Scottish Government

Annual report on the 2011/12 audit

AUDIT SCOTLAND

Prepared for the Auditor General for Scotland and the Scottish Government
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Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Key messages

Auditors' reports on accounts

Unqualified opinions were provided on the Scottish Government Consolidated Accounts, the Scottish Consolidated Fund accounts and the Non Domestic Rating accounts.

The signed consolidated accounts were laid in the Scottish Parliament and published on 27 September 2012. Unaudited accounts were submitted in line with agreed timetables and working papers and responses provided by officials were of a good standard, allowing us to conclude our audit in line with the agreed timetable. However, there were delays in the compilation and submission of Whole of Government Accounts returns.

Financial position

Budget rules require spending to be controlled to a single budget total for the Scottish Administration. Notwithstanding the flexibility this allows, spending in all portfolios included in the consolidated accounts was within the budget set for each. Overall outturn for the Scottish Administration was within the limit set. Budget management during the year was effective.

A new Budget Exchange Scheme for the Devolved Administrations was introduced in 2011/12 covering the remaining years of the 2010 Spending Review. The Scottish Government can carry forward funding from one year to the next within pre-determined limits. In 2011/12 this limit equated to a cap of £195 million. Any underspend in excess of this amount is returnable to the UK Government. In 2011/12 the aggregate underspend of £179 million has been carried forward in full to 2012/13. After taking account of £100 million planned carry forward, the unplanned underspend of £79 million represented around 0.3% of budget.

The financial challenges facing the Scottish public sector are well documented, with public bodies facing deep and prolonged cuts in funding. This brings immediate challenges for the Scottish Government - in partnership with other public sector organisations - to reduce expenditure and ensure long-term, sustainable public services. The Scottish Budget is anticipated to reduce by 11% (resource 8%, capital 33%) in real terms in the four years to 2014/15, given current HM Treasury assumptions about inflation.

The Scottish Government has set itself a target of reducing Administration costs by 20% during this period. It is employing voluntary exit schemes to help it achieve the required reductions in staff costs and to reshape the organisation. Significant early progress has been made, but this is becoming more difficult. There is also a significant challenge in reducing costs at the speed required without impacting unduly on organisational performance.

The Scotland Act 2012 will have significant implications for the Scottish Government as it manages the risks and opportunities for the Scottish budget during the transition to new financial powers. Governance arrangements have been established at a UK and Scottish level, and initial progress has been made in some key areas. Implications for budget setting, financial management and public financial reporting will have to be kept under review.

Governance and accountability

Following a period of significant change to the people leading the organisation, senior roles and responsibilities are now increasingly settled over key areas. Governance structures continue to be subject to change as they are kept under review and refined. This included the recent introduction of a new structure for corporate boards. Following a review, audit and risk committees have been better aligned to the responsibilities of Directors' General and non-executive directors have become increasingly involved in supporting the work of Boards. The Strategic Board has also recently agreed that a further review should be carried out of its own role and operations.

As the new audit and risk committee arrangements mature, it is important that there is a shared understanding amongst all of those involved about role and scope, and how these should be exercised in practice. During 2011/12 there was no formal assessment of individuals' performance in their role as board members. This was introduced during 2012/13 and arrangements are still bedding in.

Overall, governance arrangements operated effectively during 2011/12. There were adequate systems of internal control in place and key financial controls operated effectively during the year. Improvements have been made in key areas including control over European funding and travel and subsistence. European funding continues to be a high risk area, and ongoing work is required to improve controls and ensure the smooth introduction of new schemes.

Reducing resources and increasing demands from European work have been particularly challenging to the work of internal audit (IA). While IA has continued to operate to required standards, there remain some risks to future delivery. A revised approach to audit planning provides an opportunity to better manage the programme of internal audit work against this backdrop, and it's important that IA performance and resourcing remain under review.

Best value, use of resources and performance

At the end of October 2012, the Scottish Government was reporting a more mixed performance than previous years against the purpose targets and national indicators included in the National Performance Framework. While reported performance over the 50 national indicators showed an improved position, performance against the 11 purpose targets did not improve to the same extent as previous years. This may be an early indication that the financial environment may be beginning to have an impact on aspects of overall performance.

The Scottish Government has made significant progress in establishing more effective risk management throughout the organisation. Workforce management and procurement arrangements are generally well developed with plans for further improvement. However, progress in implementing asset management plans has been limited.

Introduction

1. This report is the summary of our findings arising from the 2011/12 audit of the Scottish Government. The purpose of the annual audit report is to set out concisely the scope, nature and extent of the audit, and to summarise the auditor's opinions (i.e. on the financial statements) and conclusions and any significant issues arising. The report is divided into sections which reflect the extent of our public sector audit model.

2. A number of reports have been issued in the course of the year in which we make recommendations for improvements (Appendix A). We do not repeat all of the findings in this report, but instead we focus on the financial statements and any significant findings from our wider review of the Scottish Government.

3. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officials have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that the Scottish Government understands its risks and has arrangements in place to manage these risks. In some cases management had already identified the issues highlighted and action is underway. The Strategic Board and Accountable Officer should ensure that they are satisfied with the proposed management action and have a mechanism in place to assess progress.

4. This report is addressed to Scottish Government and the Auditor General and should form a key part of discussions with audit and risk committees, as soon as possible after the formal completion of the audit of the financial statements. Reports should be made available to stakeholders and the public, where appropriate. Audit is an essential element of accountability and the process of public reporting.

5. This report will be published on our website after consideration by Scottish Government Audit and Risk Committee.

6. The management of the audited body is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to our attention during their normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements 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.

Financial statements

7. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.

8. We are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:

- whether they give a true and fair view of the financial position of audited bodies and their expenditure and income
- whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements
- the regularity of the expenditure and income (except for local government bodies).

9. We review and report on, as appropriate, other information published with the financial statements, including the management commentary, governance statement and the remuneration report. Where required, auditors also review and report on the Whole of Government Accounts return. This section summarises the results of our audit on the financial statements.

Audit opinions

10. On 21 September the Auditor General for Scotland provided her unqualified opinions on the Scottish Government Consolidated Accounts.

11. The Scottish Government is required by Ministerial Direction to follow the 2011/12 Government Financial Reporting Manual (the FReM). We confirm that financial statements have been properly prepared in accordance with the FReM.

Accounting issues

Accounts submission

12. The unaudited schedules for the core accounts and the consolidated accounts were submitted in line with agreed plans. The unaudited sub-consolidation pack for health was also received by the agreed deadline. Working papers and responses provided by staff in Finance were of a good standard and allowed the Auditor General for Scotland to conclude the audit within the agreed timetable and provide her opinion on 21 September. Matters arising from the audit were reported to the Scottish Government Audit and Risk Committee on 18 September 2012. The signed consolidated accounts were laid in the Scottish Parliament and published on 27 September 2012.

Changes to accounting estimates

13. There have been a number of changes to accounting policies and / or accounting estimates and judgements, that were processed through the 2011/12 accounts. These are detailed in paragraphs 14 to 18 below. We have reviewed these and are content that revised approaches were appropriate.

Prior year adjustments

14. The following prior year adjustments were made:

- the Scottish Government reviewed its approach to accounting for transactions and balances associated with European funding in 2011/12 to ensure that it properly applied its policy on foreign exchange. A prior year adjustment was made. This resulted in additional exchange rate losses of £21 million being recognised, reducing the value of net assets as at 31 March 2011.
- the Scottish Government reviewed its approach to accounting for funds disbursed by the Energy Savings Trust (EST) and Scottish Investment Fund (SIF). A prior year adjustment was made to account for advances to EST and SIF that were then used to fund lending as investments rather than grants, increasing the value of net assets by £31 million as at 1 April 2011.
- the FReM has been amended so that most grants and donated assets should be recognised as income. The donated asset reserve and the EU grant reserve have been removed from the financial statements with a corresponding adjustment to the prior year figures.

Student loan debt

15. Two types of student loans were made by the Scottish Government – the current Income Contingent Repayment (ICR) type loans and older Mortgage Style (MS) loans. MS loans were issued for courses beginning before September 1998 and repayments can be deferred if the borrower earns less than the loan repayment threshold. These loans make up less than 5% of the total outstanding Scottish student loan balance of £2.690 billion.

16. In light of the age and profile of outstanding MS loans, the relatively high repayment threshold (£27,734 currently) and the prevailing economic position, the Scottish Government conducted an impairment review of MS loans in 2011/12. As a result the value of these loans recognised in the 2011/12 accounts has been reduced by £61.5 million to £34.3 million. The amount provided for non payment in the accounts is now £93 million. This is consistent with a repayment profile which is expected to worsen as debt ages further and better payers fulfil their outstanding commitment.

Transport Scotland

17. Transport Scotland's road asset valuation system did not previously include reports to identify the element of depreciation that related to revaluation, which would require to be released from the revaluation reserve. As a result there was an immaterial misstatement

in the consolidated accounts between the value of the revaluation reserve and the general fund, which we estimate to be £52 million. If no action were taken then the value of this misstatement would continue to increase over time and Transport Scotland's auditor anticipates that it would become material to its accounts within four years. Transport Scotland has subsequently instructed an update to the system to enable the relevant depreciation to be identified in future years.

