government guarantees. A contingent asset is a possible asset and a contingent liability is a possible obligation, whose existence will be confirmed only by uncertain future events not wholly within the Scottish Government’s control.

33. The Scottish Government has reported various contingent assets and liabilities in the Consolidated Accounts. Only some of the liabilities can be quantified, with amounts totalling an estimated £429 million. Some of these amounts may need to be funded from future budgets, but this is by no means certain. Similarly, the Scottish Government has a number of financial guarantees where the likelihood of settlement is more remote and therefore is not

classed as a contingent asset or liability. For example, in December 2016 the Scottish Government entered into a guarantee relating to the hydro plant and aluminium smelter at Lochaber in relation to a power purchase agreement. In 2016/17 this guarantee was valued at £21.4 million. Although settlement is remote, this reflects the Scottish Government's increasing activity and risk appetite in providing financial support and guarantees to support policy objectives.

34. As detailed in Exhibit 5, taxpayers' equity has increased in each of the last five years. This increase is due largely to an increase in physical assets and financial assets. It is important to note that whilst taxpayers' equity as reported in the Scottish Government Consolidated Accounts is increasing, the position does not reflect all the assets and liabilities of the Scottish public sector. For example, key liabilities over and above those detailed in the consolidated accounts including local government borrowing or all public sector pension liabilities funded from the Scottish budget. As detailed in paragraph 39 of this report, publication of a consolidated account for the whole of the public sector in Scotland will give a more comprehensive view of the assets and liabilities of the public sector as a whole.

35. The Consolidated Accounts provides some narrative on the components of the Statement of Financial Position. This is largely in line with improvements noted last year. There remains scope for the Scottish Government to build on these improvements by outlining the opportunities and risks over potential future assets and liabilities and their impact on annual budgets and the overall financial position. This would strengthen transparency and help support the Parliament in their scrutiny of the potential impact of Scottish Government's budget plans and policy choices.

Financial and performance reporting

Financial reporting

36. The Scottish Parliament has seen its financial powers increase substantially, with new responsibilities for taxes, social security and management of finances flowing from the 2012 and 2016 Scotland Acts. These changes have significant implications for public financial management in Scotland and how public finances are reported. A more strategic approach is required that is underpinned by a strong understanding of the economic context at both Scottish and UK levels. This requires comprehensive information to be available that links economic performance with financial information covering income, borrowing and spending.

37. In March this year, I reported that the Scottish Government is taking steps to enhance financial reporting of Scotland's public finances, but more work is required to provide a clear overall picture.[5] The increasingly complex nature of Scotland's public finances means there is an expectation and responsibility on the Scottish Government to provide clear and consistent budget and financial reporting. It is important that information is presented in such a way that is easy to understand and navigate. This will encourage greater public engagement and help

[5] *Managing new financial powers: an update*, Audit Scotland, March 2017.

the Parliament to build a comprehensive picture of Scotland's public finances. This allows the potential consequences of policy choices and decisions on long-term financial sustainability to be better understood and contribute to public trust and confidence in Government.

38. The Scottish Government reports financial information in a variety of documents including the Consolidated Accounts. The Scottish Government has made some improvements to the presentation of this year's consolidated statements, which should help the reader's understanding of individual Scottish Government portfolios' financial performance. I welcome this but there is scope to go further to make the accounts more accessible to the public and Parliament.

39. The Scottish Government has established a programme of work to develop its public financial reporting. As part of this, it has committed to producing a consolidated account to cover the whole public sector in Scotland including local government borrowing and public sector pension liabilities. It is expected this will provide information on total assets, liabilities, borrowing and investments across the Scottish public sector. The Scottish Government has designated 2016/17 as a 'shadow-year' with a view to publishing the account during 2018. This is a welcome development and should aim to allow for the Parliament and others to see a comprehensive picture of the financial health of the public sector in Scotland.

40. In December 2016, the Scottish Government published its first Open Government National Plan.[6] The plan aims to give the public a better understanding of how government works so that they can have more influence in holding them to account. One of the commitments in the plan aims to clearly explain how public finances work, so people can understand how money flows into and out of the Scottish Government, to support public spending in Scotland. By April 2018, it aims to have undertaken a review of the content and format of the information that it currently publishes on its website to then allow greater clarity and wider access to the information that is published. In addition, the Scottish Government has committed to consider what new financial reporting information it needs to publish to reflect a more open approach to public finances alongside the introduction of new financial powers. It aims to make any changes in 2018/19.

41. In 2016, the Finance and Constitution Committee established a Budget Process Review Group to carry out a fundamental review of the budget process in light of the Scottish Parliament's new financial powers. The Group consisted of parliamentary and government officials alongside a panel of external experts including me as Auditor General. The Group published its final report in June 2017, making detailed recommendations to significantly change the existing budget process.[7] This included a recommendation that the revised process should:

- have a greater influence on the formulation of the Scottish Government’s budget proposals;
- improve transparency and raise public understanding and awareness of the budget;

[6] *Open Government Partnership Scottish Action Plan*, Scottish Government, December 2016.
[7] *Budget Process Review Group, Final Report*, June 2017.

- respond effectively to new fiscal and wider policy challenges;
- lead to better outputs and outcomes as measured against benchmarks and stated objectives.

42. The Group recommended a revised framework for the Scottish Parliament and Government to agree a new budget process. This centres on a full-year approach with continuous scrutiny allowing for a better understanding of the impact of decisions over a number of years. It also recommends there should be a greater focus on outcomes and the interdependencies and prioritisation of policies considering both financial constraints and an increased demand for public services.

43. To support improvements to the budget process, the Group's recommendations include some significant changes to the Scottish Government's financial reporting. These include:
    - The introduction of an annual Fiscal Framework Outturn Report. This is to support scrutiny of the operation of the Fiscal Framework agreed between the UK and Scottish governments in relation to the arrangements for new tax and social security powers and how this affects the Scottish budget. The report should include details on the reconciliation process between forecasts and outturn, use of Scotland Reserve and borrowing powers.
    - The introduction of a Medium-Term Financial Strategy to outline the Scottish Government's high-level financial plans and projections for at least five years. The strategy should be published on an annual, rolling basis to help inform detailed budget proposals in each year.
    - A presumption that the Scottish Government returns to publishing multi-year spending reviews following the equivalent publication at UK level. This would provide support to public bodies in developing and setting medium-term priorities and plans.
    - The introduction of a mid-year report to Parliament on revenue and spending up to the end of December of the current financial year to accompany any proposed budget amendments in the Spring Budget Revision.

44. I welcome and support the Group's findings and recommendations, which are consistent with themes I have reported to Parliament in recent years. A key aspect is that the scrutiny of public finances moves towards a whole-cycle approach rather than its current annual focus that follows the publication of the draft budget. This would provide more space and time for year-round scrutiny of value for money decisions and inform future spending proposals. Longer-term planning and a clear financial strategy are fundamental elements for effective policy decision making. The principles of financial sustainability, transparency and accountability should be demonstrated in the Government's financial reporting on the current financial position, future forecasts and its plans to address any emerging pressures. This is necessary to enable the Parliament to take a broader perspective to hold Government to account for its approach to spending and tax-raising and its overall management of public finances.

45. Relevant recommendations are to be reflected in a revised Written Agreement between the Scottish Government and the Finance Committee.

