SCOTTISH GOVERNMENT

Annual report on the 2013/14 audit

Prepared for Scottish Government and the Auditor General for Scotland

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Contents

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Key messages

Financial statements	• Unqualified audit opinions were provided on the 2013/14 SG consolidated accounts. • Audit adjustments led to a decrease in net assets of £276 million. • Accounting arrangements for CNORIS to be reviewed across the NHS.
Financial position	• Overall budget management during the year was effective. • Spending was within the limit for the Scottish Administration set by Parliament. • Cabinet Secretary has reported fiscal DEL underspend is within carry forward limits. • Value of tax payers equity (net assets) has increased by 3% from the previous year. • Scope to provide more transparent information about off-balance sheet items.
Governance & accountability	• Overall corporate governance and internal control arrangements operated effectively, with scope for improvements in some systems. • Good risk management processes. • Common Agricultural Policy change programme - risks to timely delivery and value for money. • Satisfactory anti-fraud and corruption arrangements.
Best Value, use of resources & performance	• Reductions in staffing levels and continuing financial pressures are stretching the organisation's capacity in some areas. • National Performance Framework sets out what SG wants to achieve well. • Continued development of approaches to align plans, budgets and outcomes required.
Outlook	• Financial outlook remains very challenging. • The prospect of further devolved power has implications for how Scotland's public finances are managed and reported. • Current challenge is the successful implementation of the Scotland Act 2012 tax and borrowing powers starting in April 2015.

Financial statements

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

Health bodies in Scotland are required to participate in the Clinical Negligence and other Risk Indemnity Scheme (CNORIS). The SG consolidated accounts incorrectly included debtor balances of £305 million that related to reimbursement from the CNORIS scheme. The SG made the required changes to the consolidated accounts, removing these balances. A full review of the scheme is being undertaken in 2014/15.

We gave an unqualified opinion in respect of the 2013/14 SG Whole of Government Account (WGA) pack's consistency with the audited SG consolidated accounts. We qualified our opinion in respect of inaccurate and incomplete counter party information data included in the WGA pack supplied to HM Treasury.

Financial position

Budget management was effective during the year. 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.

The SG needs to review the arrangements it has in place to ensure consistency in how it funds sponsored bodies.

Governance and accountability

Overall, governance and internal control arrangements operated effectively during 2013/14 with continuing improvement to arrangements for risk management and for the prevention and detection of fraud.

Internal Audit provided reasonable assurance on risk management, control and governance. The overall assurance level provided in the last two years is lower than previous assessments. Given the competing priorities and resourcing pressures being experienced by the organisation as costs and staffing numbers are reduced, internal control standards will require to be closely monitored.

The Auditor General for Scotland reported to draw Parliament's attention to the costs and progress of the change programme to implement Common Agricultural Policy reforms in Scotland. This highlighted the ongoing risks to achieving the successful delivery of the programme and overall value for money.

The Scotland Act 2012 includes new financial powers for the Scottish Parliament that will be introduced over the next two years. We will report publicly on preparations for the implementation of the Scotland Act 2012. There a number of risks to manage up to the implementation date of 1 April 2015.

Internal audit resources and management capacity have remained under pressure. It has been challenging for Internal Audit to deliver on its programme of work in 2013/14 within the agreed timescales. If not resolved quickly these ongoing pressures may adversely impact on the robustness of the overall control environment.

Best Value, use of resources and performance

Our performance audit reports have highlighted the continuing pressures on public sector budgets, and the importance of financial sustainability, linking spending and outcomes, improving leadership, and information to support decision making and transparency.

The SG has recognised that continued development of approaches to performance management is required. A key challenge will be aligning financial and performance information in a meaningful way.

Overall progress in reducing staff numbers has been broadly in line with plans. The reductions in staffing levels and continuing financial pressures are stretching the organisation's capacity in some areas. SG will need to find other methods of cost efficiency as the use of exit schemes reduces.

Audit Scotland is undertaking an audit which will consider the Scottish Government's approach to the purchase of Prestwick Airport, the future plans for its development and the arrangements for monitoring its future performance. Our audit will look at the factors taken into account by the Scottish Government when deciding to go ahead with the purchase, such as Prestwick Airport's potential for future development and wider social implications.

Outlook

The financial outlook remains very challenging, with continuing reductions in real terms funding through the block grant anticipated. The draft 2015/16 budget sets out the SG's current spending priorities. As it progresses its priorities in areas such as the economy or welfare, and with new tax and borrowing powers, the SG will need to manage the risks to its overall financial position.

Following the referendum on Scottish independence in September 2014, the UK Government established the Smith Commission to consider what further financial, welfare and taxation powers should be devolved to the Scottish Parliament.

The Scotland Act 2012 will give the Scottish Government more financial powers, but it will also introduce greater volatility in its funding. Scotland's economic performance is likely to influence the amount raised through the new taxes, and the Scottish Government will bear the risk of the amounts raised being more or less than budgeted for. This, and the prospect of further devolved powers, has implications for how Scotland's public finances are managed and reported.

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Introduction

1. This report is a summary of our findings arising from the 2013/14 audit of Scottish Government (SG). The purpose of the annual audit report is to summarise the auditor's opinions and conclusions, and to report any significant issues arising from the audit. The report is divided into sections which reflect our public sector audit model.

2. Our responsibility, as the external auditor of SG, is to undertake our audit in accordance with International Standards on Auditing (UK and Ireland) and the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011.

3. The management of SG is responsible for:
   - preparing financial statements which give a true and fair view
   - implementing appropriate internal control systems
   - putting in place proper arrangements for the conduct of its affairs
   - ensuring that the financial position is soundly based.

4. This report is addressed to SG and the Auditor General for Scotland and should form the basis of discussions with the audit and risk committees as soon as possible after it has been issued. Annual audit reports should be made available to stakeholders and the public, as audit is an essential element of accountability and the process of public reporting.

5. This report will be published on our website after it has been considered by SG.

6. Audit Scotland has issued a number of reports, both local and national, during the course of the year that have relevance to this audit. The reports issued during the year have been listed in Appendix I. 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 SG. National Reports are considered on paragraphs 132 to 142.

7. The concept of audit risk is of key importance to the audit process. During the planning stage of our audit we identified a number of key audit risks which involved the highest level of judgement and impact on the financial statements and in our wider dimension audit work. We set out in our annual audit plan the related source of assurances and the audit work we proposed to undertake to secure appropriate levels of assurance. Appendix II sets out the key audit risks identified at the planning stage and how we addressed each risk as part of our audit.