18. The annual professional valuation of the roads network identified that there was an immaterial error in the previous valuation of £46 million. This arose from measurement errors identified in the former valuer's report. Transport Scotland decided to correct this in year rather than as a prior year adjustment on the grounds of materiality. It has therefore been adjusted in year within the consolidated accounts.

NHS bodies - equal pay claims

19. The National Health Service in Scotland had received in excess of 10,000 claims for equal pay as at 31 March 2012. These have been referred for the attention of the NHS Scotland Central Legal Office (CLO) to co-ordinate the legal response to this issue.

20. Developments over the past year have slowed the progress of claims and led to a reduction of claims going forward. The CLO and Equal Pay Unit are monitoring the progress of claims as well as developments relating to NHS equal pay claims elsewhere that may further inform the position. We are aware that a Scottish test case is currently under appeal.

21. Discussions were held between Audit Scotland, its partner firms, the Scottish Government, the CLO and board representatives to ascertain the appropriate accounting treatment of equal pay claims in 2011/12. Given the NHS CLO has stated that claims still do not provide sufficient detail about the comparator jobs to allow an estimate to be made of the likelihood of the success of the claims or of any financial impact that they may have, it was agreed that disclosure as an unquantified contingent liability remained appropriate for the 2011/12 financial statements.

22. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Accounting standards highlight that only in "extremely rare" cases, will an entity be unable to determine a range of possible outcomes in order to make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. As more information becomes available, including details of the progress of cases in Scotland and England, we would expect it would become possible for the Scottish Government to prepare an estimate of probable liabilities that is sufficiently reliable to be disclosed in future accounting periods.

Refer Action Plan No. 1

Scottish Consolidated Fund (SCF) and Non Domestic Rating Account (NDR)

23. The Scottish Government prepares separate financial statements for the Scottish Consolidated Fund (SCF) and Non-Domestic Rating (NDR) account on a receipts and payments basis, which are subject to separate audits. We have given unqualified opinions on the financial statements of both the SCF and NDR for the year ended 31 March 2012. Separate Annual Audit Reports are prepared for each of these audits.

Whole of Government Accounts

24. Whole of Government Accounts (WGA) are consolidated financial statements for all components of Government in the UK. These are prepared by HM Treasury with the aim of providing improved data for fiscal planning, increasing transparency and improving accountability.

25. The main legislative authority for WGA does not apply in Scotland. However, the Scottish Government has agreed to provide HM Treasury with information for entities in the consolidated accounts and the SCF. It also oversees the return of WGA information by Non Departmental Public Bodies, Non Ministerial Departments, Public Corporations and local government bodies in Scotland.

26. The 2009/10 WGA accounts were the first to be audited and published (in November 2011). The UK Parliament's Public Accounts Committee report on them highlighted the important role that WGA has to play in identifying and addressing the risks to public finances, and the potential to inform longer term fiscal planning and decision making. The 2010/11 WGA were published on 31 October 2012.

27. The Comptroller and Auditor General qualified both the 2009/10 and 2010/11 accounts for a number of issues, although none of these directly applied to the Scottish Government.

28. We review the Scottish Government's own WGA returns to confirm that they have been properly prepared and are consistent with the audited accounts. There have been delays in the preparation of 2011/12 returns. In turn, this has impacted on the delivery of the WGA audit and contributed to some difficulties in the WGA process more generally.

29. Our work on the 2011/12 packs is continuing. Going forward the Scottish Government should consider giving a greater priority to its contribution to WGA.

Refer Action Plan No. 2

30. As changes are made to the financial powers following the Scotland Act and the manner in which the organisation works with other parts of the Scottish public sector, the Scottish Government should consider and keep under review how best to account for the finances of the Scottish public sector.

Accounting outlook

Proposed amendments to 2012/13 FReM

31. The rise in public sector restructuring has highlighted practical, and in some cases, legal obstacles to applying merger accounting. An amendment to the current application of merger accounting has been approved. Any future reorganisation of bodies included in the Scottish Government consolidated accounts will now be required to be accounted for under these revised accounting rules.

Financial position

32. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based. We consider whether audited bodies have established adequate arrangements and examine:

- financial performance in the period under audit
- compliance with any statutory financial requirements and financial targets
- ability to meet known or contingent, statutory and other financial obligations
- responses to developments which may have an impact on the financial position
- financial plans for future periods.

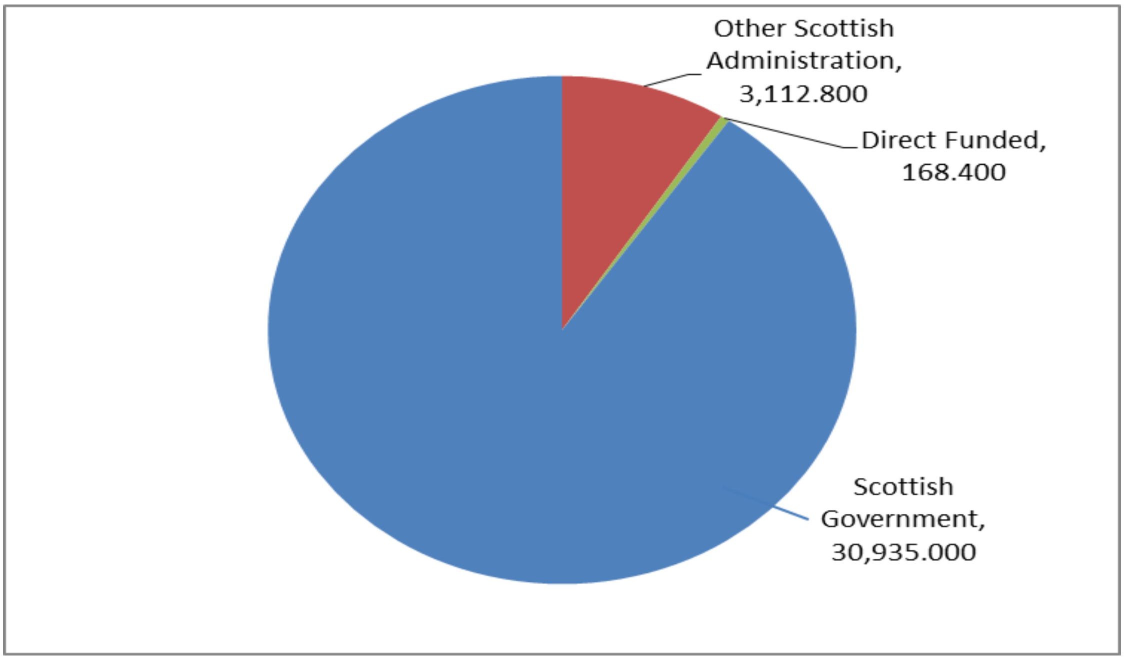
33. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the organisation.

Financial results 2011/12

Scottish Budget for 2011/12

34. The Budget (Scotland) Act 2011 made provision for financial year 2011/12 for the use of resources by the Scottish Administration and certain bodies whose expenditure is payable out of the Scottish Consolidated Fund. The final budget approved by the Scottish Parliament permitted total expenditure of £34,216.7 million. The majority of this 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 Direct Funded bodies as shown in exhibit 1.

Exhibit 1: The Scottish Budget 2011/12 (£ million)



Source: Audit Scotland from the Spring Budget Revision 2011

Outturn reported in the Consolidated Accounts

35. The final budget for the expenditure included in the Scottish Government's Consolidated Accounts for 2011/12 was £30,936 million. Total net expenditure during the year was £30,735 million, resulting in an overall underspend of £201 million (2010/11 £330 million). Within this total, resource was underspent by £72 million and capital was underspent by £129 million against respective budgets with spending in all portfolios within the individual budgets for each as set out in table 1.

Table 1: Scottish Government outturn against budget 2011/12

Portfolio	Outturn £m	Budget £m	Over / underspend £m
Finance and Sustainable Growth	412	426	(14)
Health and Wellbeing	11,742	11,769	(27)
Education and Lifelong Learning	2,656	2,705	(49)
Parliamentary Business and Government Strategy	13	14	(1)
Justice	1,755	1,757	(2)
Rural Affairs and the Environment	439	494	(55)
Culture and External Affairs	199	203	(4)
Infrastructure and Capital Investment	2,616	2,655	(39)

Portfolio	Outturn £m	Budget £m	Over / underspend £m
Local Government	10,555	10,558	(3)
Administration	239	246	(7)
Crown office and procurator fiscal service	109	109	-
Total	30,735	30,936	(201)

Source: Scottish Government Consolidated Accounts 2011/12

36. Overall, outturn was within 1% of budget and budget management during the year was effective. An analysis and explanations for major variances over £3 million are disclosed in the consolidated accounts.

37. Spending in the consolidated accounts must be taken together with other expenditure set out in Schedule 1 of the budget act in order to determine whether the Scottish Administration has remained within the statutory budget limit. The outturn against budget for all relevant purposes is summarised in table 2.