46. The recommendations together with the need to finalise policies for borrowing and reserves, and the Scottish Government's plans to develop a whole public sector consolidated account, provide a real opportunity for the Scottish Government to significantly strengthen its financial reporting. This will help support both Parliamentary and public scrutiny as we enter a new environment for public financial management in Scotland. I will continue to examine and report on the Government's progress in this area.

Performance reporting

47. The Consolidated Accounts are required to comply with the accounting principles and disclosure requirements of the Government Financial Reporting Manual (FReM).[8] A direction by the Scottish ministers to that effect is set out in the Consolidated Accounts (page 124). In Scotland, the form and content of the annual report and accounts is a matter for the Scottish Parliament, which in practice involves an agreement between the Scottish ministers and the Public Audit and Post-Legislative Scrutiny Committee on a format based on the principles contained in the FReM.

48. The 2016/17 Consolidated Accounts comply with the principles of the FReM, including a performance report and an accountability report. The performance report (pages 6 to 22) summarises financial performance for the year, with particular emphasis on performance against budget. It also contains some specific performance information which is required by current guidance on supplier payment performance compared with policy targets and signposts where more information is available on sustainability and environmental performance. For information on the Scottish Government's progress towards its overall aims and objectives, users of the accounts are directed to the National Performance Framework (NPF). The NPF sets out the purpose, objectives and national outcomes which describe in more detail what the Scottish Government aims to achieve. The report provides a link to the Scotland Performs website where progress against the measures set out in the NPF is regularly updated.

49. Consequently, while the performance report provides analysis of some key aspects of financial performance, the Consolidated Accounts focus on the Government's finances. They do not report on the performance of individual portfolios or the Scottish Government as a whole, limiting the reader's ability to see the Government's own contribution to national outcomes.

50. As Scotland's fiscal responsibilities continue to grow, expectations are increasing for the Scottish Government to produce more detailed and transparent performance reporting, that better links spending with outcomes. The Budget Process Review Group recommended that the Scottish Government strengthens their performance planning and reporting to provide a greater focus on the delivery of outcomes. This includes providing better information about

[8] *Government Financial Reporting Manual 2016/17*, HM Treasury.

what activity public spending will support, its aims, and the contribution it expects to make to national outcomes.

51. Greater transparency around the Scottish Government's own performance towards meeting its strategic objectives would provide greater accountability for the use of financial resources outlined in the Consolidated Accounts. This would provide a more rounded account of the Scottish Government’s overall performance and would enhance reporting to the Scottish Parliament and the public, and help strengthen accountability and scrutiny.

Governance

52. A Governance Statement (pages 24 to 33) prepared by the Permanent Secretary is a key feature of the Consolidated Accounts. It forms part of a wider accountability report and summarises how the core Scottish Government organisation is controlled and directed. The statement reports that it complies with relevant guidance on corporate governance. It also highlights some of the main risks and opportunities for the organisation and any significant internal control issues in 2016/17. I am content that the Governance Statement is consistent with the financial statements and has been prepared in accordance with guidance on this issued by the Scottish Ministers.

53. In October 2016, the Scottish Government implemented new governance arrangements with the aim that they better reflect the demands created by new financial powers and constitutional change. This followed a review undertaken by the Permanent Secretary to explore options for streamlining arrangements while ensuring the principles of effectiveness and transparency are maintained. In July 2017, further changes were made at executive team level including the creation of a Director General role to better reflect Scotland's new fiscal responsibilities and a Chief Financial Officer role to cover in-year financial management and operations. The changes provide an opportunity for the Scottish Government to strengthen oversight of public financial management during a period of significant change for Scotland's public finances.

54. In June 2017, an independent review of the governance arrangements commenced led by the Director of Internal Audit, supported by the Crown Agent and a former non-executive director. The review aims to assess whether the design principles and governance tests of the new arrangements are being met or if any further measures are required. It is good practice to undertake an early review of new arrangements in order to address any concerns or to identify any lessons learned can be identified. The review is due to be reported to the Scottish Government in October 2017.

55. The success of the new arrangements will be determined by how they operate in practice. Central to this will be the culture and behaviours adopted by those involved including the contributions made by non-executive directors to ensure scrutiny and challenge are effective and transparency is exercised. It is important that non-executive directors are able to provide an appropriate balance of support and challenge and their level of engagement should reflect this independent role. I will keep the revised governance arrangements under review as part of our continuing work and engagement with the Scottish Government.

56. In implementing these new arrangements it is also important to recognise the Scottish Government's leadership role for other bodies. In my view, the new approach must remain, and be seen to remain, aligned with what it expects of other public bodies and that in developing its new arrangements it demonstrates the culture and behaviours that support the principles of good governance including transparency.

Other significant audit matters

European Funding - CAP Futures

57. The Scottish Government provides financial support to farmers and other rural businesses as part of the Common Agricultural Policy (CAP). The 2016/17 Consolidated Accounts include resource expenditure of £10.6 million on the CAP Futures programme, an IT-enabled change programme to implement the CAP reforms in Scotland. Capital spending was £29.4 million.

58. In June 2017, I reported that the CAP Futures programme closed as planned on 31 March 2017.[9] Significant parts of the system continue to be delivered by the Agriculture and Rural Economy directorate. The directorate expects to deliver the minimum required scope to comply with European Commission (EC) regulations within the £178 million budget.

59. The Governance Statement in the Consolidated Accounts notes that delivering the CAP payments remains extremely challenging and that there remains a significant risk to meeting EC regulatory requirements. In my June 2017 report I estimated potential financial penalties of up to £60 million, but I highlighted that the Scottish Government had not undertaken a detailed analysis of potential financial penalties. My estimate was based on a combination of the financial impact of findings from the 2015/16 audit of European Agricultual Funds Accounts, penalties relating to the late payment of 2015 single application form claims and the failure to meet other deadlines. The Consolidated Accounts show provisions and contingent liabilities relating to potential penalties from the European Commission. Note 12 of the Consolidated Accounts (page 98) includes a provision of £2.5 million in relation to penalties. An unquantifiable contingent liability in respect of potential future liabilities is also included in Note 17 (page 111). The relevant amounts are appropriately disclosed in the Consolidated Accounts. A provision is a liability of uncertain timing or amount where there is an obligation based on a past event, it is probable it will mean a payment to settle the obligation and the amount is based on a reliable estimate. A contingent liability is more uncertain in both timing and amount, and is dependent on a future event to confirm its existence; or no reliable estimate can be made for it.

60. The Consolidated Accounts also show an unquantifiable contingent liability for the potential penalty from the missed extended payment deadline for 2015 payments. There is an accrual of £1 million in relation to this missed deadline as well as a contingent liability for the potential penalty that is to be negotiated. The liability is probable, however a reliable estimate cannot be made and therefore we accepted the treatment as a contingent liability.

[9] *Common Agricultural Policy Futures programme: further update*, Audit Scotland, June 2017.

61. There is also a contingent liability disclosure for a number of European Commission audits which may result in disallowance of grant or penalties, but these cannot be quantified because of the uncertainty in timing and estimates as they can change through negotiations with the European Commission. Negotiations on disallowance with the European Commission can last for many months and the agreed disallowance or penalty can sometimes be significantly different from initial notification of potential penalty. Consequently, the £60 million estimate of potential financial penalties does not appear in the Consolidated Accounts.