8. Appendix III is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "Management action/response".

9. We recognise that not all risks can be eliminated or even minimised. What is important is that SG understands the risks, is clear about its risk appetite and has arrangements in place to manage these risks. SG and the Principal Accountable Officer should ensure that they are satisfied with proposed management actions and the current mechanism in place to assess progress and monitor outcomes is operating effectively.

10. We have included in this report only those matters that have come to our attention as a result of our normal audit procedures; consequently, our comments should not be regarded as a comprehensive record of all deficiencies that may exist or improvements that could be made.

11. The cooperation and assistance afforded to the audit team during the course of the audit is gratefully acknowledged.

Financial statements

Audit opinion

12. The Auditor General for Scotland provided her unqualified opinions on the Scottish Government Consolidated Accounts on 18 September.

Other information published with the financial statements

13. Auditors review and report on other information published with the financial statements, including the Introduction, Strategic Report, Public Interest Reporting, Governance Statement and the Remuneration Report. No issues required to be reported in respect of these statements.

Regularity

14. The Public Finance and Accountability (Scotland) Act 2000 requires auditors to certify that, in all material respects, the income and expenditure shown in the accounts was incurred or applied in accordance with relevant legislation and guidance issued by Scottish Ministers. We addressed the requirements of the Act through a range of procedures, including obtaining written assurances from the Principal Accountable Officer.

15. No issues required to be reported in respect of regularity.

Accounting issues arising

16. A number of presentational and monetary adjustments were identified in the financial statements during the course of our audit. These were discussed with management who agreed to amend the unaudited financial statements. The effect of these adjustments decreased net assets by £276 million, with compensating adjustments to the Consolidated Statement of Changes in Taxpayer's Equity. Key items of interest arising from our audit of the accounts are set out below.

Clinical Negligence and other Risk Indemnity Scheme (CNORIS)

17. Health bodies in Scotland are required to participate in the Clinical Negligence and other Risk Indemnity Scheme (CNORIS). This is a risk sharing agreement used to manage financial risk across the NHS in Scotland. Member organisations make contributions to the scheme based on their risk profile, which then funds the costs of compensation payments as they fall due. The scheme is self-funding so that costs are shared across health bodies.

18. The 2013/14 accounts and audit process identified a need to review the accounting treatment associated with CNORIS. The consolidated accounts included debtor balances of £305 million that related to reimbursement from the CNORIS scheme; which did not represent amounts due to the Scottish Government.

19. The SG made the required changes to the consolidated accounts, removing these balances. A full accounting review of the CNORIS scheme is being undertaken in 2014/15.

Refer Action Plan No.1

White Paper

20. The Scottish Government published a white paper – *Scotland's Future: Your Guide to an Independent Scotland* - in November 2013. The total spend included in the 2013/14 accounts was £1.420 million on direct costs associated with the white paper publication and associated activity.

21. Section 22(1) of the Public Finance and Accountability (Scotland) Act 2000 ("PFA 2000") specifies the matters on which auditors must set out findings in relation to the Scottish Government's accounts, including the following aspects:

- Compliance with relevant legislation (legal cover) and the Budget Act (budget cover) S22(1)(a) & (b)
- Compliance with any applicable guidance (whether as to propriety or otherwise) issued by the Scottish Ministers – S22 (1) (c).

22. We concluded based on the evidence available that such expenditure was consistent with the provisions of the Scotland Act 1998 and, therefore, that there was appropriate legal cover.

23. The Budget Act 2013, as amended, included a provision for £1.560 million of activity in relation to "Strategic Communications" as part of the Parliamentary Business and Government Strategy budget. Expenditure on the white paper and associated activity was within the ambit provided by the budget act. We therefore concluded that there was appropriate budget cover.

24. We are also required to consider aspects of propriety insofar as they related to specific items of expenditure. Auditing standards[1] recognise that propriety is not readily susceptible to objective verification. These issues therefore required careful consideration. Overall, we concluded that relevant propriety requirements for this expenditure had not been breached and there was no need to modify our regularity opinion.

Treatment of VAT in asset valuations

25. An audit adjustment was made in respect of valuations of police and fire colleges prior to the transfer to the Scottish Police Authority and Scottish Fire and Rescue Service respectively. This was required to ensure consistency in the application of value added tax, (VAT) to the college depreciated replacement cost (DRC) building valuations.

26. An inconsistent valuation methodology had been applied. VAT had been included in the fire college valuation but excluded from the police college valuation.

Refer Action Plan No.2

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[1] Auditing Practices Board Practice Note 10 (Revised) October 2010.

Report to those charged with governance

27. We presented our report to those charged with governance (ISA 260) to the Audit and Risk Committee on 17 September 2014. The primary purpose of this report was to communicate the significant findings arising from our audit prior to finalisation of the independent auditor's report. The main points raised have been summarised in the previous paragraphs.

Accounts submission

28. The unaudited schedules for the core and consolidated accounts were submitted in line with agreed plans. Working papers and responses provided by staff in Finance were of a satisfactory standard.

29. Matters arising from the audit were reported to the Scottish Government Audit and Risk Committee on 17 September 2014.

30. The Principal Accountable Officer signed the accounts on 17 September 2014 which allowed the Auditor General to conclude the audit within the agreed timetable and provide her opinions on 18 September.

31. The signed consolidated accounts and report were laid in the Scottish Parliament and published on 2 October 2014. The Auditor General issued a report to the Scottish Parliament on matters raised in the audit of the 2013/14 accounts for the Scottish Government.

Scottish Consolidated Fund and Non Domestic Rating Account

32. The SG prepares separate financial statements for the Scottish Consolidated Fund (SCF) and Non-Domestic Rating (NDR) account on a receipts and payments basis. These are subject to separate audits. Key outcomes were that we issued unqualified opinions for the year ended 31 March 2014 on:

- the financial statements on the SCF
- the financial statements on the NDR. This is a memorandum account covering non-domestic rate transactions through the SCF.

33. The unaudited NDR accounts were received on 20 October 2014, after the prescribed deadline of 30 September. This was due to competing priorities and resourcing pressures within the finance department, and meant that we were unable to conclude our audit prior to the target date of 31 October.

34. Further details of our audits of the SCF and NDR accounts are included in the respective annual audit reports for these audits.