Table 2: Scottish Administration entities outturn against budget 2011/12

Entity	Outturn £m	Budget £m	Over / underspend £m
Scottish Government Consolidated	30,735	30,936	(201)
National Records of Scotland	31	34	(3)
Teachers' and National Health Service Pension Schemes	2,978	2,991	(13)
Office of the Scottish Charity Regulator	3	3	-
Scottish Courts Service	82	84	(2)
Total	**33,829**	**34,048**	**(219)**

Source: Audited Accounts 2011/12

38. The net position for all of the Scottish Administration is an underspend of £219 million, meaning that spending has been contained within the limit set.

39. In January 2012 the Scottish Ministers laid before Parliament a statement of total outturn for the financial year 2010/11 against the final Budget for the Scottish Administration. This was the first time that such a report has been made and formed an important part of the Scottish Government's accountability to the Scottish Parliament. We expect a similar report will be required for 2011/12.

Implications for Total Managed Expenditure

40. Total Managed Expenditure (TME) is the total budget agreed with HM Treasury, and is used by the UK Government to manage its spending on the Scottish Block. This varies slightly from the budget approved by the Scottish Parliament, largely for technical reasons. A reconciliation of the two amounts is included in the consolidated accounts.

41. In assessing actual TME for the year, it is necessary to consider the spending of the Scottish Government reflected in the consolidated accounts, other expenditure of the Scottish Administration and the spending of direct funded bodies (Forestry Commission, Food Standards Agency, Scottish Parliamentary Corporate Body and Audit Scotland). A number of technical adjustments then require to be made, reflecting differences between accounting rules and UK budget rules.

42. Under budget rules TME is categorised as either Annually Managed Expenditure (AME) or Departmental Expenditure Limit (DEL). AME is not subject to firm multi-year limits and generally any under/ over spend against AME budgets in one year will be adjusted for in subsequent years without affecting the Scottish Government's spending power. DEL is subject to greater control.

43. As part of the Government's three year spending plans, a planned £100 million carry forward from 2011/12 to 2012/13 was included in the Draft Budget 2012/13. The provisional outturn 2011/12 announcement made by the Cabinet Secretary for Finance, Employment and Sustainable Growth in June 2012 indicated that the cash DEL budget in 2011/12 was underspent by £179 million (£148 million resource, £30 million capital). After taking account the planned carry forward, the actual fiscal DEL underspend of £79 million represents 0.3% of the total DEL cash budget.

44. A new Budget Exchange Scheme for the Devolved Administrations was introduced in 2011/12 and will operate for the remaining years covered by the 2010 Spending Review. This enables Devolved Administrations to carry forward 0.6% of Revenue DEL and 1.5% of capital DEL from one year to the next. For the Scottish Government in 2011/12 this equated to a cap of £195 million. Any underspend in excess of this amount is returnable to the UK Government. The full balance of DEL underspend of £179 million has been carried forward into 2012/13.

Financial outlook

Scotland's future budgets

45. The financial challenges facing the Scottish public sector are well documented, with public bodies facing deep and prolonged cuts in funding. The Government Economic Strategy estimated Scottish public spending will continue to fall in real terms until 2016/17 and that it could take until 2025/26 for the Scottish Government budget to return to 2009/10 levels. The UK Comprehensive Spending Review settlement (covering the three year period to 2014/15) is designed to achieve fiscal consolidation – a reduction in the UK Government's

annual deficit and, over time, a fall in the UK's accumulated debt. The Scottish budget is receiving a share of the spending reductions through the operation of the Barnett formula.

46. Reductions in real terms funding available to Scotland through the block grant presents a number of challenges to achieving a balanced budget in 2012/13 and subsequent years. In respect of the DEL budget for 2012/13, the available budget represents a real terms cut of 6.8% (resource 4.9%, capital 21.7%) compared with 2010/11. Over the period to 2014/15, the DEL budget available to Scotland is predicted to reduce, in real terms, by 11.1% (resource 8.3%, capital 32.9%) compared with 2010/11 given current assumptions about inflation using available GDP deflators published by HM Treasury.

47. The reduction in public spending comes at a time that demand for public services is increasing, and this is likely to continue into the future. This places an additional burden on the capacity of public bodies to provide efficient and quality services. They also face a number of significant cost pressures including increasing backlog maintenance and repair costs and rising energy costs. These, together with existing financial commitments, will make it difficult to reduce costs while maintaining service standards.

48. As well as setting out its spending priorities, the Scottish Government has an important role in providing leadership and support to public sector bodies as they seek to reduce costs, improve efficiency and deliver on national priorities. It also needs to ensure that it manages its own operating costs within the Administration budget while delivering the Government's purpose, supporting Minsters in their work, and ensuring the proper stewardship of public money.

Preparing for increased fiscal autonomy

49. The Scotland Act received Royal Assent on 1 May 2012. The key financial provisions of the Act include:

- the introduction of a Scottish Rate of Income Tax (SRIT) and corresponding adjustment to the Scottish block grant from April 2016. Transitional arrangements will be in place, with the final mechanism being introduced from April 2018 at the earliest. All implementation issues are subject to agreement between the UK and Scottish Governments
- stamp duty and landfill tax will be entirely devolved from April 2015, subject to relevant decisions in the Scottish Parliament in sufficient time. There is scope for further taxes to be devolved subject to agreement between the two Governments
- new powers for Scottish Ministers to borrow for revenue and capital purposes within agreed limits (currently £2.8 billion in total) from April 2015, and to operate a Scottish cash reserve to provide additional flexibility during the initial phase of the new system. Payments may be made into the reserve over the next five years.

50. Governance arrangements for the oversight of implementation of the Act have been established at a UK and Scottish Government level and are now operating. These include:

- a Joint Exchequer Committee (JEC) of UK and Scottish Government ministers. The JEC has been established to provide joint assurance on the implementation of the financial provisions of the Scotland Act and associated measures, to ensure systems are implemented in time.
- an Inter-Governmental Assurance Board involving senior officials from the Scottish Government, HM Treasury, HM Revenue and Customs and the Scotland Office. This is the primary forum for discussions between the officials of both Governments, supporting the work of the JEC and overseeing the management of risk in relation to the implementation of the Act.
- a Programme Board for managing the development of SRIT within HM Revenue & Customs, including representation from Scottish Government officials.
- a Scottish Government Fiscal Responsibility Programme Board. This senior official group oversees programme and project management within the Scottish Government and meets quarterly.

51. The JEC has developed some key milestones for managing progress up to the date of full implementation of new financial powers in 2020. It has agreed that progress against these will be monitored at each meeting. It has also agreed a process for establishing new and additional devolved taxes in Scotland for application where agreement had been reached on this.

52. Under the Scotland Act 2012, both the Scottish and UK Governments must make annual reports on progress with the financial provisions in the Act to both the UK and Scottish Parliaments. The first of these is due by May 2013, the first anniversary of the Royal Assent of the Act. In September 2012 the Cabinet Secretary for Finance, Employment and Sustainable Growth gave evidence on progress to the Finance Committee of the Scottish Parliament.

53. Key progress made by the Scottish Government since the Act became law has included the announcement of the Scottish Government's principles for taxation in June 2012 and consultation on proposals for a Land and Buildings Transaction Tax which closed in August 2012. The Scottish Government is currently compiling consultation responses and has committed to publishing a summary of these shortly. Arrangements have also been put in place to establish Revenue Scotland, to work with Registers of Scotland and the Scottish Environmental Protection Agency to collect devolved taxes. The Head of Revenue Scotland took up post in October 2012.

54. Work is continuing at an official level on critical next steps, which will include:

- consultation on proposals for a replacement landfill tax (launched in October 2012)
- agreement of a Memorandum of Understanding between the Scottish Government and HM Revenue and Customs covering arrangements for setting up and operating the SRIT. The JEC has discussed the broad content of the Memorandum and wishes to reach agreement on its terms in early 2013. The Scottish Government has indicated that it will reflect on the views of the Scottish Parliament in key areas including transparency and

accountability arrangements before reaching agreement on the Memorandum. It has also been agreed that HM Revenue and Customs will appoint an additional Accounting Officer for SRIT (appointed in early November 2012).

- preparation of bills to put in place devolved taxes, announced as part of the Scottish Government's programme of legislative priorities for 2012/13, and a tax management bill announced as part of the anticipated 2013/14 legislative programme.

55. The costs of establishing and operating the SRIT require to be met by the Scottish Government. The UK Government's initial estimate of the cost of introduction is £40-45 million, incurred between 2013/14 and 2015/16. The estimated annual running cost is £4-4.5 million. In respect of the devolved taxes, set up costs of £2.5–3 million and annual running costs of about £3 million have been estimated by the Scottish Government. All these amounts will require to be met from future budgets.

56. Significant further work is required to deliver the financial provisions of the Act and this is continuing. Critical issues for the Scottish Government in the period ahead will include building capacity to support the new function of tax administration, the effective forecasting of tax revenues as a basis for future financial planning and development of budgeting, accounting and financial management arrangements to reflect new financial powers.

Refer Action Plan No. 3

Governance and Accountability

57. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.

58. Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.

59. Consistent with the wider scope of public audit, we have a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:

- corporate governance and systems of internal control
- the prevention and detection of fraud and irregularity
- standards of conduct and arrangements for the prevention and detection of corruption

60. In this part of the report we comment on key areas of governance.

Corporate governance

Overall effectiveness

61. We found that overall, corporate governance arrangements operated effectively during 2011/12, although there is scope to make improvements in some areas as outlined below.