62. Exhibit 6 below shows the time it takes for a potential liability to crystallise to a payment.

Exhibit 6

Time lag between CAP scheme year and repayment to the European Commission

Source: Audit Scotland

63. The Scottish Government established two loan schemes during 2016/17 to help farmers and rural businesses receive money more quickly. These included funding from the Scottish Government's financial transactions budget which supports loan schemes that go beyond the public sector. Note 9 (page 91) of the Consolidated Accounts discloses that loan payments of £370 million were made in 2016/17, with £239 million recovered by 31 March 2017. The Scottish Government managed in-year loan funding to minimise the risk of overspending its 2016/17 capital budget. At the same time, the Government ensured any underspend did not exceed its budget exchange limit which would have reduced the level of carry forward available in 2017/18.

64. Due to the continued delays developing the software for 2016 Less Favoured Area Support Scheme payments, the Cabinet Secretary for Rural Economy and Connectivity announced a £50 million loan scheme in April 2017. In addition, a further loan scheme in relation to the 2017 Basic Payment Scheme (BPS) was announced in September 2017.

European Structural Funds

65. The Scottish Government manages four European structural fund programmes (two programmes funded by the European Social Fund and two funded by the European Regional Development Fund). These programmes provide financial assistance to, for example, help improve transport links, support business growth and improve skills.

66. In my report last year on the 2015/16 Consolidated Accounts, I highlighted that the European Commission had lifted the suspensions and interruption imposed on the 2007-13 programmes. While the suspensions and interruptions remained in place, amounts due from the EC accumulated. Following their removal, £165 million receipts were received during 2016/17. The 2016/17 Consolidated Accounts show that the £14 million provision created in 2015/16 crystallised into a liability of £31 million as a result of the 2007-13 programme closure representing grant payments received over and above expenditure declared to the EC. Taking into account all receipts in year, the net cost to the Scottish Government is £21 million, subject to final EC checks.

67. Closure of the 2007-13 programmes also identified that the Scottish Government overpaid project sponsors a total of £16 million as a result of errors identified by Internal Audit and the subsequent application of penalties. The Scottish Government has started to raise invoices for these amounts owed to them by sponsors. The Consolidated Accounts include an unquantified contingent asset as there remains uncertainty over whether the amounts will be recovered as they may be subject to appeal.

Conclusion

68. The Scottish Government has published a sound financial report in its Consolidated Accounts for 2016/17. It covers spending against budget for the financial year and sets out what it owns and owes as at 31 March 2017. The accounts are prepared from the perspective of the Scottish Government's role in managing the budget it directly controls and covers the majority of public spending in the Scottish budget. This is a critical component of the Scottish Government's accountability to the Parliament and the public.

69. The Scottish Government has a good record of financial management and reporting. In 2016/17 improvements were made to the Consolidated Accounts in its presentation and narrative. Governance arrangements continue to evolve and the National Performance Framework provides details on what the Government aims to achieve and performance against national outcomes. My audit work has highlighted a number of areas for further improvement to help support the Parliament and the public in their scrutiny of public finances. Priorities for the Scottish Government should be to:

- publish a public sector consolidated account for the whole public sector to outline total assets, liabilities, borrowing and investments;
- introduce a medium-term financial strategy to outline high-level financial plans for the next five years; and
- finalise policies and principles for borrowing and reserves.

70. The implementation of new financial powers and changes that will arise from the UK's decision to leave the European Union, mean it is critical that the Scottish Government continues to strengthen its approach to public financial management and reporting. These challenges provide a unique opportunity for the Scottish Government to engage with both the Parliament and the public about the risks and opportunities facing Scotland's public finances. The increasingly complex nature of public finances means there is a growing expectation and responsibility on the Scottish Government to provide clear and consistent budget and financial reporting. This will help support the Parliament, as it implements its new budget process, to build a comprehensive picture of Scotland's public finances and will help foster greater public trust and confidence in Government.

71. Working with Audit Scotland and the Accounts Commission, I will continue to support the independent scrutiny of Scotland's public finances through all of our audit work.

Appendix 1

Scottish budget 2016/17: outturn against budget for bodies not included in the Consolidated Accounts.

Entity	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Scottish Government Consolidated Accounts	33,870	33,955	(85)
National Records of Scotland	25	26	(1)
Teachers' and NHS Pension Schemes	3,282	3,300	(18)
Office of the Scottish Charity Regulator	3	3	-
Scottish Courts and Tribunal Service	108	107	1
Scottish Housing Regulator	4	4	-
Revenue Scotland	5	5	-
Food Standards Scotland	15	15	-
Total Scottish Administration	**37,312**	**37,415**	**(103)**
Forestry Commission	54	57	(3)
Scottish Parliamentary Corporate Body	98	100	(2)
Audit Scotland	8	8	-
Total Scottish Budget	**37,472**	**37,580**	**(108)**

Source: Audit Scotland based on 2016/17 audited accounts where available at the time of writing.

THE 2016-17 AUDIT OF THE SCOTTISH GOVERNMENT CONSOLIDATED ACCOUNTS DRAFT ANNUAL AUDIT REPORT

Key Messages

- **Point 5 –** You agreed to consider whether this sentence could respect that the weaknesses were relatively minor.
- **Point 8** – You agreed to review the wording of the second sentence. (The text in Part 4 states that "It is therefore too early to comment on their effectiveness.)
- **Point 9** – we discussed that, under the heading of "value for money" the "further developments sentence could be misleading; suggest being more specific about "this area" e.g. "further developments in the Scottish Government's performance reporting are desirable".

Introduction

- **Para 4** – just an observation that the long sentence might read better as a list, e.g. the SG s responsible for: preparing…; the accuracy...; etc.

Part 1: Audit of 2016-17 Financial Statements

- **Main Judgements –** we agreed that the present tense may be more helpful, i.e. (audit opinions <u>are</u> unqualified.
- **Para 15 –** this is slightly misleading because the core schedules are not draft financial statements, but part of the accounts preparation process. It makes sense for these to be shared as a starting point for audit but there will inevitably be changes and refinements to these as work progresses to produce financial statements.
- **Para 17** – as we discussed, reference to a "delay" in receiving the Governance statement is not accurate: as the subsequent sentence indicates, the draft Governance statement (as reviewed by the Permanent Secretary) was provided according to the timetable. The timetable allows for the appropriate governance processes, including consideration by DG's of the certificates of assurance, formal review by DG Finance and by Perm Sec before a draft statement is provided with the accounts to Executive Board and then to SGAAC. It would not be possible for a complete Governance statement to be submitted to audit with the draft consolidated accounts. We do appreciate that the timetable for audit consideration is tight, though important to remember that the audit team has had access to the certificates of assurance system throughout and can gather relevant information as part of its regular audit enquiries. **Action Plan point 1** – an action in the current terms could not be agreed. We would be happy to look at the scheduling for next year to see which elements could be brought forward; we'd also be comfortable sharing the narrative elements of the draft Statement at an earlier stage (as we used to do).
- **Para 18** – the description of the issue should have "audited" added before "consolidation packs and audited cash flow data". We also discussed that the issue would benefit also from review of the audit processes.
- **Para 20 –** as highlighted, it would be helpful to record also that the SG provided the WGA schedules for audit in early August in accordance with the agreed timetable.
- **Evaluation of misstatements –** we discussed that a few revisions, and an analysis would help with accuracy and balance. As noted re **para 15**, the core schedules are part of the

accounts preparation process and it would be more accurate to indicate that between the provision of core schedules and draft accounts for audit a number of adjustments were made both as part of the accounts process and audit. **Para 28** could usefully follow para 26 as both are dealing with adjustments. We agreed that "discount rate" should be referenced rather than "cost of capital".

- **Para 31** – it would be helpful to include "minor" in the heading.