Whole of Government Accounts

35. Whole of Government Accounts (WGA) are consolidated financial statements for all parts of Government in the UK.

36. The 2012/13 WGA for the UK were published on 10 June 2014. This was the fourth year of publication. The Comptroller and Auditor General has qualified the accounts in each year since publication began. The 2012/13 WGA were qualified on six counts, one of which was a limitation in audit scope due to lack of evidence supporting the completeness of the elimination of intra-government transactions and balances.

37. The SG provides HM Treasury with key financial information to assist its preparation of WGA. We gave an unqualified opinion in respect of the 2013/14 SG WGA pack's consistency with the audited Scottish Government consolidated accounts. The reported counter party information was incomplete and inaccurate in respect of the intra-government transactions and balances that should be eliminated. This has resulted in a qualified opinion in respect of this section of the assurance statement.

Refer Action Plan No.3

Financial position

Resource Expenditure	Capital Expenditure	Balance Sheet
Budget £30,175 million	Budget £1,573 million	Total assets £33,354 million
Outturn £29,947 million	Outturn £1,388 million	Total liabilities £5,906 million
Underspend £228 million	Underspend £185 million	General Fund £17,397 million

38. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.

39. 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.

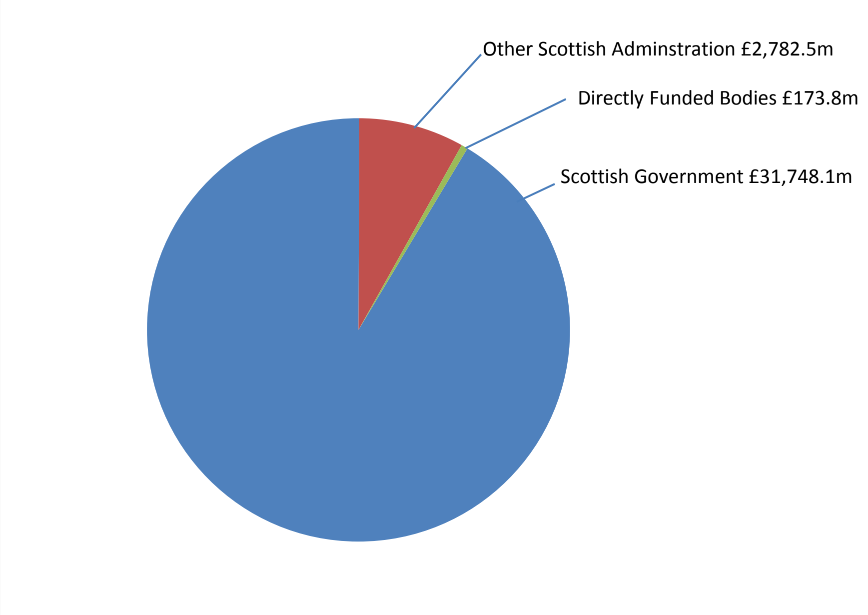
40. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for SG.

Financial results

Scottish Budget for 2013/14

41. The Budget (Scotland) Act 2013 made provision for financial year 2013/14 for the use of resources by the Scottish Administration and certain bodies whose expenditure is payable directly out of the Scottish Consolidated Fund. The final budget approved by the Scottish Parliament permitted total expenditure of £34,704.4 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 directly funded bodies as shown in exhibit 1

Exhibit 1: The Scottish Budget 2013/14 (£ million)



Source: Audit Scotland from the Spring Budget Revision (SBR) 2013/14

Table 1: Scottish Government outturn against budget 2013/14

Portfolio	Outturn £m	Budget £m	Over / (under) spend £m
Finance and Sustainable Growth	458	462	(4)
Health and Wellbeing	11,988	12,005	(17)
Education and Lifelong Learning	2,853	3,018	(165)
Justice	2,468	2,559	(91)
Rural Affairs and the Environment	451	468	(17)
Culture and External Affairs	210	217	(7)
Infrastructure and Capital Investment	2,486	2,588	(102)
Local Government	10,105	10,105	-
Administration	206	216	(10)
Crown office and procurator fiscal service	110	110	-
Total	31,335	31,748	(413)

Source: Scottish Government Consolidated Accounts 2013/14

Outturn reported in the Consolidated Accounts

42. The final budget for the expenditure included in the SG's Consolidated Accounts for 2013/14 was £31,748 million. Total net expenditure during the year was £31,335 million, resulting in an overall underspend of £413 million (2012/13 £200 million) - resource by £228 million and capital by £185 million. Spending in all portfolios was within the individual budgets as set out in table 1 above.

43. SG consolidated accounts outturn 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.

44. The net position for all of the Scottish Administration is an underspend of £445 million, meaning that spending has been managed within the limit set. Outturn was within 1.3% of budget and overall budget management during the year was effective.

45. In December each year the Scottish Ministers lay before Parliament a statement of total audited outturn for the preceding financial year against the final Budget for the Scottish Administration. This forms an important part of the SG's accountability to the Scottish Parliament.

Table 2: Scottish Administration entities outturn against budget 2013/14

Entity	Outturn £m	Budget £m	Over/ (Under) spend £m
Scottish Government Consolidated	31,335	31,748	(413)
National Records of Scotland	21	21	-
Teachers' and National Health Service Pension Schemes	2,636	2,668	(32)
Office of the Scottish Charity Regulator	3	3	-
Scottish Court Service	87	87	-
Scottish Housing Regulator	4	4	-
Total	**34,086**	**34,531**	**(445)**

Source: Audited Accounts 2013/14

Total Managed Expenditure

46. 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 reflecting differences between accounting rules and UK budget rules. A reconciliation is included at Note 24 to the SG's Consolidated Accounts for 31 March 2014 (summarised in table 3).

47. TME is categorised as either Annually Managed Expenditure (AME) or Departmental Expenditure Limit (DEL). AME is not subject to firm multi-year limits and does not impact on the SG's spending power. DEL is subject to greater control, with a particular focus on fiscal DEL as a measure of real spending power. This excludes depreciation, some impairment and other technical accounting non-cash items.

48. In June 2014, the Cabinet Secretary for Finance, Employment and Sustainable Growth announced the provisional outturn, indicating that the fiscal DEL budget was underspent by £145 million (£144 million resource £1 million capital) against a fiscal DEL carry forward cap of £218 million. The Scottish Government is able to carry forward the full amount of this underspend into 2014/15. The Scottish Budget incorporated a planned carry forward of £57 million.