Processes and committees

Strategic board

62. The *Role of boards* was published by the Auditor General in September 2010. This report examined the system of accountability of Scottish public bodies and the performance of boards in the central government sector. During the 2011/12 audit, we undertook follow-up work to assess progress made by the Scottish Government against relevant recommendations in the report. The review focussed on the arrangements to support the work of the Strategic Board. Overall we found that:

- the Strategic Board regularly receives detailed information in relation to key areas including corporate performance, financial management and risk management. This provides the opportunity for the board to challenge management and to hold it to account for performance. In line with recommended practice, the nature and volume of information continues to be kept under review.

- senior management has taken the major role in ensuring that the Strategic Board has the appropriate skills. During 2011/12 this did not involve a formal assessment of the Strategic Board's performance, or individuals' performance in their role as board members. This was introduced during 2012/13 and arrangements are still bedding in. There is also scope for the Strategic Board to make a more significant collective contribution to succession planning.

63. A review of the corporate governance framework was undertaken during 2011/12. It concluded that there should be six corporate areas with boards (supporting the Strategic Board) and led at Director General level focussing on: People, Resources, Improvement, Finance and Risk, Constitution and Economy. All corporate area boards have been fully operational since April 2012. The corporate governance framework in place prior to the review - and therefore for much of the 2011/12 financial year – consisted of three corporate area boards focussing on: People, Resources and Performance.

64. At a recent meeting of the Strategic Board it was agreed that a review should be carried out of the Board’s role and operations to consider membership, how it operates, how it interacts with other groups and how it communicates with the rest of the organisation. The outcome of this review will help identify any improvements.

Non-executive directors

65. The Scottish Government has 13 independent non-executive directors. They support the Permanent Secretary, Directors General and other senior managers in their leadership of the Scottish Government. Their role is to provide an effective assurance and challenge function to the Executive Team, with primary responsibility to Parliament and Ministers remaining with Accountable Officers.

66. Following a review undertaken during the year, the role of non-executive directors has been extended to cover all the main governance groups within the SG. Non-executive directors are represented on the Strategic Board, Audit and Risk Committees (ARCs), Remuneration Group, People Board, Performance Board, Resources Board and Economy Board amongst others. The number of ARCs has been reduced and these have been better aligned to the responsibilities of individual Directors General.

67. A more structured induction process is also being introduced. The quarterly non-executive network meetings have been reviewed to be more effective and targeted.

68. It is evident that non-executive directors play an important part in the organisation, bringing valuable experience and an independent perspective to their roles. Their involvement over a number of different Boards and ARCs helps to promote and maintain understanding, and knowledge sharing.

69. We attend all ARCs. In the early stages of new arrangements we observed some variation in approaches between committees. This was particularly evident in relation to:

- the extent to which committees' interest is directed to consolidated entities (including agencies, the NHS in Scotland and the Crown Office) and other sponsored public bodies (including NDPBs) alongside core Scottish Government business.
- the balance between support and challenge offered to senior officials (the Permanent Secretary, Directors General and their respective teams).

70. While some variation is expected as ARCs respond to the risks and issues evident in their particular portfolios or areas of responsibility, our observation through attendance at ARCs is that it has not been clear that these have been the primary drivers of differences in approach. As the new arrangements mature, it is important that there is a clear understanding amongst all of those involved about role and scope and a shared understanding of how these should be exercised in practice.

Refer Action Plan No. 4

Systems of internal control

Internal Control Framework

71. While we concentrate on significant systems and key controls in support of the opinion on the financial statements, our wider responsibilities require us to consider the financial systems and controls of audited bodies as a whole. The extent of this work is informed by our assessment of risk and the activities of internal audit.

72. As part of our audit we reviewed the high level controls in all of the Scottish Government's central systems that impact on the financial statements. Our overall conclusion was that key controls were operating effectively and that adequate systems of internal control were in place.

73. In his annual report on 2011/12, the Head of Internal Audit provided his opinion that based on the internal audit work undertaken during the year that he was able to provide substantial assurance on overall arrangements for risk management, control and governance.

Governance Statement

74. In 2011/12 the Scottish Government included a governance statement in its annual accounts for the first time. In accordance with guidance, this included description and assessment of the essential components of corporate governance and details of any significant risk-related matters arising during the period.

75. Arrangements for the preparation of the Governance Statement functioned well during the year. The statement is based on a well established pyramid of assurance that includes reviews by each Accountable Officer supported by the work of ARCs.

76. We were satisfied that the final statement met the requirements of the SPFM. Some improvements were made to arrangements to support consideration of the statement at an earlier stage. However, the timing of assurance processes did mean changes were

being made to the statement just prior to the SGARC meeting on 18 September. This constrains audit review and introduces a risk that any issues raised are not able to be resolved without delay to the conclusion of the audit.

77. We recommend that the timing of assurance is completed to allow the final Governance Statement to be presented to SGARC, 10 days in advance of the committee meeting, in line with recommended internal practice. This will provide sufficient time for scrutiny and review by SGARC. It will also allow external audit review to be completed and any areas of concern to be discussed with the Scottish Government in advance of SGARC.

Refer Action Plan No. 5

Internal Audit

78. The establishment and operation of an effective internal audit function forms a key element of effective governance and stewardship. We seek to rely on the work of internal audit wherever possible. We concluded that the Internal Audit Division (IAD) operates in accordance with the Government Internal Audit Manual and that we could place reliance on their work during 2011/12.

79. In May 2011 the Permanent Secretary confirmed the appointment of a Non Executive Director lead for internal audit. This arrangement is now working well and has resulted in input to the redesign of the Scottish Government risk management process, and general governance development including self assessment.

80. Internal audit resources have been under pressure from a number of sources, in particular the need to devote increasing levels of resource to European funding related commitments. At the same time the staff complement and level of experienced staff working in the division has continued to reduce.

81. This raises risks for the extent and delivery of planned internal audit work, with a possible knock on impact on the robustness of the overall control environment. This has not led to any significant concerns about the quality and extent of internal audit work undertaken in 2011/12, but the position will need to be kept under review by the Scottish Government.

82. Internal audit has revised its approach to audit planning in response to the current environment, reflecting on Scottish Government's new Business Strategy, revised risk management arrangements, Workforce 2015 and other related issues. They have consulted with senior management on the priorities for audit coverage. A clear message from this consultation was the need for the 2012/13 plan to take account of the current economic situation and its impact on the delivery capacity of the Scottish Government.

83. The revised approach involves more cross cutting reviews and a clearer linkage with the organisation's high level risks. In also includes continued coverage of the key corporate systems on which the wider organisation relies. An updated Audit Charter and Strategy, which reflect the changes to the audit planning process, were presented to SGARC in May 2012.

84. These changes provide an opportunity for internal audit to better manage its programme of work and deliver this with an overall reduced capacity. We continue to work with internal audit to identify opportunities to work together and reduce duplication of audit work.

Refer Action Plan No. 6

European funding

85. In 2010/11 the Auditor General for Scotland (AGS) submitted a section 22 (3) report to the Scottish Parliament which considered the Scottish Government's management of European Funds. Since the issue of the report, governance and risk management arrangements have been strengthened to provide improved oversight and new measures have been put in place to limit the prospect of future financial corrections and disallowances. Progress has been made in improving controls in a number of areas, but further work is required to address known and emerging issues.

European Agricultural Funds

86. Audit Scotland acts in the role of Certifying Body for these Fund accounts in Scotland under a consortium arrangement across the UK that is managed by the National Audit Office. The accounts are certified by the Comptroller and Auditor General.

European Agricultural Guarantee Fund

87. The Scottish Government has made significant progress in addressing the control issues previously identified by European Commission (EC) auditors, particularly in relation to the inspection regime which now incorporates an integrated approach across all European schemes and has been supported by additional staff training and improved guidance. Management control and oversight have also been strengthened. However, a major project to update the database of agricultural land is on-going with expected completion during 2013/14.

88. Scottish Government proposals for the disallowance of funding resulting from previous control deficiencies were accepted by the EC. In January 2012 it proposed disallowance of €40 million, equivalent to £35 million at the exchange rate at the time (£32 million at the current exchange rate). Discussion is continuing on a number of smaller amounts.

89. Our audit of the EAGF account for the year ending 15 October 2011 was completed without any significant issues arising, and an unqualified audit opinion was given. The audit of the year ending 15 October 2012 is continuing.

European Agricultural Fund for Rural Development

90. Our audit opinion on the EAFRD account for the year ending 15 October 2011 was unqualified but drew attention to a significant level of error in one area of expenditure, as required by the reporting arrangements prescribed by the EC. The high error rate resulted in the EC delaying clearance of the EAFRD account within its own processes.

The EC also indicated that it would not be able to accept the resubmission of €20 million for funding in relation to items that the Scottish Government had previously 'de-committed', removing its claim for funding while it reviewed the eligibility of projects.

91. These issues stemmed from weaknesses in the controls applied to new schemes that commenced from January 2007. The Scottish Government has made significant progress in addressing control weaknesses since that time, but the nature of the projects concerned mean that payments made now frequently relate to projects that were approved when controls were poor. This risk was addressed through a task force review of older, higher risk projects to ensure compliance with regulations. Nevertheless, there remains a continuing risk in relation to older projects, albeit decreasing in time.