Significant Findings – Exhibit 3 and related Action Plan points

1. European Structural Funds – as noted for the s22 report

- the explanation of the 'overpayments' point is not quite correct: it would be more accurate to say that:

  > The Scottish Government's closure work on the 2007-16 programmes identified that approximately £16m had been paid by the Scottish Government to project sponsors, which cannot be claimed from the EC.

- Invoices have been issued to project sponsors where possible. The contingent asset disclosure reflects a prudent assessment that recovery may not be achieved.

3. CAP contingent liability disclosures – at the time of submission of the draft statements (which contained an accrual for known element), it was flagged that CAP disclosures would be looked at, in light of best information, as the situation progressed. The figure quoted should be removed as discussed: our understanding is that this was from advice to Ministers which quoted a potential range. **Related Action Plan point 2** – the contingent asset recognises that money may be recovered, not a risk that it won't.
4. Student Loans – as discussed, the description of the impact should be corrected.
5. Gender analysis – We are content to indicate that this will be looked at but, as discussed, this is not straightforward and there is a question of what would be useful disclosure. As we discussed, the specific FReM requirement is aimed at Departments where the specified analysis is straightforward, whereas the consolidated accounts bring together the SG and Agencies with NHS bodies, where the civil service banding is not valid. (We also want to look at the separately published workforce data.)

Part 2: Financial Management

- **Main Judgements** – we discussed the apparent mismatch in scale between the finding on overall budget management and the engagement with the NFI; you explained that the NFI is a standing item for report in each audit.
- **Para 32** – as we discussed, it would be more accurate to refer to the "budget authorised by the Scottish Parliament"
- **Para 33 and Exhibit 4** – this should simply refer to the "financial performance compared to the Scottish Budget, and the table can omit reference to DEL. The column with "Initial budget" doesn't seem to add anything here, and may confuse (the accounts do provide a reconciliation of the Budget.)
- **Para 34 –** the analysis here relates to the Scottish Budget as a whole, rather than the "Scottish Government's budget", i.e. what is covered in the accounts.
- **Para 37** – the preceding paragraph refers to HM Treasury and Scottish Parliament budgets so may be worth being explicit here that this is in Scottish Parliament terms.
- **Para 41** – as we discussed, this is an example where individuals did not follow the required processes rather than a weakness in the controls, and we question the

emphasis here. The text notes 2 examples out of a sample of 32, but the wider context is not clear, i.e. how many leavers in the year in total.

- **Para 42 (and re Action Plan point 4)** – we are not clear why this is included here and as a recommendation because the approach for the 2014-2020 programmes does not follow this previous practice: for the 2014-2020 programmes no payment is made until the checking of a claim has been completed.
- **Para 43 (and Action Plan point 5)** – this recommendation is directed at Internal Audit. We have shared the text with the Director and have been advised that she has a concern and will offer a more detailed response tomorrow morning when she returns to the office.
- **Paras 44 and 45 (and related Action Plan point 6) –** as mentioned, it would be helpful if it was explicit that this relates to ESF debt management.
- **NFI – Exhibit 5** was to be reviewed as discussed. You noted that the procurement matches are new this year, and there does seem to have been a lack of communication about this. We can have a look at this.
- **Para 53** – this is a bit unclear; would be better to refer to the Integrity model as the model recommended by Police Scotland for public sector bodies.

Part 3: Financial Sustainability

- A general point here that, beyond the narrative about the Statement of Financial Position the section discusses the financial position not of the SG, but of the Scottish Budget, i.e. matters of capital borrowing, devolved taxes etc. fund the Scottish Budget as a whole, not the SG accounts, which are funded by drawing down funding from the SCF. As for the s22 report, it should be clear that these are Audit Scotland recommendations rather than present requirements with which the SG does not comply.
- Main Judgement – the 3rd "main judgement" on staffing and resource relating to new powers doesn't seem to be substantiated anywhere in the chapter? There's a reference to IT skill shortages in one division in para 80 but that doesn't seem relevant to main statement. Should there be a link to the previous *New Financial Powers* report?
- **Para 60** - the FT carry forward is not £53.5m, not £48m. The "for example" sentence isn't accurate because the 2017-18 budget already assumed a level of carry forward, and the final position will be factored in in due course.
- **Para 65** – as flagged, the figure of £200m quoted is not correct; the Fiscal Framework changed this to £600m. The final sentence is possibly misleading in that the "or for cash management" reads as if additional, whereas this can only be used for cash management associated with the 2 conditions listed.
- **Para 66** – as discussed, it isn't usual to refer to three devolved taxes (strictly, SRIT is an assigned tax).
- **Para 68 –** the Scotland Reserve does replace Budget Exchange but it is odd to refer to the Budget Exchange Scheme as being closed. As discussed, any surplus or shortfall will flow through the Scotland Reserve.
- **Para 69 –** as discussed elsewhere, we do not agree the use of "urgently". It is likely that this will feature in medium term financial planning (as discussed with the Director of Financial Strategy recently?)
- **Paras 71 to 73** – these duplicate paras 26 to 28 of the draft s22 and should be revised in the same way to reflect: that ONS assessment confirmed the judgement on the 3 projects and that the assessment was incorporated in to spending plans when set.

- **Para 76** – as flagged, the wording isn't accurate: there was no budget transfer, the loan funding was funded from the two sources.
- **Para 81** – as discussed, the final sentence is not clear and perhaps implies that the new financial powers are not fully played into budgeting and planning, which is not the case.
- **Para 82** – we agreed that "MTFS" is not an accepted acronym and not useful here.
- **Para 85 –** we discussed this paragraph and questioned the assertion that the production of the new Scottish Administration will require the SG to explain how some of the liabilities of the public sector will be met. It is accurate that this statement will include relevant explanation but it is not correct to imply that there is not already public explanation of how these liabilities are funded, not least in the relevant accounts and in the annual Budget documents.
- **Para 86** – as discussed, it would be more accurate to say that we plan to use the WGA inputs produced by relevant bodies to prepare the consolidated account (the reference to OSCAR seems unnecessary).

Part 4: Governance and Transparency

- **Para 89** – question the reference in the first sentence here? Is it necessary?
- **Para 90** – the usual SG references are Executive Team and Chief Financial Officer.
- **Para 91 –** as written, the third sentence isn't clear; would be simpler to list both as observed factors.
- **Para 92** – the second sentence hints at a pre-judgement.

  "We consider this review a positive step and evidence of good practice ~~but we~~ await to see how it will now inform future revisions of governance arrangements. ~~is unclear~~.
- **Para 92** – as discussed, the report is to be finalised in September, presented to EB on 3 October, and then shared with SGAAC members.
- **Para 94** – as discussed, colleagues in the Executive Team support team have indicated that all cleared minutes have been forwarded as agreed, so follow up is needed here.
- **Para 101** – in the 3rd bullet, the findings were presented to SGAAC in June 2017, and I would be more accurate to say "continues to comply" in the final sentence.
- **Para 102** – colleagues offer minor suggested changes to that para 102 to reflect most up-to-date position. Also suggest that this may read better as a separate para.

  A Cyber Security Strategy 2020 has been agreed. The Scottish Government intends to work with the National Cyber Resilience Leaders' Board to develop an action plan that will promote a common approach to improving cyber resilience across Scotland's public bodies. a clear set of guidelines and a standards as well as a monitoring framework for central government that will help boost cyber resilience capabilities. This will include encouraging organisations to sign up to the Cyber Essentials Scheme to help them to protect themselves against common Internet-based cyber threats.