Table 3: Calculation of fiscal DEL budget for 2013/14 (£ million)

Scottish Budget approved	34,705
Add: planned carry forward to 2014/15	57
Add: HMT funding for AME not included in SBR	113
Add: HMT funding for DEL not included in SBR	4
Add: Net technical adjustments	123
HM Treasury Budget	35,002
HM Treasury AME Budget	(5,654)
HM Treasury DEL Budget	**29,348**

Scottish DEL Budget agreed with HM Treasury

Fiscal Resource DEL Budget	25,118
Capital DEL Budget	2,969
Total Fiscal DEL Budget	**28,087**
Non-Cash Resource DEL	893
Total DEL Budget	**29,348**

Source: Audit Scotland from Audited Accounts 2013/14

Balance Sheet

49. The balance sheet is one of the primary financial statements within the annual accounts. It summarises taxpayers equity – an accounting measurement of the amount invested by taxpayers that has continuing public benefit. It shows the proportion of this that has arisen through changes over time in the value of physical assets and that which has resulted from the application of revenues (including the block grant).

50. The balance sheet includes:

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

51. A good understanding of the items on the balance sheet and how these are changing over time is therefore important to understanding the constraints, risks and opportunities for the SG in managing future budgets.

52. The key items in the balance sheet at the start and end of 2013/14 are summarised in table 4.

Table 4: Summary of consolidated balance sheet 2013/14

£ million	At 1/4/13	At 31/3/14
Physical assets	25,887	26,153
Financial assets	5,775	6,228
Receivables	921	973
Total assets	**32,583**	**33,354**
Payables	(4,527)	(4,572)
Financial liabilities	(705)	(698)
Provisions	(720)	(636)
Total Liabilities	**(5,952)**	**(5,906)**
Net Assets	26,631	27,448
General Fund	16,468	17,397
Revaluation Reserve	10,163	10,051
Taxpayers Equity	**26,631**	**27,448**

Source: Audit Scotland from Audited Accounts 2013/14

Physical assets

53. The highest value group of assets in the consolidated accounts is property, plant and equipment (PPE) with a value at 31 March 2014 of £25,929 million (£25,675 million 2012/13), of which 66% or £17,127 million (£17,433 million) relates specifically to the road network. There were additions of £856 million to PPE in 2013/14 which was offset by asset disposals and the net effect of depreciation and revaluations.

54. PPE is valued by professional valuers in line with recognised methodologies. This provides an assessment of the continuing benefit they provide in financial terms. Where these assets have been funded by traditional means through capital DEL then there are no continuing liabilities relating to them (maintenance and repair costs will arise). By contrast those funded through alternative means (such as PFI, NPD and borrowing) also lead to liabilities representing the amounts that will require to be met from future resource budgets.

Financial assets

55. Financial assets include loans made directly to other organisations and individuals, investment funds used to deliver programmes which include the issue of loans and investments in nationalised industries and fully or part owned companies.

56. These assets are of continuing benefit to the SG, and have the potential over time to release the resources currently invested for future use – including reinvestment. This is constrained by the terms of the loan or other investment made.

57. The largest financial assets are loans of £2,512 million (£2,458 million 2012/13) that have been made to Scottish Water to finance its capital investment programmes and student loans valued at £2,334 million (£2,046 million 2012/13). The latter are made under the terms of the student loans scheme, administered by the Student Loans Company Limited.

Payables and financial liabilities

58. Financial liabilities relate almost entirely to long term borrowing of £695 million (£702 million 2012/13) from the national loans fund - for Scottish Water - inherited when the Scottish Parliament was established. Payables also include £1,849 million (£1,871 million) that is due under PFI contracts. Both of these amounts will fall to be met from future budgets in line with agreed terms.

Provisions for liabilities and charges

59. Provisions are legal or constructive obligations which are of uncertain timing or amount at the balance sheet date. Total provisions as at 31 March 2014 were valued at £636 million (£720 million in 2012/13). The main elements are NHS Clinical and Medical Negligence Claims of £261 million, early departure costs of £153 million and Transport Scotland items of £113 million which relate mainly to land and property acquisitions.

60. The extent to which provisions require to be funded from future budgets depends on when amounts were recognised following a change of budget rules in 2010/11. Amounts provided for prior to this change have already been charged to DEL, but those recognised since have not.

Off balance sheet

61. Off-balance sheet means an asset, debt or financing activity is not shown on the balance sheet under accounting rules. This may be because of the high level of uncertainty involved. This includes potential liabilities, such as unfunded pension schemes, contingent liabilities and government guarantees.

62. While accounting disclosures comply with requirements in all material respects, there is an opportunity for SG to review the level of disclosure and supporting narrative to provide a more transparent understanding of the financial implications of off-balance sheet items.

Contingent assets and liabilities

63. A contingent asset is a possible asset, whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the SG's control. A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events.

64. The SG has disclosed various contingent assets and liabilities. Only some of these are able to be quantified, with aggregate potential liabilities of £427 million being reported. Some of these amounts may fall to require to be funded from future budgets, but this is by no means certain.

NHS bodies - equal pay claims

65. The SG has disclosed as an unquantified contingent liability claims made under the Equal Pay Act 1970. NHS Scotland has chosen to deal with these claims on a pan-Scotland basis, with the NHS Scotland Central Legal Office (CLO) co-ordinating a response on all claims.

66. The SG, the CLO and Audit Scotland met in February 2014 to review the accounting treatment and disclosure requirements for the 2013/14 accounts. The CLO continues to advise that it is not possible to provide any financial quantification of Equal Pay Claims due to the lack of information available. It was agreed that disclosure as an unquantified contingent liability remained appropriate for the 2013/14 financial statements.

67. There remains uncertainty as to the extent and timing of any impact on future budgets. We continue to strongly encourage the SG, working with the CLO and other NHS boards to form a view of the potential liabilities as soon as possible taking into account the progress of cases in England and Wales.

Refer Action Plan No.4

Transactions with non-consolidated entities

68. The accounts incorporate the transactions and balances of bodies within the consolidation boundary defined in line with the Government Financial Reporting Manual. This includes the core SG portfolios, executive agencies, the NHS in Scotland and the Crown Office and Procurator Fiscal Service. Other

bodies funded from the Scottish Budget, such as Non-Departmental Public Bodies and Non-Ministerial Departments fall outwith this boundary – as do local government bodies.

69. Given their relationship with SG, the balance sheet and off-balance sheet items in these bodies can also present constraints, opportunities and risks to the SG's budget decisions. The manner in which transactions with such bodies are managed can also affect the reported financial performance and position of both the SG and the body itself.