92. Areas where further improvement is needed include:

- additional strengthening of the application appraisal function, especially in relation to complex or capital works projects
- improving documentation standards and consistency between EAFRD schemes
- improving control and compliance issues within the LEADER scheme (which is managed by 20 Local Action Groups under delegated arrangements).

European Structural Funds

93. The Scottish Government Internal Audit Division (IAD) acts in the role of Audit Authority Body for these funds in Scotland.

94. The Scottish Government has been working to limit the financial consequences of previous control concerns. Additional work has been undertaken by IAD to provide the EC with further evidence. Procedures have also been improved to ensure better compliance with required prepayment checks and future audit activity scheduled in line with required timescales.

95. A detailed Management Control system was developed and agreed with the EC. The Scottish Government continue to carry out a process of rolling reviews of this system to ensure that it is fit for purpose and is further developed to reflect changing circumstances.

2007-2013 European Social Fund

96. In April 2012 the EC withheld funding on an interim basis for the two ESF programmes following concerns about the accuracy of error rates and the application by grant recipients of public procurement rules. An interruption is made where the EC considers there is evidence that there may be a serious deficiency in the functioning of the management and control system.

97. The interruption to one programme was lifted in July 2012 and to the second programme in September 2012 following provision of the further information and assurance sought by the EC. For the second programme the Scottish Government agreed with EC auditors to make a financial self-correction of £3.6 million to offset the risk to the fund which would enable the funding to be reused for other projects. One of the key issues raised by the

EC auditors was that the design of the programme adds to the complexity of the control processes. The Scottish Government is designing a standard cost methodology to simplify control processes for the remainder of the Social Fund programmes period up to 2014; this will be developed and agreed with EC auditors prior to implementation.

2007- 2013 European Regional Development Fund

98. Warning letters have been issued by the EC covering two ERDF programmes. These programmes cannot be formally interrupted as currently Scotland is due no EC funding. The EC has suggested that procurement and state aid checks did not go into sufficient detail. These checks covering 2009 and 2010 expenditure are being re-performed by the Scottish Government.

Forward risks affecting European funding

99. Current European Agricultural Fund and Structural Funds programmes are due to conclude in December 2013. The EC is currently negotiating with the Council of Ministers and the European Parliament on the regulations which will set out how these funds are managed and implemented, and is proposing significant changes to existing arrangements to improve and simplify financial management and accountability, increase consistency of practice between funds and better align outcomes with strategic objectives. Scottish Government and other UK administrations and other Member States are contributing to on-going discussions.

100. Anticipated changes will present a number of risks to the efficient and effective management of European funds by the Scottish Government in the short to medium term:

- interpreting and adhering to potentially new complex regulatory requirements , developing new Scottish programmes within these
- developing the IT systems and business processes to ensure effective delivery and regulatory compliance from the launch of the new programmes
- ensuring that the underlying controls and records are sufficient to meet the regulatory requirements and to manage the risk of payment interruptions, disallowance or other penalties
- ensure staff resources and skills are sufficient, especially in the overlap between developing the new programmes and running down the old ones.

101. The Scottish Government has set up an European Funds Integration Project Board to examine the scope for policy and operational integration of the various EC funds post 2013/14.

Refer Action Plan No. 7

Data handling

102. We have continued to monitor the Scottish Government's corporate arrangements for data handling and information security, including the actions taken by the SG to address the recommendations of the *Data Handling in Government* (DHiG) report published in

June 2008. We have previously reported that staffing pressures within the Office of Security and Information Assurance (OSIA) arising from the effects of the early release scheme had delayed the implementation of a number of these recommendations. These staffing pressures were resolved during the latter part of 2011, and OSIA has maintained stable staffing during 2012, allowing progress to be made in a number of areas.

Freedom of information

103. Scottish Freedom of Information (FOI) legislation gives everyone the right to ask for any recorded information held by a Scottish public authority. Information can only be withheld where specific exemptions apply. Where, after having asked for an internal review, an individual is still dissatisfied with an authority's response to their request, they have a right of appeal to the Scottish Information Commissioner. During 2011, the Commissioner considered 86 appeals in relation to the Scottish Government, and found wholly or partially in favour of the SG on 62 occasions (72%)*.

104. In July 2012 the Commissioner found in favour of an appeal in relation to the release of internal audit reports. In her judgement the Commissioner drew attention to a number of concerns about the extent to which the Scottish Government had followed its own FOI guidance and that it had failed to modify its approach in relation to her previous advice and judgements. It is important the Scottish Government considers carefully the observations made in this judgement and FOI judgements more generally in its future approach.

Refer Action Plan No. 8

Prevention and detection of fraud and irregularities

105. The Scottish Government is responsible for establishing arrangements to prevent and detect fraud and other irregularity. We review and report on these arrangements.

106. The Scottish Public Finance Manual (SPFM) is issued by the Scottish Ministers to provide guidance to the Scottish Government and other relevant bodies on the proper handling of public funds. Robust procedures following the requirements of the SPFM are in place within the Scottish Government.

107. The Scottish Government Counter Fraud Strategy, Counter Fraud Policy and Counter Fraud Response Plan were updated and published in April 2012. These documents are available to all Scottish Government staff, as well as other public sector organisations to which the SPFM is applicable, via the Scottish Government website. The Strategy

* Source: Figures provided by Scottish Government.

108. A network of Counter Fraud Champions (CFC), coordinated by the Home Office through the National Fraud Authority was established in January 2011, drawn from every UK department and the devolved administrations, to work collaboratively to address a number of areas. The Director, Procurement and Commercial continued his role as the CFC for the Scottish Government throughout 2011/12.

109. Our review concluded that there are robust procedures are in place to help prevent and detect fraud and irregularities.

National Fraud Initiative in Scotland

110. The Scottish Government participates in the National Fraud Initiative (NFI). This is a counter-fraud exercise that uses computerised techniques to compare information about individuals held by different public bodies to identify circumstances that might suggest the existence of fraud or error (matches). Where matches are identified public bodies are expected to investigate these and if fraud and error has taken place, to stop payments and attempt to recover the amounts involved. The exercise also provides assurance on the effectiveness of arrangements and helps deter fraud.

111. The exercise considered Scottish Government's payroll data. Investigation was undertaken on a risk basis. No frauds, irregularities or monetary errors were identified. The exercise helps the Scottish Government work towards achieving the strategic objectives outlined in the Counter Fraud Strategy. In line with previous recommendations, the organisation's approach to NFI has been documented and the final outcomes of the exercise were reported to senior officials and the relevant ARC.

112. National results were published by Audit Scotland in May 2012. This highlighted that fraud, overpayments and recoveries totalling £19.8 million had been identified across Scotland in the most recent exercise and outcomes of £78 million had been achieved since NFI was introduced. The report contains a self-appraisal checklist that all participants are recommended to use prior to the start of the next exercise in October 2012.

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

113. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. We consider whether bodies have adequate arrangements in place.

114. The Bribery Act 2010 came into force on 1 July 2011. The Act creates two general offences covering the offering, promising or giving of an advantage, and requesting, agreeing to receive, or acceptance of an advantage. It also introduces a corporate offence of failure to prevent bribery by persons working on behalf of a business.

115. The Scottish Government published "*Protecting Public Resources: The Scottish Government's Approach to Counter Fraud"* document in April 2012 partly in response to the new requirements of the Bribery Act. There is supporting guidance on what procedures a public body can put in place to prevent bribery, and on what action should be taken if this is suspected.

116. We are satisfied that the Scottish Government has appropriate procedures in place to help ensure appropriate standards of conduct and to help prevent and detect bribery and corruption.

Governance outlook

117. The structure of the Scottish Government continues to change, in an environment of continually reducing resources. It is in such conditions that an organisation's governance and internal control arrangements will be tested.

118. Having sound governance structures, and policies in place will help ensure that the Scottish Government is better placed to deal with these challenges going forward.

Best Value, use of resources and performance

119. Audited bodies have responsibility to ensure that arrangements have been made to secure best value. The Auditor General may require that we consider whether accountable officers have put in place appropriate arrangements to satisfy their corresponding duty of best value. Where such requirements are not specified we may, in conjunction with audited bodies, agree to undertake local work in this area.

120. As part of their statutory responsibilities, the Auditor General may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. We may be requested from time to time to participate in:

- a performance audit which may result in the publication of a national report
- an examination of the implications of a particular topic or performance audit for an audited body at local level
- a review of a body's response to national recommendations.

121. During the course of our audit appointment we also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years. We may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.

122. This section includes a commentary on the best value and performance management arrangements within the Scottish Government. We also summarise headline performance measures used by the Scottish Government, highlight any relevant national reports and comment on the body's response to these.

Performance management

Overview of performance

123. The Scottish Government's National Performance Framework sets out its purpose, objectives and national outcomes that describe in more detail what the government wants to achieve. The Scottish Government reports whether recent performance against each indicator is improving, being maintained or worsening, alongside detailed data.

124. As at the beginning of September 2012 the Scottish Government was reporting improving performance against 4 purpose targets, maintained performance against 4 targets and worsening performance against 3 of the targets (to close the gap with the top 5 world economies by 2017, to reduce emissions over the period to 2011 and to reduce emissions by 80% by 2050). In headline terms, this is a declining position from that highlighted in our 2010/11 annual audit report (7 improving, 3 maintaining and 1 declining).