- **Appendix 2, item 4** – as flagged, something is amiss with the text here. We don't recognise the point about the financial guarantee rather than a contingent liability, so grateful for clarification please.

THE 2016-17 AUDIT OF THE SCOTTISH GOVERNMENT CONSOLIDATED ACCOUNTS
DRAFT S22 REPORT

Introduction

- **Para 2 -** We spoke about the use and possible confusion of "Scottish Budget" and "Scottish budget" used in the text. In this para, the 2016/17 Budget document referenced set out the spending priorities and plans for the Scottish Budget as a whole; the SG accounts report against the element of the budget within the accounting boundary; the accounts do also provide narrative about the wider budget position but that is not their primary purpose.
- **Para 3 –** linked to the above, the performance report gives a detailed account of financial performance.
- **Para 4** – we discussed that the audit opinion on the accounts is, for us, the key audit output and you were considering its inclusion in the Key Messages section.
- **Para 5** - I appreciate "significant audit findings" as a category for reporting; in this context, though, it could be read as suggesting that, despite the clean audit opinion, there were significant issues about the accounts. More accurate perhaps would be to say "findings (or information?) about significant matters "within the accounts".

Key Messages

- **1st bullet** – the Scottish Administration is the first level at which a Budget authorisation limit applies, but I suspect that a lay reader may not appreciate; retaining budget management was effective but omitting a specific reference would work equally well?
- **2nd bullet** – it could be helpful context to provide the date of the forecasts, and in the connected paragraph 22.
- **3rd bullet** – we asked about the reference here to the UK's decision to leave the EU, which is not something discussed during the audit in the context of the accounts and you were going to reflect.
- **4th bullet** – a minor point of helpful clarification that would aid a reader's understanding: the main body of the text (para 41) is clear that the SG was part of the PBRG and it would be helpful for this to be clear here also.

Financial Management

- **Para 7** – the tax and borrowing powers fund the Scottish Budget as a whole so better simply to use "the Scottish Budget" here (the use of Scottish Government could suggest the element covered in the accounts).
- **Para 8 and elsewhere** – for consistency and read across to the accounts, we agreed that "devolved taxes" be used for LBTT and SLfT, with SRIT identified separately.
- **Para 11 –** page 7 of the accounts explains the accounting boundary in detail so may be helpful to provide a cross-reference or link.
- **Para 12** – a minor point; as worded a reader may think that the directly funded bodies are part of the Scottish Administration. Just a suggestion, but rather than list only a few of the bodies, a cross-reference to the relevant Exhibit and to Appendix 1 would do the trick.
- **Para 14** – as discussed, our usual naming convention is to say "provide a Final Outturn statement to Parliament, showing…" Consistent terminology would help a reader to find

that report, which will be available earlier this year. We'd also prefer if the last sentence was specific that this is part of the accountability to the Scottish Parliament in terms of reporting on the budget authorised.

- **Para 15** – as above re Scottish Administration reference.
- **Exhibit 1 –** to amend in line with Appendix 1 table
- **Para 16 –** we noted yesterday that there is a risk in paraphrasing the accounts explanations and you were going to consider. In particular the Health reference suggests that this is a "new" provision rather than the effect of a technical change in the discount rate; similarly the use of "delayed implementation" in the 2nd bullet could be misleading.

HM Treasury Budget

- **Para 18** – a minor point is that HMT does not "agree" the budget
- **Para 19** – Exhibit 2 shows the 2016-17 position; the statement in para 19 could be read as suggesting that this could be amended by borrowing and reserves. Perhaps better placed in the forward-looking section?
- **Exhibit 3** explains the position as at the date of the Provisional Outturn statement (as flagged, the Cash DEL line should be formatted as a sub total). Would it be helpful to bring this up to date with the final accounts position? (Liaise with Joe)

Devolved Tax Powers

- **Para 22** – useful to include a link to the SFC analysis? (I mentioned an SG analysis but what I was thinking about related to the 2015-16 forecasts; sorry for any confusion). **Para 23 –** a minor point: although Revenue Scotland produce and handle the publication of the Devolved Taxes account, it is an important part of the picture and will be available from the SG web page.
- **Para 24** – you are aware of our views that the use of "urgently" is misleading. This could also be clearer that this is an Audit Scotland recommendation rather than the present implication that there is a current obligation and that Ministers have already made commitments to be transparent about their intentions to borrow and use of reserves, and the next opportunity for this will be the forthcoming Budget.
- **Para 25 & Exhibit 5** - you indicated that this is to be reviewed.

Capital Borrowing

- Paras 26 to 29 – as we discussed, this is quite complex and hard to explain in simple terms. Two key points about the text as is: the assessments for the other projects noted in para 27 were subsequently confirmed by ONS, and para 28 presently gives the impression that spending plans had to be modified to accommodate NPD expenditure within overall annual budget limits, whereas the NPD costs into the 2016-17 budget process. ." We would accept there is an opportunity cost but this gives the impression that we had to alter our plans and stop doing other things whereas " The timing of the classification decision on the AWPR and its impact on the other four NPD projects meant that the budgetary implications were factored into the budgets for 2016-17 and 2017-18 at the planning stage, so that there was no need to change existing capital budget allocations."

- My colleague who is steeped in this has offered the following distillation for your consideration:

> **27.** In 2015, the Office for National Statistics decided that the Aberdeen Western Peripheral Route (AWPR), which was a Scottish NPD investment project, should be classified to the central government sector in the National Accounts. Subsequently 3 further similarly structured projects (Edinburgh Sick Kids Hospital, Dumfries & Galloway Royal Infirmary and the National Blood Transfusion Centre) were also classified as central government. Budget treatment of these projects is determined by their position in the National Accounts. Classification to the central government sector requires budget cover for the capital value of the project, rather than revenue budget cover for the annual payments over the lifetime of the contract.
>
> **28.** The budgetary impact of these classification decisions needs to be managed within Scottish Government budget limits. 2016-17 budget plans were drawn up to include accommodating the notional NPD expenditure within overall annual budget limits. The Scottish Government agreed with HM Treasury that it could record these notional amounts against its capital borrowing limit of £333 million. This notional borrowing fully utilised Scottish Government's power to borrow for capital purposes in 2016/17.
>
> **29.** A further £190 million of notional capital spending for these four projects will occur in 2017/18. In March 2017, HM Treasury informed the Scottish Government that no notional borrowing arrangement would be available for 2017-18. Scotland Act 2016 does provide for an uplift in the limits on capital borrowing from 2017-18 which could provide additional flexibility in responding to spending pressures across its capital programme.

Overall Financial Position

- **Exhibit 6** – we discussed the categorisation of assets and the presentation and you were going to consider.
- **Para 34** – as discussed, this doesn't mention key assets and the reference to "public sector pension liabilities" may be misleading as only those funded from the Scottish Budget could be within scope.
- **Para 35** – the development suggested would more appropriately take place in forward-looking ministerial publications, rather than the accounts, whose primary role is to demonstrate the stewardship of public funds.