Non-Profit Distributing Finance (NPD)

70. NPD was introduced as an alternative to the traditional Private Finance Initiative (PFI) model in Scotland. The SG's use of revenue-financed methods such as NPD to finance capital projects help to increase capital investment activity. These methods can be used to support investment. The immediate benefits must be considered along with their effect to create longer-term financial commitments and to reduce flexibility in how future revenue budgets can be used.

71. The SG has set a limit of five per cent of future total annual DEL budgets to be used on the total annual costs associated with these financing methods (borrowing, PFI and NPD).

Funding of Scottish Police Authority (SPA) and Scottish Fire and Rescue Service (SFRS)

72. An inconsistent approach has been adopted in providing funding for reform costs to these newly created bodies:

- the police reform budget of £59.7 million was transferred to the SPA in the Spring Budget Revision and was included within the aggregate grant-in-aid to the SPA in the justice outturn statement in the SG's accounts
- expenditure on costs associated with fire reform of £6.2 million was treated as a grant to the SFRS included within miscellaneous justice expenditure in the justice outturn statement in addition to the grant-in-aid to SFRS.

73. Grant-in-aid is provided to match the recipient's cash needs and is accounted for on a cash basis, being credited to reserves by the receiving body. The full amount of grant-in-aid was paid over to SPA prior to year end. It subsequently reported £24.7 million of its year-end cash balance related to unspent 2013/14 grant in aid. The Scottish Public Finance Manual (SPFM) states that the sponsoring unit within the SG should ensure grant in aid is not paid in advance of need to prevent sponsored bodies accumulating large balances.

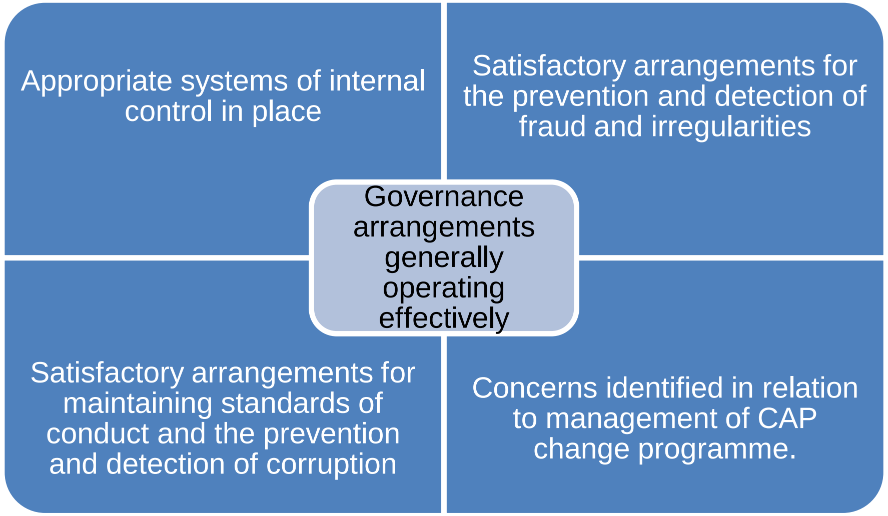
74. Contrastingly, none of the grant to SFRS for similar purposes was paid prior to year end. The grant was accrued by the SG at 31 March 2014 as an amount payable, and included as income in the SFRS accounts. SFRS did not make a claim for payment until August 2014. The SPFM states that, in the interests of transparency, there should be a presumption against sponsored bodies supported by grant-in-aid from the SG being eligible for separate payments of grant. Any grant

payments to sponsored bodies in such circumstances must be approved in advance, and this was done in this case.

75. In both cases the approach adopted meant the full amount of committed funding was brought to account during 2013/14. Inconsistent approaches to funding were reflected in how it was accounted for within the consolidated accounts and the accounts of recipient bodies. The SG should ensure that appropriate consideration is given to such arrangements and keep them under review.

Refer Action Plan No.5

Governance and accountability



76. SG, through its Principal Accountable Officer, is responsible for establishing arrangements for ensuring the proper conduct of the affairs of SG and for monitoring the adequacy and effectiveness of these arrangements.

Corporate governance

Overall effectiveness

77. We found that overall, corporate governance arrangements operated effectively during 2013/14, although there is scope to make improvements in some areas as outlined below.

Boards and committees

Strategic board

78. The Strategic Board has responsibility for ensuring that the SG is organised and managed to support Ministers in the delivery of their Programme for Government. It is supported by six boards with responsibilities for key aspects of business, the Scottish Government Audit and Risk Committee and four portfolio Audit and Risk Committees.

Non-executive directors

79. The SG has 15 independent non-executive directors. They support the Permanent Secretary, Directors General and other senior managers in their leadership of the SG. 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.

80. The involvement of the Non-executive directors (NXDs) across the organisational boards and audit and risk committees provides challenge and support to senior management. NXDs serve on the Strategic Board, Audit and Risk Committees (ARCs), and the main organisational boards and groups. They play an important part in the organisation, bringing valuable experience and an independent perspective to their roles.

81. There has been a significant change in appointed NXDs, as a number of existing appointments came to an end. This transition was managed effectively. In 2014 seven new NXDs were recruited to the SG; six appointed in February 2014 with a further appointment in September 2014. The SG provided an induction day for all new NXDs covering a number of topics. In addition, individual boards and portfolios audit and risk committees (PARCs) had local induction arrangements in place specific to their Board or committee.

82. Improvements were made in the consistency of approaches between ARCs, and overall NXDs are working more cohesively and effectively. The NXD network meets on a quarterly basis. The chair of the Scottish Government Audit and Risk Committee (SGARC) also meets with the Chairs of the PARCs every six months.

Risk management

83. The SG has made considerable improvement in its approach to risk management in recent years. During 2013/14 risk management work by the Governance and Risk Team has focussed on three main areas:

- Developing the Risk Management Framework
- Raising Awareness
- Capability.

84. Some important improvements have been made across this agenda, introducing new tools to underpin risk management activity, and the wider effectiveness of governance and internal control including:

- the launch of an online system to prepare and submit Certificates of Assurance. This supported the annual assurance process for 2013/14 and preparation of the Governance Statement. This worked well and provides opportunities for the further development of more detailed management reporting on risk and assurance
- this links directly to the Delivery Essentials platform which launched in August 2013 and provides information and direction to staff on key governance requirements
- the start of a Grant Process Review project in April 2014, focussing on streamlining processes and procedures
- the development of a communications plan to engage staff in Delivery Essentials and the wider governance agenda
- support to a number of external bodies in the form of presentations to audit committees, discussions with organisation risk leads and training for staff.