125. Reported performance in relation to the 50 national indicators indicates an improving position. As at the beginning of September 2012, 23 indicators showed improving performance, 19 indicators showed maintained performance, 7 showed declining performance and 1 which had no data available for previous years. This compares to the position in mid-December 2011, when the Framework was revised and the indicator set refreshed, of 18 improving, 22 maintaining, 7 declining and 3 unavailable. Detailed analysis of available data is available from the Scotland Performs website.

Risk management

126. The Scottish Government has made significant improvements to its risk management structure since October 2010. A Centre of Expertise has been established, led by a senior risk manager. Its aim is to facilitate and support effective risk management practices across the Scottish Government and its Executive Agencies. The Centre provides training and guidance for staff, and offers workshops to fit the needs of different business areas.

127. An engagement project on risk, undertaken across 2011/12 was published in May 2012. This culminated in the publication of the revised approach to risk management in July 2012 which included:

- revisions to policy and guidance, including risk appetite and use of risk registers
- clarification of roles and responsibilities, including the role of the Strategic Board and ARCs, who now regularly review and analyse specific risks in detail.

128. New processes and procedures that have recently been implemented will take some time to become fully embedded within the organisation. The Scottish Government should continue to review these processes, and how effective they are in practice.

Best value & efficiency

129. In March 2011 the Scottish Government issued new guidance for accountable officers on Best Value in Public Services. This requires public bodies to take a systematic approach to self-evaluation and continuous improvement. It clarifies the themes organisations need to focus on to deliver on Best Value responsibilities, and notes that implementation should be appropriate and proportionate to the priorities, operating environment, scale and nature of the business.

130. On behalf of the Auditor General and the Accounts Commission, Audit Scotland has identified a set of principles that form the basis for a consistent approach to the audit of Best Value across the public sector, although its application differs to reflect the different accountability regimes and reporting arrangements in place in different sectors. These are contained in Best Value toolkits. Working closely with Scottish Government officials, we use these toolkits to consider how well the organisation is responding to Best Value responsibilities in particular areas.

Use of resources – workforce management

131. We agreed with the Scottish Government that we would facilitate a self-evaluation using Audit Scotland's People Management toolkit. This area was selected in recognition of the challenges facing the Scottish Government as it reshapes and reduces staffing costs. Effective people management is central to the delivery of Best Value. The focus was on the organisation's own arrangements.

132. The review involved an initial self-assessment of arrangements by the Scottish Government, followed by discussion of supporting evidence and judgements with the audit team. This approach supports improvement through dialogue between management and the auditor. Each area is assessed using a four point scale as set out in table 3.

Table 3: Best value toolkits - possible assessments

Does not meet basic requirements	An organisation may not yet demonstrate the basic practice level in any particular category.
Basic Practices	Minimum acceptable standards, which would be sufficient to allow an organisation to demonstrate sound performance.
Better Practices	As basic, with some elements of good or even best practice, but not on a consistent basis.
Advanced Practices	Consistently demonstrating good or best practice and contributing to innovation.

Source: Audit Scotland

133. The Scottish Government have completed a self-assessment, providing information and evidence against the evaluation criteria in the toolkit. The outcomes are summarised in table 4. Overall, the Scottish Government arrangements were evaluated as demonstrating better practices, with elements of advanced practices.

Table 4: People management toolkit assessment

Description	Overall Assessment
Policies and structures supporting effective people management	Better practice
Integrating workforce planning with strategic and financial planning processes	Better practice
Managing and developing the performance of staff	Better practice
Communication and involvement with staff	Advanced practice

Source: Audit Scotland

134. The review identified a number of positive aspects including:

- a strategic approach, with a People Strategy drawn up in conjunction with the Business Strategy and underpinned by a plan, with milestones to be assessed at regular intervals
- development of Workforce 2015; the prioritisation of significant organisational change through enhancing the role of HR, and the development of the Scottish Leaders Forum
- increased engagement with staff at all levels of the organisation which feed into improved motivation and performance and good use of a secondment programme.

135. Areas for further development included:

- senior management regularly consider information on the skills and development of the Senior Civil Service. However, there is scope to improve the information available to allow management to monitor the development of the required skills of the broader workforce and of professional groups to ensure they match requirements.
- further development of productivity measurement, benchmarking and analysis, to help indicate areas that would merit targeted review.

Workforce reduction

136. The Scottish Government has continued the use of voluntary exit schemes during 2011/12, to help it achieve required reductions in staff numbers and to reshape the organisation. The Scottish Government administered scheme is available to all staff in the Scottish Government core and the majority of the executive agencies.

137. The terms of exit arrangements offered to staff are in accordance with the provisions of the Civil Service Compensation Scheme. A rolling programme was announced in August 2011 and closed on 31 March 2012. Applications were considered against defined criteria, including financial case and organisational implications. The rolling programme was renewed for the 2012/13 year in August 2012.

138. During 2011/12 a total of 964 departures were agreed across the organisations included in the consolidated accounts, at a cost of £38 million; with 324 of these departures within core Scottish Government departments, at a cost of £13 million. This was significantly less than the 2010/11 core figures of 516 staff and at a cost of £26m.

139. Progress in reducing staff numbers and costs is monitored closely by the Scottish Government’s Resources Board, helping to manage progress against a target of a 20% reduction in core administration costs. Significant early progress has been made, but as demonstrated by this year’s reduction in the overall number of departures, it will be increasingly challenging to reduce the number of staff while maintaining sufficient capacity, skills and experience within the organisation.

Procurement

140. The Scottish Government has a critical role in leading public procurement reform, working with centres of expertise across the public sector to provide strategic direction, monitor

progress, coordinate activity and provide advice and guidance. An effective approach will help reduce the strain on the Scottish Government's budget through increasing value for money, while helping the achievement of other policy objectives such as support for the economy.

141. The Scottish Procurement Directorate was renamed Scottish Procurement & Commercial Directorate (SPCD) in January 2011, reflecting a new focus on building commercial capability within the Scottish Government. SPCD awards collaborative contracts that cover the whole of the public sector in Scotland and the central government sector, and supports the delivery of contracts for the core Scottish Government. Consultation on a Procurement Reform Bill was launched in August 2012, with the proposed legislation included in the 2012/13 legislative programme. The purpose of the bill is to establish a national legislative framework for sustainable public procurement that supports Scotland's economic growth by:

- delivering economic, social and environmental benefits
- supporting innovation and promoting processes and systems which are transparent, streamlined, standardised, proportionate, fair and business-friendly.

142. Working with the sectoral centres of expertise, the Scottish Government co-ordinates annual procurement capability assessments (PCA) in over 150 public bodies across the public sector with progress reported to the Public Procurement Reform Board. Scottish Government was assessed in November 2011 and achieved a compliance score of 81%. This is an improvement on the previous score of 56% and is now classified as "superior".

143. In June 2011 the McClelland Review of ICT Infrastructure in the Public Sector set out a series of recommendations which if followed could produce savings of between £230m and £300m per annum from 2012/13. The Scottish Government's response published in September 2011 announced that planned ICT procurement strategies are being aligned with the McClelland recommendations.

Asset management

144. In September 2011 a review by the Scottish Futures Trust of asset management within central government highlighted a range of recommendations including creation of a new central property unit, improved information, improved estates management and a rationalisation of office space by 25%, to generate annual revenue efficiencies of approximately £28 million.

145. Work is currently underway to rationalise office space across central government. However, this remains in its early stages. The review of office space owned by the Scottish Government is being overseen by the Resources Board as part of the 'Transforming our workplace' project.

146. The executive agencies' share of the overall target is approximately £23 million. Currently delivery relies on the individual agencies delivering savings as part of their own cost

saving programmes. However, there is no overarching scheme which looks at opportunities for joint property working across public bodies.

Refer Action Plan No. 9

National Performance Reports

147. Since November 2011 we have published ten performance audit reports on behalf of the Auditor General, or jointly for the Auditor General and the Accounts Commission (Exhibit 2), all of which are relevant to the Scottish Government.

Exhibit 2

Performance audit reports published since November 2011

Five of the eight reports have resulted in an inquiry by the Parliament's Public Audit Committee.

Report	Sector	Published	PAC inquiry?
Role of community planning partnerships in economic development	Joint	November 2011	Yes
Reducing greenhouse gas emissions	AGS - CG	December 2011	No
NHS Overview 2010/11	AGS - health	December 2011	No
NHS Financial Performance 2011/12	AGS - health	October 2011	No
Review of cardiology services	AGS - health	February 2012	Yes
Commissioning social care	Joint	March 2012	Yes
Commonwealth Games 2014: Progress Report 2	Joint	March 2012	No
Mergers of public bodies	AGS - CG	June 2012	Yes
Managing ICT contracts	AGS - CG	August 2012	Yes
NHS Financial Performance 2012/13	AGS - health	October 2012	TBD

Note: 'AGS - CG' means reports for the Auditor General about central government topics.