Financial Reporting

- **Para 37** – it would be helpful to acknowledge that the changes are progressive, as powers come into effect and decisions implemented. In the penultimate sentence the use of "will" seems overly definitive – "has the potential to"?
- **Para 38** – as you know, our developing financial reporting plans do include consideration of accessibility, linked to the project to implement the new SG website.
- **Para 43** - the 2nd bullet seems to go further than the BPRG report wording so we would suggest the following change for accuracy:
  - The introduction of a Medium-Term Financial Strategy to outline the Scottish Government's high-level financial plans and projections for at least five years, to be published on an annual, rolling basis ~~and set out the Scottish Government's expectations and the financial implications of existing policy to inform detailed budget proposals in each year~~.
- **Para 45** – I mentioned that I didn't think there was an agreement to publish a formal response to the BPRG; I have checked with colleagues and what has been agreed with the Committee clerks (at a meeting last week) is that the relevant recommendations will

be reflected in the revised Written Agreement between the Finance Committee and the SG which will be agreed in due course.

Performance reporting

- We discussed our divergent views on what is appropriate coverage in the performance reporting section of the accounts, particularly given the complexity and range of activities included within the consolidation and the detailed information available in the accounts of the constituent bodies. A key point is that the SG Accounts primarily report on a measure of inputs, i.e. the funding provided in support of the activities which are working towards outcomes. The activities contributing to outcomes range across the sector, through delivery bodies not consolidated here and there is no distinct separation between "contributions" in the way suggested. Our particular concern is that, as presently worded, para 48 does not reflect that complexity and gives the impression that there is something relatively easy that is just not being done.
- Para 47 notes that the **Scotland Performs** website, which is the reporting tool for the National Performance Framework) provides the very latest information "on how Scotland is doing" against a wide range of indicators. This is perhaps within "regularly", but more accurate to reflect that data is provided in as close to real time as possible, to give the most up-to-date and transparent account of performance that has ever been offered to the public and Parliament. It would also be helpful to be clear that, aligned with the NPF, there are also more detailed performance frameworks for individual policy, for example the new "Justice in Scotland: Vision and Priorities".
- It would also be helpful to acknowledge that there is work in progress, both on the development of the NPF and in relation to the performance reporting system.

Governance

- **Para 51** – noted in passing, Scottish Ministers.
- **Para 52** – as mentioned the July change is not reflected in the accounts (because it does not affect the financial year, or accounts process).
- **Para 53** – the last sentence implies that the report is late, which it is not, the report will be finalised late September. As we discussed, the expected consideration by SGAAC has changed. The report will be presented to the Executive Board on Tuesday 3 October, and then will be circulated to SGAAC members before the meeting in December.

Significant Audit Matters

- **Para 56 –** the wording perhaps suggests that there are "new" issues in 2016-17. May be more helpful to indicate that the 2016-17 accounts report on developments in relation to continuing….

– CAP Futures

- **Para 57** – there is a missing 'resource' before words 'expenditure of £10.6 million'.

– European Structural Funds

- **Para 66** – the emphasis on the £35m is inaccurate: the estimation of the provision has changed in the period, reworked sentences offered below. A key point also is that the final position will only be confirmed when the EC finalise their checks, which, as reported to PAPLS, is likely to be March 2018.

The 2016/17 Consolidated Accounts show that the £14 million provision created in 2015/16 has increased to an estimated liability of £31 million as a result of the 2007-13 programme closure. The reconciliation of the 2007-13 programme shows a net cost to the Scottish Government on this basis of £21.2 million. The final figure the Scottish Government will need to repay to the EC will only be confirmed following completion of EC checks. These are anticipated to be complete by March 2018.

- **Para 67 –** The 'overpayments' point is not quite correct: it would be more accurate to say that

  The Scottish Government's closure work on the 2007-16 programmes identified that approximately £16m had been paid by the Scottish Government to project sponsors, which cannot be claimed from the EC.

- **Para 67** – as mentioned there seems to be some confusion here: invoices have been issued where possible. Similarly in relation to the contingent asset and not pursing - the contingent asset in the accounts is not as described but a prudent assessment that recovery may not be achieved,

  Not all of this can be recovered from project sponsors since some no longer exist. Where possible, the Scottish Government has issued invoices to project sponsors to seek recovery of these payments.

[redacted]

From:	[redacted]
Sent:	23 July 2018 15:23
To:	[redacted]
Subject:	FW: Draft reports
Attachments:	2016_17_SCF_AAReport_draft.docx; 2016_17_SG_AAReport_DRAFT.docx; 16-17_s22 _report_issued_draft_11092017.docx

From: [redacted][mailto: [redacted]@audit-scotland.gov.uk]
Sent: 11 September 2017 14:06
To: Chief Financial Officer; Wright AG (Aileen); [redacted]
Cc: [redacted]Stephen Boyle; Michael Oliphant
Subject: Draft reports

Hi all,

Please find attached the following draft reports:

- Section 22 on the Scottish Government consolidated accounts
- Scottish Government Annual Audit Report
- Scottish Consolidated Fund Annual Audit Report

We look forward to our meeting on Thursday to discuss, with a formal response including management responses for Tuesday 19th September. We are of course happy to know of any areas of concern before then so we can address.

Many thanks,

[redacted]

[redacted]
Senior Auditor
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has been swept for the presence of computer viruses.

****

[redacted]

From: [redacted]
Sent: 23 July 2018 15:22
To: [redacted]
Subject: FW: S22 report and letter for laying
Attachments: 2016-17_s22_report.pdf; 2016-17 Letter for laying accounts and S22.pdf

From: [redacted]
Sent: 28 September 2017 09:33
To: [redacted]; Wright AG (Aileen)
Cc: Michael Oliphant; [redacted]
Subject: S22 report and letter for laying

Hi [redacted]

Please find attached our Section 22 report on the Consolidated Accounts, and the letter for laying the Consolidated Accounts and Section 22 report.

I'd be grateful if you could confirm when the Consolidated Accounts and Section 22 report have been laid in the Scottish Parliament.

Kind regards,
[redacted]

[redacted] |Senior Auditor | Audit Services
Audit Scotland | 102 West Port | Edinburgh | EH3 9DN
T: 0131 625 [redacted] | E: [redacted]@audit-scotland.gov.uk

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[redacted]

From: [redacted]
Sent: 23 July 2018 15:22
To: [redacted]
Subject: FW: SGAAC - Audit Scotland papers
Attachments: 16_17_SGAAC_update_September_2017.pdf; 2016_17_SG_AAReport_to_SGAAC.pdf; 2016-17_s22_report_to_SGAAC.pdf; 2016-17_SCF_AAR_to_SGAAC.pdf

From: Michael Oliphant [mailto[redacted]@audit-scotland.gov.uk]
Sent: 21 September 2017 15:11
To: Wright AG (Aileen); [redacted]
Cc: Stephen Boyle; [redacted]
Subject: FW: SGAAC - Audit Scotland papers

Hi Aileen,

Thanks very much for the comments on both the Annual Audit and section 22 reports. We've considered these and have updated the reports to reflect any changes made.

Attached are the papers we've submitted to SGAAC this afternoon. We understand from [redacted] that there are some comments forthcoming on the SCF audit report. It would be great to get these before Tuesday if possible so we can update members at the meeting if there are any significant changes.

Similarly, if you are in a position to share management responses on the SG audit report by then, we can update the Committee on Tuesday.

Thanks again,
Michael

From: Michael Oliphant
Sent: 21 September 2017 14:52
To: 'DGBusMan@gov.scot'
Cc: [redacted]; Stephen Boyle; [redacted]
Subject: SGAAC - Audit Scotland papers

Hi [redacted],

Please find attached the following papers for the Scottish Government's Assurance and Audit Committee meeting on 26 September 2017.

- Audit Scotland progress update
- Scottish Government: Annual Audit Report 2016/17
- The 2016/17 audit of the Scottish Government Consolidated Accounts
- Scottish Consolidated Fund: Annual Audit Report 2016/17.