85. There has been continued scrutiny of risk management at both SGARC and PARCs, including review of risk registers and risk interrogation of individual risks. This helps to ensure ongoing challenge and support to senior management within the SG.

Governance Statement

86. 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. Improvements were made to both arrangements as detailed above, supporting consideration of the statement at an earlier stage, and the extent of disclosure of risk related items.

Common Agricultural Policy Futures programme

87. The 2013/14 accounts included expenditure of £26.8 million on the Futures Programme - an IT enabled business transformation programme to implement Common Agricultural Policy (CAP) reforms in Scotland. The programme covers the period from 2012/13 to 2016/17.

88. The Auditor General prepared a report under section 22(3) of the Public Finance and Accountability (Scotland) Act 2000 to draw Parliament's attention to the costs and progress of this challenging programme, which will continue over a number of years. It highlighted ongoing risks to achieving the successful delivery of the programme and to overall value for money.

89. One of the key drivers of the Futures Programme is to minimise the risk of non-compliance with European Commission (EC) regulations. Any failure to meet the EC regulations can have financial consequences. The SG has estimated that it could incur costs of up to £50 million per year if the IT system failed to deliver the requirements of CAP reform, with risks to future EU funding if payments are not made in accordance with the EC regulations.

90. This programme has proved more complex and challenging than the SG anticipated. The programme team assessed there is significant risk to the programme, arising from the potential late delivery of critical milestones and increasing costs.

91. The programme team commissioned a series of independent assurance reviews. The report in May 2014 concluded that significant changes to the programme arrangements were immediately required if successful delivery was to be achieved. The key themes included:

- insufficient capacity and capability for different skillsets
- lack of a programme plan and critical path
- lack of integration of the whole programme and approach.

92. These themes are very similar to those raised in our 2012 report on Managing ICT contracts which highlighted the lack of specialist skills and experience and the detrimental impact on the ICT programmes. It also highlighted that core programme management activity should be a focus, including governance structures, monitoring costs and progress reporting.

93. Delivery of the CAP Futures Programme will carry significant risk right up until implementation and beyond. The SG has recognised this and embarked on a range of actions to strengthen its management of the programme. There are ongoing risks to achieving the successful delivery of the programme and to overall value for money.

Refer Action Plan No.6

Scotland Act 2012

94. The Scotland Act 2012 includes new financial powers for the Scottish Parliament that aim to strengthen accountability. These powers will be introduced over the next two years, specifically new:

- taxes on land transactions and waste disposals to landfill, from April 2015
- borrowing and cash management powers, from April 2015
- powers to set a Scottish rate of income tax, from April 2016.

95. We issued a report to management in August 2014 entitled, *Preparedness for the Scotland Act 2012*. This report assessed the SG progress as at 30 June 2014. We have continued to review progress since then and will report publicly on preparations for the implementation of the Scotland Act 2012 in December 2014. The key messages from our work are:

- The SG established clear structures for managing the set-up of Revenue Scotland and there are now well-developed project plans for implementing the devolved taxes. The staff required to manage the overall programme were not in place early enough. There were also delays in procuring the IT system to collect and administer the taxes. These delays have reduced the time available to develop the IT system and appoint staff. As a result, there is increased risk that the IT system may not be fully operational by 1 April 2015 and that Revenue Scotland may not have the expertise to manage the devolved taxes effectively from 1 April 2015.
- The SG is working closely with HMRC to prepare for the implementation of the Scottish rate of income tax in April 2016. It has clear oversight of progress and contributes to decisions. The SG is responsible for meeting the costs of the Scottish rate of income tax. The latest estimated set-up costs are between £35 million and £40 million, revised downwards from £40 million to £45 million initial estimates.
- The SG has established the Fiscal Capability 2015 programme to manage preparations for its new financial powers. It is working to incorporate the financial aspects of the new powers within its financial management arrangements.
- The Scottish and UK governments have still to agree the terms of the block grant adjustment in relation to the devolved taxes and use of the cash reserve. The administrative arrangements for capital borrowing are also still to be fully agreed.

96. The SG should consider the detailed recommendations set out in this report and consider what further actions, if any, are necessary to ensure appropriate arrangements are in place to manage the collection of devolved taxes from April 2015.

Refer Action Plan No.7

Internal Control

97. 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. This work is informed by our assessment of risk and the activities of internal audit.

98. Our audit considered the high level controls in all of the SG's central systems that impact on the financial statements. Our overall conclusion was key controls were operating effectively and there were adequate systems of internal control.

99. In his annual report on 2013/14, the Head of Internal Audit provided reasonable assurance on overall arrangements for risk management, control and governance. This is based on a well established internal audit approach and is the middle of three available levels of assessment (Substantial, Reasonable, Limited). The overall assurance level provided the last two years is lower than previous assessments as shown in table 5.

Table 5: Internal audit assurance conclusions

2010/11	2011/12	2012/13	2013/14
Substantial	**Substantial**	**Reasonable**	**Reasonable**

Source: SG Internal Audit Division

100. Specific control issues identified through work performed during the year, included:

- **Payroll** (including starters and leavers): The SG introduced a new payroll system in July 2013. There were no major issues in respect of the functionality of the new IT system; however a number of individual issues were identified regarding manual and offline calculations, management checks and the retention of evidence to support individual payments.
- **Travel and Subsistence:** The SG introduced the i-expenses system in 2013 which delegated more control over approval to line managers. Issues were identified with exception reporting, non-compliance with guidance in respect of receipting procedures, lack of documentation for some T&S Card transactions and minor transactional errors.
- **SEAS:** Issues were identified in respect of the handling of VAT; procedures for setting up suppliers and in the overall management of debt. Outstanding issues raised in previous audit reports had still to be fully implemented.
- **European Agricultural Guarantee and European Agricultural Rural Development Funds:** A review of the Skills Development Scheme audit found claims for financial assistance made in advance of the applicant settling associated invoices. The IT Security Management Review highlighted the need to improve controls over assets and patch management; and update and test the

disaster recovery plan.

- **Verification and Compliance (VAC) Findings:** Issues were identified across projects receiving EC Structural Funds relating to the inadequate storage of supporting evidence for claims at beneficiaries. The resulting error rate led to an interruption of the ERDF LUPS fund.

101. These reflect ongoing issues such as skill gaps in some core areas (including ICT and Finance). It is important progress is made to address these issues and to ensure the effectiveness of overall control arrangements in such areas is maintained. SG should continue to review staff capacity and expertise in key areas of control to ensure these are sufficient.