148. The Scottish Parliament’s Public Audit Committee (PAC) receives performance audit reports published on behalf of the Auditor General for consideration. It held or will hold its own inquiry concerning five reports. In other cases, it corresponded with the Scottish Government and relevant Accountable Officers on issues arising.

149. In response to any PAC inquiry or as part of correspondence, the Scottish Government should detail how it intends to implement any recommendations we made. Even when no PAC inquiry takes place, the Scottish Government's own audit and risk committees should play an important role in considering each report. They can hold officials to account to ensure that any agreed action takes place as planned. While all reports are

considered, there is scope to further develop current arrangements to provide more information on action that the Scottish Government is planning to take in relation to the issues highlighted.

150. Where appropriate, impact returns are produced for national performance audit reports, six to 12 months after publication. These summarise how individual public bodies, including the Scottish Government have responded to the national report. The returns contribute to Audit Scotland's monitoring of the impact of its performance audit reports and may help to identify areas where further follow-up work is required.

Key themes in our performance audits

151. Audit Scotland's performance audits examine value for money (economy, efficiency and effectiveness), governance and accountability. We seek to focus our performance audit reports on five strategic themes (Exhibit 3). A summary of key findings and recommendations from our recent reports is included in appendix 3. Most reports included recommendations addressed to the Scottish Government, though in some cases our recommendations were mainly addressed to other public bodies.

Exhibit 3

Strategic themes underpinning Audit Scotland's performance audits

Theme	Audit focus
Managing reductions in public sector budgets	We recognise the cost pressures facing public services and the need for financial sustainability and sustainable economic growth. We aim to build on and develop issues arising from our series of reports on *Scotland's public finances*.
Investment	We assess accountability for the use of public funds, the scope for reducing cost overruns and for improving the project management of major capital projects. We may assess whether investment in preventative services leads to better outcomes and savings in the longer term.
Partnership working	We examine the value for money of partnership working and if it makes a real difference to the quality of local services.
User focus and personalisation	We look across organisational boundaries to identify cost-effective ways of delivering services that better suit people's needs.
Environmental auditing	We review how Scotland is responding to the challenges of reducing carbon emissions and adapting to the effects of climate change.

Appendix A: action plan

Key Risk Areas and Planned Management Action

Action point	Recommendation	Planned management action	Responsible officer	Target date
1.	**NHS Bodies- Equal pay claims** The Scottish Government has been unable to quantify probable liabilities for equal pay claims in the NHS in Scotland as the NHS CLO has stated that claims still do not provide sufficient detail about the comparator jobs to allow an estimate to be made of the likelihood of the success of the claims or of any financial impact that they may have. As more information becomes available, we would expect it would become possible for the Scottish Government to estimate these probable liabilities in future accounting periods using recognised 'expected value' techniques. ***The Scottish Government should develop an approach for the estimation of NHS equal pay liabilities that enables the quantification of probable liabilities for accounting and financial planning purposes.***	On the basis of the NHS CLO view, the appropriate accounting treatment has been to disclose the claims as a contingent liability that is not possible to quantify. This is a view which has been discussed and agreed with Audit Scotland as part of the annual accounts process. SGHSCD will again meet with Audit Scotland around February 2013 to discuss and agree disclosure in the 2012-13 annual accounts.	Director of Health Finance and Information	February 2013

Action point	Recommendation	Planned management action	Responsible officer	Target date
2.	**Whole of Government Accounts (WGA)** There have been delays and some difficulties in the preparation of Scottish Government's 2011/12 WGA returns. ***The Scottish Government should consider giving a greater priority to its contribution to WGA.***	Participation in WGA is by agreement and is not part of the Scottish Government's statutory reporting or accountability responsibilities. The HMT process does not sit well with Scottish reporting timetables. SG Finance does work to avoid delays where possible and for 2012-13 new processes will have bedded in, and this year's new staff will have the benefit of experience. Completion of WGA work is unlikely to be prioritised at the expense of work on the annual accounts or financial management.	Deputy Director, Finance, Corporate Reporting	Sept 2013
3.	**Increased fiscal autonomy** Continuing work is required to deliver the financial provisions of the Scotland Act. Critical issues will include building capacity for forecasting and the development of budgeting, accounting and financial management arrangements to reflect new financial powers. ***The Scottish Government should continue to develop its arrangements for implementation of the provisions of the Scotland Act.***	Being taken forward within the Fiscal Responsibility Programme, overseen through quarterly programme board meetings. Both critical issues highlighted appear in the programme timetable monitored by the Board. Economic and fiscal forecasting capacity is being built in the Office of the Chief Economic Adviser. Development of budgeting, accounting and financial management arrangements is being considered by Finance Directorate. Other developments required for implementation of Scotland Act are included in detailed programme plans.	Deputy Director, Finance, Fiscal Responsibility, in support of DG Finance	Next programme board meeting due January 2013; timetable for delivery being monitored by Board

Action point	Recommendation	Planned management action	Responsible officer	Target date
4.	**Audit and Risk Committees** There has been some variation of approach between ARCs, which is not always linked to differences in risks and issues evident in their particular portfolios or areas of responsibility. ***The Scottish Government should ensure there is a clear understanding of how the role and scope of ARCs should be exercised in practice.***	The recently updated guidance for Audit and Risk Committees is clear about the role and scope of their responsibilities. Non executive directors also have the opportunity of network events and engagement with SGARC and other members. It is expected that there should be less variation of approach in practice than there may have been in the past but this will be kept under review.	DG Finance	Ongoing
5.	**Governance Statement** The timing of assurance processes may constrain audit review of the Governance Statement and introduces a risk of delay to sign-off. ***The Scottish Government should review the timetable for receipt of all related assurance processes that inform the Governance Statement.***	The planning for the 2012-13 accounts will include guidance to PARCS on the scheduling of meetings to complete the necessary assurance processes. The final senior management review and assurance processes necessarily take place close to the date of the SGARC meeting to approve the accounts and the statement therefore remains subject to change until the date of signing of the accounts.	Corporate Business Secretariat	Jan 2013
6.	**Internal Audit** Internal audit resources have been under pressure from a number of sources. Internal audit has revised its approach to planning. ***The Scottish Government should keep the extent, delivery and quality of internal audit work under review.***	The SG's senior management and its Audit and Risk Committee continue to review the extent, delivery and quality of this work regularly. In addition, the resource position continues to be monitored. Further, there is an External Quality Assurance review of the Internal Audit Division planned for 2012/13.	DG Finance	31 May 2013

Action point	Recommendation	Planned management action	Responsible officer	Target date
7.	**European funding** Progress has been made in improving controls in a number of areas, but further work is required to address known and emerging concerns. ***The Scottish Government should continue to address identified concerns about the management and control of European funding programmes***.	The management of EU funds continue to have an important profile within the Scottish Government and there is ongoing review of any concerns identified and of all developments in this area.	Director for Agriculture, Food & Rural Communities; Deputy Director, European Structural Funds	Ongoing
8.	**Freedom of Information (FOI) judgements** In a recent judgement the Scottish Information Commissioner drew attention to a number of concerns about the extent to which the Scottish Government had followed FOI guidance, advice and previous judgements. ***The Scottish Government should consider carefully the observations made in this judgement and FOI judgements more generally in its approach to the use of FOI exemptions.***	The FOI Unit has reviewed relevant guidance in response to this judgement, and does so as necessary for judgements made by the Commissioner.	FOI Unit	Completed

Action point	Recommendation	Planned management action	Responsible officer	Target date
9.	**Asset management** The rationalisation of office space within central government is still in the early stages. ***The Scottish Government should progress plans to improve its asset management to deliver on key aims.***	Scottish Futures Trust was been given a new remit in May 2012 to champion a strategic approach to asset management, and support and challenge public bodies, across the central and local estates, to improve property asset management. An Asset Management Programme Board has been set up to oversee the programme, and it is in the process of agreeing the direction of the programme, which will include opportunities for joint working between public bodies.	DG Finance (programme sponsor)	Following initial pilots and scoping, full programme of work will be agreed March 2013.

Appendix B: audit reports

Exhibit 1: 2011/12 Outputs

Planned Outputs		
Audit Opinions		
Independent auditor's opinion on the Scottish Government Consolidated Account		September 2012
Governance		
Review of the Adequacy of Internal Audit		March 2012
Key Controls Assurance - Central Financial Systems		April 2012
Role of Boards -Follow-up		December 2012
Performance		
Best Value - People Management Toolkit		December 2012
Report to Audit Committee in terms of ISA 260 (Communication of audit matters to those charged with governance)		September 2012
Annual Audit Reports		
Scottish Government		November 2012
NHS sub-consolidation		
Independent auditor's assurance on the NHS sub-consolidation		July 2012
Whole of Government Accounts		
Report and certification letter to NAO and Scottish Government		December 2012

Appendix C: recent performance audit reports

Managing reductions in public sector budgets

1. Good information to help control costs, improve productivity and allow performance monitoring is important at a time of reducing budgets when the future shape and delivery of public services is under review. Strong leadership is also necessary to deliver financial savings, balancing short-term decision-making with more sustainable long-term planning.