Please let me know if you need anything further.

Thanks,
Michael

Michael Oliphant
Senior Audit Manager
Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN

T: [redacted] **E:** [redacted]@audit-scotland.gov.uk
www.audit-scotland.gov.uk

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[redacted]

From: [redacted]
Sent: [redacted]
To: [redacted])
Subject: FW: Draft reports

From: [redacted]@audit-scotland.gov.uk]
Sent: 21 September 2017 13:42
To: [redacted]; Wright AG (Aileen); Michael Oliphant
Cc: [redacted]; Stephen Boyle; Chief Financial Officer
Subject: RE: Draft reports

Hi [redacted],

We had picked up on this but thanks for flagging. We've reported the total budget in line with the accounts and are aware of the inconsistency with the SBR. We'll consider this as part of our final checks on the report.

Thanks again,

[redacted]

[redacted]
Senior Auditor
Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 [redacted]
E: [redacted]

www.audit-scotland.gov.uk

From: [redacted]@gov.scot [mailto: [redacted]
Sent: 21 September 2017 13:14
To: [redacted]@gov.scot; [redacted]; Michael Oliphant
Cc: [redacted]; Stephen Boyle; cfo@gov.scot
Subject: RE: Draft reports

[redacted],

I am preparing some notes relating to our Final Outturn Report and I note that the Appendix 1 total in your S22 report is £1 million lower than the SBR total – I think the Food Standards Scotland figure showing at £15 million should be £16 million. You may already identified this.

Regards.

[redacted]

gov.scot

[redacted]
Head of Financial Management and Reporting
Financial Management Directorate
T: 0131 [redacted]

M: [redacted]

E: [redacted]
Scottish Government
Victoria Quay
Edinburgh EH6 6QQ

From: Wright AG (Aileen)
Sent: 19 September 2017 13:01
To[redacted]; Michael Oliphant
Cc: [redacted]; Stephen Boyle; Chief Financial Officer; [redacted]
Subject: RE: Draft reports
Importance: High

[redacted], Michael (welcome back – hope you enjoyed your leave!)

As promised, I attach collated comments on the two SG draft reports. These reflect our discussion on Thursday and include contributions for the relevant business areas. I have flagged where I know this to be incomplete, and where I think there needs to be follow up. There are a few other areas where I have yet to receive comments but it seemed sensible to share this meantime and I will supplement as necessary.

As we discussed on Thursday, we have prioritised the s22 report. As we also discussed, a number of our comments would affect the recommendations in the Annual Report Action Plan, so we will not produce formal responses until you have had a chance to consider. A key element is the text on European Structural Funds where a number of concerns have been flagged; please let us know if it would be easier to discuss.

As you will appreciate, management responses have to be cleared by the appropriate senior colleagues, so we would suggest that the report be provided to SGAAC without responses at this stage.

Aileen
X [redacted]

From: [redacted][mailto: [redacted]@audit-scotland.gov.uk]
Sent: 11 September 2017 14:06
To: Chief Financial Officer; Wright AG (Aileen); [redacted]
Cc: [redacted]; Stephen Boyle; Michael Oliphant
Subject: Draft reports

Hi all,

Please find attached the following draft reports:

- Section 22 on the Scottish Government consolidated accounts
- Scottish Government Annual Audit Report
- Scottish Consolidated Fund Annual Audit Report

We look forward to our meeting on Thursday to discuss, with a formal response including management responses for Tuesday 19th September. We are of course happy to know of any areas of concern before then so we can address.

Many thanks,

[redacted]

[redacted]
Senior Auditor
Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 [redacted]
E: [redacted]@audit-scotland.gov.uk
www.audit-scotland.gov.uk

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[redacted]

From: [redacted]
Sent: 23 July 2018 15:22
To: [redacted]
Subject: FW: Draft reports

From: [redacted]

Sent: 20 September 2017 15:06
To: [redacted]
Cc: Wright AG (Aileen); [redacted]; Michael Oliphant; [redacted]

Subject: RE: Draft reports

[redacted],

Thank you for your note - please see my comments below.

Happy to speak if helpful.

Regards.

[redacted]

[redacted]
Head of Financial Management and Reporting
Financial Management Directorate
T: 0131 244 [redacted]
M: [redacted]
E: [redacted]@gov.scot
Scottish Government
Victoria Quay
Edinburgh EH6 6QQ

From: [redacted][mailto: [redacted]@audit-scotland.gov.uk]
Sent: 20 September 2017 11:44
To: [redacted]
Cc: Wright AG (Aileen); [redacted]; Michael Oliphant
Subject: RE: Draft reports

[redacted],

We’ve had a look at the comments on the Section 22 report, and we have a few queries, I’m hoping you can help us with?

Aileen suggested that if we wanted to use final outturn figures for Exhibit 3 Provisional HM Treasury budget performance, we should speak to you. We would prefer to use final outturn figures rather than provisional outturn figures for Exhibit 3, if these figures are available?

To confirm that there are no changes to the provisional outturn figures (HM Treasury) at the final consolidated accounts stage so happy for you to go with the figures in your draft report – final figures will be confirmed later this year following our assessment of the final audited NDPB accounts.

On the treatment of the 3 projects as outlined in paragraph 27, could you share something with us that confirms that the ONS did confirm treatment in 2016/17 on these 3 projects (Edinburgh Sick Kids Hospital, Dumfries and Galloway Royal Infirmary, and National Blood Transfusion Centre)?

The link to the ONS website below has the letter confirming the position for the two hospitals – we are currently checking the SNBTS position.

https://www.ons.gov.uk/economy/nationalaccounts/uksectoraccounts/adhocs/006367lettertothescottishgovernmentdetailingonsdecisionsonnonprofitdistributingmodelprojects

On paragraphs 66 and 67: We have not seen evidence of the £21.2 million, and if you think it is a reasonable estimate then that changes the accounting treatment. Similarly, if SG has started to raise invoices, then again we have a question over whether that changes the accounting treatment from a contingent asset to a receivable (adjusting post balance sheet event).

I understand that you have been provided with the working papers explaining the £21.2 million figure which includes a number of adjustments including the final income payment received from the EC all of which is accounted for in 2016-17 (I can ask Owen to send the paper again if helpful). The potential additional income disclosed through the contingent asset is not included within this figure. The recovery of the potential additional income remains highly uncertain, and in terms of our accounts we believe this to be immaterial. In context of the continuing uncertainty in relation to the amounts that may be recovered and the associated uncertainty on timings we would intend to hold the contingent asset position.

I'm unclear as to when the Scottish Government started to raise invoices for the £16 million, so if you could arrange for evidence of this to be provided, that would be helpful, so I can see the extent of invoices raised and when they were raised?

I understand that these invoices have now been raised as we made this commitment – if you would like further details quickly it would be best to contact the team directly ([redacted]**) .**

Kind regards,

[redacted]

[redacted] | **Senior Auditor | Audit Services**
Audit Scotland | 102 West Port | Edinburgh | EH3 9DN
T: 0131 625 [redacted] | E: [redacted]@audit-scotland.gov.uk

From: [redacted]@gov.scot [mailto [redacted]@gov.scot]
Sent: 19 September 2017 13:01
To: [redacted]; Michael Oliphant
Cc: [redacted]@gov.scot; [redacted]; Stephen Boyle; cfo@gov.scot; [redacted]@gov.scot
Subject: RE: Draft reports
Importance: High

[redacted], Michael (welcome back – hope you enjoyed your leave!)