Refer Action Plan No.8

Internal Audit

102. 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 Public Sector Internal Audit Standards and we could place reliance on their work in 2013/14.

103. Internal audit resources and management capacity have remained under pressure with demands of European Commission related work and a lengthy external recruitment exercise to fill management vacancies.

104. Audit manager vacancies arising from November 2013 and May 2014 required to be filled. A recruitment campaign was undertaken over the summer and three candidates were appointed to the audit manager grade, with two external and one internal appointment in September 2014. Whilst there is now more capacity at the senior level the IAD has had difficulty in recruiting staff at the lower grades with a number of long term unfilled vacancies. Temporary contract staff have been deployed to address some key priorities.

105. Against this background, it has been challenging for the IAD to deliver on its programme of work in 2013/14 within the agreed timescales. There have been a number of competing priorities and this has led to difficulties meeting in full the expectations of some Executive Agency audit committees.

106. If not resolved quickly, these ongoing pressures may adversely impact on the completion of future planned work programmes, ongoing relationships with clients in the wider SG family and the robustness of the overall control environment.

Refer Action Plan No.9

Arrangements for the prevention and detection of fraud

107. SG's arrangements in relation to the prevention and detection of fraud and irregularities were satisfactory. The SG has been

proactive in developing a number of new projects and has contributed to ongoing initiatives.

108. During 2013/14 the SG established the Scottish Government Counter Fraud Forum, a network with the aim of improving counter fraud awareness and practices across Scotland. Membership of the group includes COSLA, the Department of Work and Pensions, Trading Standards, Scottish Local Authorities Investigators Group & Chief Internal Auditors, Audit Scotland, the Crown Office and Procurator Fiscal Service, Police Scotland (Counter Corruption Unit), National Services Scotland (NHS), Student Awards Agency Scotland and the Scottish Public Pensions Agency.

109. SG participates in the National Fraud Initiative (NFI). The NFI uses electronic data analysis techniques to compare information held on individuals by different public sector bodies and different financial systems, to identify data matches that might indicate the existence of fraud or error. Overall, we concluded that SG has satisfactory arrangements in place for investigating and reporting data matches identified by the NFI.

110. Audit Scotland's National Fraud Initiative Report was published on 26 June 2014. Since we last reported on the NFI in May 2012, outcomes valued at £16 million have been recorded and the cumulative outcomes from the NFI in Scotland are now at £94 million. These outcomes are a significant return to the public finances of Scotland at a time when public finances continue to be under pressure. What cannot be measured, but is important, is the deterrent effects that undertaking regular data sharing and matching exercises, such as the NFI, have. The NFI 2012/13 involved 127 Scottish bodies across four sectors. Scottish bodies submitted 599 data sets and these generated 382,137 data matches for further investigation.

111. The SG completed a Spend/Recovery Audit to detect potential fraudulent or erroneous payments within the SG accounting system. This work was designed to build on the work of NFI and ensure SG followed good practice in other parts of the public sector as part of the UK wide Fraud, Error and Debt Taskforce. The outcome of this will be reported in due course.

112. The SG has demonstrated continuing improvement in the arrangements for the prevention and detection of fraud within both the SG core and through cross organisational engagement. It has been proactive in creating cross organisational participation through the establishment of the Scottish Government Counter Fraud Forum and its organisation of the Counter Fraud Conference.

Arrangements for maintaining standards of conduct and the prevention and detection of corruption

113. The arrangements for the prevention and detection of corruption in SG are satisfactory there are no specific issues that we need to record in this report. There were no instances of internal fraud or irregularity reported by SG in 2013/14.

Best Value, use of resources and performance

114. This section includes a commentary on the best value and performance management arrangements within the SG. We also summarise headline performance measures used by the SG and highlight themes arising from our national reports.

Use of resources

Performance management

115. The Scottish Government's National Performance Framework sets out the purpose, objectives and national outcomes that describe in more detail what the government wants to achieve. The Framework was a major step forward in setting out the Government’s aims, and our audit work has demonstrated its impact in aligning resources and actions in different parts of the public sector in some policy areas. For example our report on *Renewable Energy* noted that clear direction for the sector and that other SG strategies and policies reflect the vision, targets and objectives for renewable energy.

116. This alignment is less clear in other areas, and there is scope for the SG to demonstrate a more systematic approach to implementing the outcomes approach. For example our report on *Modern Apprenticeships* noted that the SG had set various priorities but existing performance measures do not focus on long-term outcomes such as sustainable employment. As a result it is difficult to measure their long-term contribution to national outcomes.

117. A key challenge in managing performance is aligning financial and performance information in a meaningful way, so that the impact of spending decisions on performance and outcomes can be better understood. The SG has been discussing with the Finance Committee of the Scottish Parliament how best this might be achieved. This work is reflected in the Committee’s guidance on scrutiny of the Draft Budget 2015/16. Information about the cumulative effect of previous budget decisions and the progress towards outcomes is needed to support scrutiny of the budget proposals for the year ahead.

Workforce management

118. During 2013/14 the use of exit schemes was further reduced in comparison to prior years, with a smaller, more targeted scheme in place. A total of 169 departures were agreed across the organisations included in the consolidated accounts, at a cost of £7 million. This was significantly less than the 2012/13 figures of 461 staff at a cost of £18 million.

119. Progress in reducing staff numbers and costs continues to be monitored by the SG’s Resources Board and People Board. The SG 5 year target was to reduce the SG's administration

budget by at least 20% by 2015. Progress has been broadly in line with plans, but the SG must find other methods of cost efficiency as the use of exit schemes continues to reduce.

120. The reductions in staffing levels and continuing financial pressures are stretching the organisation's capacity in some areas. The SG will need to focus on maintaining sufficient capacity, skills and experience within the organisation.

Procurement

121. The Procurement Reform (Scotland) Act received Royal Assent in June 2014. The Act is intended to maximise the impact of the £9 billion annual procurement spend and ensure public procurement in Scotland delivers environmentally sustainable, socially responsible and innovative goods and services. The Act proposes a set of general duties on contracting authorities, some specific measures to encourage good practice, and allows Ministers to make regulations and issue guidance in a number of key areas.

122. The new regulations are expected to be in place by the end of 2015. We will continue to review this area in future audits.

Asset management

123. In 2011 the Scottish Futures Trust (SFT) looked at ways to improve asset management and estate planning across public bodies and the means by which central government could deliver enhanced value from centrally held land and property assets. In September 2011, it reported to the SG that a pilot study in the South East Hub territory had identified opportunities to achieve efficiencies of £500m over a five year programme.[2,3].