2. The report, *Learning the lessons of public body mergers* examined a sample of nine recent mergers, to help inform the planning and implementation of future mergers. [1] Recent mergers aimed to deliver a clearer, simpler and more effective public sector, with four larger mergers expected to provide net savings of £63 million. The report showed that strong and permanent leadership is necessary from the outset, to make important decisions about each new organisation's vision, structure and plans. While most recent mergers have happened on time, those leading them should have given more attention to planning how the new organisations would develop after the formal merger date. Some organisations operated for too long without a clear vision, while there were gaps in how bodies analysed and reported the costs and savings from merger. A separate good practice guide based on the report's recommendations will help the Scottish Government and public bodies to plan and implement future mergers effectively.

3. The *Overview of the NHS in Scotland performance 2010/11* highlighted that overall NHS performance was good but significant challenges are ahead. These include pressures from: an ageing population; increases in the volume of demand for public services; the public's rising expectations of the NHS; increased costs; and reducing staffing levels.

4. The NHS has strategies to help them improve quality and to make the service more efficient and effective but needs better information about costs, activity and quality. While hospital activity data are generally good, they are not sufficient to demonstrate improved productivity. Cost information needs to improve and the Scottish Government and the NHS are developing a system to cost patient activity, including linking costs to individual patients and increasing clinicians' involvement in managing costs.

5. The report also highlighted that demographics will have a significant impact on NHS services and increase cost pressures. Because of the ageing population, spending on health and social care services for older people would need to increase by £3.5 billion by 2031 if the systems remain as they are now (a real-terms increase of 74 per cent from 2008). On current projections, the number of hospital beds for emergency admissions

[1] Mergers currently in preparation include the move to single police and fire & rescue services, the establishment of a single tribunal service and changes in the colleges sector.

would need to increase by more than 6,000 (nearly 80 per cent) from 2007 to 2031 if NHS and social care services remain as they are currently designed.

6. There is a widespread recognition that services need to change but in reality services have been slow to adapt. Audit Scotland has found it hard to see evidence of meaningful shifts in the way resources are used over time, for example in moving resources from the NHS acute sector to the community.

7. The report on *NHS Financial Performance 2011/12* highlighted that while all 23 NHS boards met their financial targets for the fourth year running, this was achieved through in-year movements in funding across the NHS, which are not clearly reported in boards' financial statements. The requirement for boards to break even each year encourages a short-term focus, and the NHS needs to increase its focus on longer-term financial planning.

8. Boards are forecasting significant recurring savings in 2012/13. It may become more difficult for boards to achieve recurring savings as they have already identified those that are easier to deliver in previous years, and continue to rely on non-recurring savings.

9. The requirement for boards to break even each year encourages a short-term focus on financial planning. Changes to service provision and strategies required to deliver future sustainability often need upfront investment. The report recommended that the Scottish Government should consider whether other options are available to better promote long-term planning, and help boards to invest in new ways of working. It should also require boards to report realistic forecast outturn positions in the monthly monitoring returns during the year, made on a consistent basis across the sector.

10. The *Review of cardiology services* report examined Scotland's progress in tackling heart disease, the third highest area of spending in Scotland's hospitals. Waiting times for treatment are falling, patients are getting more effective treatment and death rates have dropped by 40 per cent in the past ten years but Scotland still has the highest rate of heart disease in Western Europe.

11. We estimate there is scope for at least £4 million a year (2.8 per cent) of efficiency savings from the £146 million that the NHS spends on cardiology services each year. Our report recommended the Scottish Government and the NHS continue to improve the evidence base on the impact and cost effectiveness of measures to help prevent heart disease. They should also make sure there is consistent and accurate information to allow NHS boards to monitor performance, compare services and find improvements in efficiency.

Investment

12. This is likely to be severe pressure over the next three years, despite the government's intention to transfer over £200 million a year from resource to capital spending and to use private finance to fund £2.5 billion of capital investment through the Non-Profit Distributing method. It is important that scarce investment resources be focused on well-justified

proposals that provide significant benefits; and that investment projects and programmes are well controlled.

13. *Commonwealth Games 2014: Progress Report 2* found that the various delivery and infrastructure programmes for the Games were generally on track. The partners were committed to delivering the Games to the required standard within the £524 million budget. At the time of the audit, November 2011, planning for the Games was generally where it should be. The organisers were forecasting that all venues and other infrastructure programmes would be ready on time and within the £524 million budget. However, the budget was inherently uncertain, as at that stage only 17 per cent of costs were committed. The report makes recommendations for the four strategic partners including the Scottish Government; these include regular future budget reviews and checking that staffing capacity remains sufficient.

14. The *Managing ICT contracts* report reviewed three important IT programmes costing £133 million that were delayed or cancelled. They were at Registers of Scotland (project originally worth £66 million), Disclosure Scotland (£31m budget) and the Crown Office and Procurator Fiscal Service (£10m budget).

15. The report highlights significant weaknesses in the management of the three programmes, including the variable quality of business cases, ineffective governance arrangements and failings in financial control and progress reporting. A key factor in the failure of the programmes was that the organisations' lack of specialist skills and experience undermined their ability to challenge suppliers of ICT equipment and systems. There were also weaknesses in basic project management and control.

16. The report recommended that the Scottish Government should review how it can best support public bodies that undertake significant projects in future. Because it is difficult for small public sector bodies to secure the appropriate mix of skills and experience for managing complex ICT programmes, the Scottish Government should consider the potential for it to provide a central source of expertise in programme management. The report included a list of questions to help managers and board members of public sector organisations to challenge and scrutinise current and future ICT programmes.

Partnership working

17. To help respond to cost and other pressures, a joined-up approach across public services and good strategic planning are important. Resources may need to move to support new ways of working. There is also a need to plan for more preventative services, which should reduce the demand on expensive hospital and care home provision. Public bodies need to work well together to provide clear leadership and governance, ensure priorities are clear and give direction to necessary change.

18. The *Commissioning Social Care Services* report reviewed how effectively the public sector commissions social care services and how partners work together, to provide high quality, sustainable social care services. Councils spend £3 billion a year on services that many people depend on such as care homes or support at home. The report concluded

that councils and NHS boards need to get better at planning and organising social care. It highlighted indications that councils are continuing to focus resources on people who need more intensive support, tightening eligibility criteria and increasing charges. However the report noted that current services are not sustainable and that progress with strategic commissioning has been slow.

19. The report recommended that the Scottish Government should ensure that councils, NHS boards and other commissioning partners are scrutinised and supported to improve joint working and to support better planning and decision-making. It highlighted the importance of councils and NHS boards preparing good commissioning strategies for social care services and recommended the Scottish Government assess with partners the need for periodic expert assessment of the social care markets.

20. The *Role of community planning partnerships in economic development* report also highlighted the need for improved partnership working. Partnership working is complex, especially because Community Planning Partnerships (CPPs) do not have their own budgets, directly employ staff or deliver services. However, the report found CPPs should make better use of available economic information and have more effective involvement with the local business community to identify local priorities. They also need to improve their understanding of the costs involved in meeting local economic priorities and what this means for individual partners' budgets.

21. The report also emphasised the principles of successful partnership working, identified in an earlier performance audit report on Community Health Partnerships, which require strong leadership and commitment from all partners. It recommended that the Scottish Government should work with CPP partners and other relevant bodies to improve the coordination of economic development at national, regional and local levels, to help support the national priority of increasing sustainable economic growth. The report also recommended that the Scottish Government ensures that relevant public bodies are held to account for their performance in community planning and contribution to achieving agreed local outcomes.

User focus and personalisation

22. Most public bodies have a statutory duty to take account of the needs of individuals when planning and delivering public services. Where possible we include a patient or user focus in our performance audits.

23. In *Commissioning Social Care Services,* we highlighted that councils and NHS boards need to do much more to improve how they plan, procure and deliver social care services. This includes the need to strengthen engagement with providers in the voluntary and private sectors and involve them in developing improvements. We also stated that users and carers need to be more involved in decisions about social care services and councils and NHS boards need better evidence of what difference the services make to people's quality of life.

24. *The Review of cardiology services* report found that treatments available for heart patients have improved and NHS boards are meeting cardiology waiting times targets. However, more could be done to ensure all patients get the services they need.

Environmental auditing

25. The Scottish Government has introduced demanding targets to reduce greenhouse gas emissions by 42 per cent by 2020 and by 80 per cent by 2050 (compared to a 1990 baseline). One of the strategic priorities in the Scottish Government's economic strategy is the transition to a low carbon economy with a particular emphasis on developing renewable energy and improving energy efficiency.

26. The *Reducing Scottish greenhouse gas emissions* report found that emissions have reduced by more than a quarter since 1990 and concluded that they must continue to fall at a similar rate between 2009 and 2020 to meet the statutory targets. Only around a third of planned emission reductions are expected to come from policies solely under the Scottish Government's control, with other action required by the EU, private sector and the public. The total cost of meeting the 2020 target could be around £10-11 billion.

27. The report noted that the Scottish Government has difficulty in assessing its performance, due to delays in the availability of emissions data. It is already taking steps to improve its management of emissions reductions but the report recommended further actions. These included: continuing to refine its estimates of the costs of policies to reduce emissions; and improving the completeness and transparency of its performance management arrangements, by finalising its performance management scorecards and publishing them on a regular basis.

28. Since the report was published, the Scottish Government has published data showing that emissions rose between 2009 and 2010, increasing the scale of the challenge in future years.