As promised, I attach collated comments on the two SG draft reports. These reflect our discussion on Thursday and include contributions for the relevant business areas. I have flagged where I know this to be incomplete, and where I think there needs to be follow up. There are a few other areas where I have yet to receive comments but it seemed sensible to share this meantime and I will supplement as necessary.

As we discussed on Thursday, we have prioritised the s22 report. As we also discussed, a number of our comments would affect the recommendations in the Annual Report Action Plan, so we will not produce formal responses until you have had a chance to consider. A key element is the text on European Structural Funds where a number of concerns have been flagged; please let us know if it would be easier to discuss.

As you will appreciate, management responses have to be cleared by the appropriate senior colleagues, so we would suggest that the report be provided to SGAAC without responses at this stage.

Aileen
[redacted]

From: [redacted][mailto: [redacted]@audit-scotland.gov.uk]
Sent: 11 September 2017 14:06
To: Chief Financial Officer; Wright AG (Aileen); [redacted]
Cc: [redacted]; Stephen Boyle; Michael Oliphant
Subject: Draft reports

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- Scottish Consolidated Fund Annual Audit Report

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Many thanks,

[redacted]

[redacted]
Senior Auditor
Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 [redacted]
E: [redacted]@audit-scotland.gov.uk
www.audit-scotland.gov.uk

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[redacted]

From: [redacted]
Sent: 23 July 2018 15:22
To: [redacted]
Subject: FW: Draft reports

From: [redacted][mailto: [redacted]@audit-scotland.gov.uk]
Sent: 20 September 2017 15:55
To: [redacted]
Cc: Wright AG (Aileen); [redacted]; Michael Oliphant
Subject: RE: Draft reports

[redacted],

Thanks for your email.

Thanks for the ONS link for the 2 hospitals. If you have something similar for the SNBTS position that would be helpful.

On ESF matters, if you could send Owen's paper to me, that would be helpful, and I'll contact Tracey regarding the invoices raised query.

Kind regards,
[redacted]

From: [redacted]@gov.scot [mailto: [redacted]@gov.scot]
Sent: 20 September 2017 15:06
To: [redacted]
Cc:[redacted]@gov.scot; [redacted]; Michael Oliphant; [redacted]

Subject: RE: Draft reports

[redacted],

Thank you for your note - please see my comments below.

Happy to speak if helpful.

Regards.

[redacted]

gov.scot

[redacted]
Head of Financial Management and Reporting
Financial Management Directorate
T: 0131 244 [redacted]

M: [redacted]

E: [redacted]@gov.scot
Scottish Government
Victoria Quay
Edinburgh EH6 6QQ

From: [redacted][mailto: [redacted]@audit-scotland.gov.uk]
Sent: 20 September 2017 11:44
To: [redacted]
Cc: Wright AG (Aileen[redacted]; Michael Oliphant
Subject: RE: Draft reports

[redacted],

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Kind regards,

[redacted]

[redacted]|**Senior Auditor | Audit Services**
Audit Scotland | 102 West Port | Edinburgh | EH3 9DN
T: 0131 625 [redacted] | E: [redacted]@audit-scotland.gov.uk

From: [redacted]@gov.scot [mailto:[redacted]@gov.scot]
Sent: 19 September 2017 13:01
To: [redacted]; Michael Oliphant
Cc[redacted]; Stephen Boyle; cfo@gov.scot; [redacted]@gov.scot
Subject: RE: Draft reports
Importance: High

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Aileen
[redacted]

From: [redacted][mailto: [redacted]@audit-scotland.gov.uk]
Sent: 11 September 2017 14:06
To: Chief Financial Officer; Wright AG (Aileen); [redacted]
Cc: [redacted]; Stephen Boyle; Michael Oliphant
Subject: Draft reports

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Many thanks,

[redacted]

[redacted]
Senior Auditor
Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 [redacted]
E: [redacted]@audit-scotland.gov.uk
www.audit-scotland.gov.uk

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còraichean, foillseachadh neo sgaoileadh, gun chead. Ma 's e is gun d'fhuair sibh seo gun fhiosd', bu choir cur às dhan phost-d agus lethbhreac sam bith air an t-siostam agaibh agus fios a leigeil chun neach a sgaoil am post-d gun dàil.

Dh'fhaodadh gum bi teachdaireachd sam bith bho Riaghaltas na h-Alba air a chlàradh neo air a sgrùdadh airson dearbhadh gu bheil an siostam ag obair gu h-èifeachdach neo airson adhbhar laghail eile. Dh'fhaodadh nach eil beachdan anns a' phost-d seo co-ionann ri beachdan Riaghaltas na h-Alba.

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[redacted]

From: [redacted]
Sent: 23 July 2018 15:23
To: [redacted]
Subject: FW: Draft reports

From: Wright AG (Aileen)
Sent: 19 September 2017 18:26
To: [redacted]; Michael Oliphant
Cc: [redacted]; Stephen Boyle; Chief Financial Officer; [redacted]
Subject: RE: Draft reports

[redacted], Michael

Para 43 (and Action Plan point 5)
The earlier paper indicated that comments were expected on the ESF recommendation relating to Internal Audit. IAD have asked that you reconsider the text here in the light of the following explanation of roles and process, in particular that the Managing Authority, not the project sponsors, is the audit client and IAS's responsibility to assess the work of the Managing Authority in order to protect EU funds.

The process in place for the final round of audits in the old programme was as follows:

- at the end of fieldwork, a wash-up meeting was held with the project sponsor and the Managing Authority so that all parties understood the emerging findings and the areas of additional evidence required
- once additional information was received from the project sponsor (which often involved on-going liaison with IAD) the draft report was shared in the first instance with the MA (as the client), who then shared it with the project sponsor
- once further work was completed in response to the draft report (involving liaison with the project sponsor if necessary), IAD issued the final report to the MA, who then shared it with the project sponsor.

Where necessary, helpful or appropriate, IAD have been involved in on-going discussions with the project sponsors and the MA on specific project issues resulting from those reports. So it is incorrect to imply that IAD do not share and agree our findings with the project sponsors. Where there are on-going concerns, especially with regards to recoveries, the main issues are not generally in relation to understanding or agreeing the findings (e.g. lack of evidence) but in the interpretation of those findings in relation to the EU regulations, error rates and potential penalties. As that is a matter of interpretation of the regulations, and the audit decision is final, there will inevitably be occasions where the project sponsors will not agree, especially where there will be a financial impact on them. It is then up to the SG and the Managing Authority to determine how to handle those individual situations / recoveries.

Jennifer Inglis-Jones is on leave this week, but Sharon or colleagues would be happy to discuss if helpful.

Aileen
[redacted]

From: Wright AG (Aileen)
Sent: 19 September 2017 13:01
To: [redacted]; Michael Oliphant
Cc: [redacted]Stephen Boyle; Chief Financial Officer; [redacted]
Subject: RE: Draft reports
Importance: High

[redacted], Michael (welcome back – hope you enjoyed your leave!)

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Aileen
[redacted]

From: [redacted][mailto: [redacted]@audit-scotland.gov.uk]
Sent: 11 September 2017 14:06
To: Chief Financial Officer; Wright AG (Aileen); [redacted]
Cc: [redacted]Stephen Boyle; Michael Oliphant
Subject: Draft reports

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Many thanks,

[redacted]

[redacted]
Senior Auditor
Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 [redacted] **E:** [redacted]@audit-scotland.gov.uk
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