124. The initial five year Asset Management implementation programme will continue to at least 2017. Working with SFT, central government aims to focus on the rationalisation of office and storage space and improve disposal of surplus property to achieve both capital receipts and increased economic activity.

125. Minsters have committed to a 25% reduction in the size of the central government estate over the period up to March 2016, as part of a wider effort to reduce running costs across the public sector. Accountability and governance mechanisms for this programme are in place, and work is continuing to achieve the required savings for the core SG buildings.

Economic Intervention

126. The SG purchased Prestwick Aviation Holdings Ltd (the company which owned Prestwick Airport) for £1 in November 2013. The SG decided to purchase the airport to prevent its closure and to protect the 3,200 jobs associated with it.

[2] Improving Asset Management across the Public Sector, Civil Estate, 2011
[3] Improving Asset Management across the Public Sector, Local Estate, 2011

127. The SG has so far committed £25.2 million to Prestwick Airport to the end of March 2016. The Deputy First Minister and Cabinet Secretary for Infrastructure, Investment and Cities reported to the Scottish Parliament in June 2014 that the SG had provided £5.5 million in the form of loan funding to Prestwick Airport since the acquisition. In 2014/15, the SG is planning to provide further loan funding of £9.7 million. This funding is intended to be a mixture of working capital support (£3 million), to allow the clearance of a backlog of essential maintenance (£4.3 million) and to support capital investment, such as the modernisation of terminal facilities (£2.4 million). The draft Scottish Budget 2015/16 commits a further £10 million to the airport in 2015/16.

128. Further public sector financial support is likely to be required. While Prestwick Airport is expected to repay the sums provided once it is trading profitably, ministers have indicated that it could take many years for the airport to be ready for re-sale to the private sector. The SG's purchase of Prestwick Airport adds to the wide range of infrastructure assets such as roads, airports and ferries that it already owns. It is important for Parliament and the public to understand:

- why the SG decided to buy Prestwick Airport
- the steps taken in buying the airport. As with any major investment decision, it is important that due process was followed and a robust business case developed
- how plans for the development of Prestwick Airport have progressed since the acquisition, including the public money being invested.

129. Audit Scotland is undertaking an audit which will consider the Scottish Government's approach to the purchase of Prestwick Airport, the future plans for its development and the arrangements for monitoring its future performance. Specifically, our audit will look at the factors taken into account by the Scottish Government when deciding to go ahead with the purchase, such as Prestwick Airport's potential for future development and wider social implications.

Performance audit

Introduction

130. The Scottish Parliament's Public Audit Committee (PAC) considers performance audit reports which are published on behalf of the Auditor General for Scotland (AGS). The PAC can take a range of actions such as noting the report, referring it to another committee for consideration, asking the audited bodies concerned to provide further information, or conducting an inquiry. In many instances the PAC will ask the SG to detail how it intends to implement any recommendations made.

131. Since November 2013, Audit Scotland published 11 performance audit reports, which contained findings or recommendations of relevance to the SG (Table 6). Key themes arising from our reports are detailed below.

Table 6: Performance audit reports published in last year

Title	Publication date:
Police reform: progress update 2013	November 2013
Scotland's public sector workforce	November 2013
Management of patients on NHS waiting lists - audit update	December 2013
Reshaping care for older people	February 2014
Modern apprenticeships	March 2014
Glasgow Community Planning Partnership	April 2014
Accident and emergency: performance update	May 2014
Falkirk Community Planning Partnership	May 2014
Scotland's public finances - a follow-up audit	June 2014
Self-directed support	June 2014
Moray Community Planning Partnership	July 2014

Source: Audit Scotland

Financial sustainability

132. Challenges around managing the financial sustainability of public services featured in a number of our performance audit reports throughout the year. *Scotland's public finances - a follow-up audit* reported that public bodies face increasingly difficult choices in reducing spending while maintaining service standards and meeting rising demand. The report set out the importance of long-term financial strategies covering a five to ten-year period in helping clarify the financial sustainability of an organisation over an extended period and can help identify problems with affordability at an early stage.

133. Meeting rising demand was also discussed in our *Reshaping care for older people* report. By 2035, 25 per cent of Scotland's population will be aged 65 or over compared to 17 per cent in 2010 with predictions that spending on health and social care for older people will need to rise from approximately £4.5 billion in 2011/12, to nearly £8 billion by 2031 unless there are changes to the health of the population and the way services are delivered. Our report found that more needs to be done to target resources on preventing or delaying ill health and on supporting people to stay at home as there is little evidence of progress in moving money to community-based services. We recommended the SG with its partners set out clear plans how this will be done in the short and longer term.

Improving leadership

134. A recurring theme in our reports was the need for public bodies to improve leadership. Service redesign, workforce planning and understanding alternative models of finance were all areas requiring more leadership and support from the SG.

135. In *Scotland's public sector workforce* we recommended SG provide strategic guidance on how bodies redesign services and work better together to jointly plan and deliver services.

136. Our *Self-directed support* report recommended SG should have a strategy to measure and report on what councils have achieved with SG transformation funding, the progress of self-directed support and planning of public sector workforces to identify and plan for future skills needs, gaps and challenges.

Linking spending and outcomes

137. Our *Scotland's public finances - a follow-up audit* commented that, in setting budgets, public bodies need to focus more on their priorities, making clearer connections between planned spending and the delivery and measurement of outcomes.

138. In our *Modern apprenticeships* report we recommended the SG review the long-term benefits of modern apprenticeships to ensure funding is directed to those which demonstrate the best value for individuals, employers and the economy.

139. One findings of our *Reshaping care for older people* (RCOP) report was the need for a greater focus on outcomes. A series of outcomes to underpin RCOP was being developed by NHS Health Scotland at the time of our publication. Without good information on outcomes, it is not possible to determine how RCOP is improving the lives of older people in Scotland.

The need for better information to support decision-making

140. A number of our recent reports have highlighted the need for public bodies to improve the information they make available to decision-makers to allow properly informed decisions on where to spend public money:

141. Our *Scotland's public finances - a follow-up audit* commented that public bodies should support effective scrutiny by ensuring that good quality information is available and that councillors and non-executive directors have the right skills to carry out their scrutiny roles.

142. In our *Reshaping care for older people* report we recommended that the Scottish Government with its partners improve and maintain data on cost, activity and outcomes for health and care services, particularly community-based services where key gaps were identified.

Outlook

143. The Scottish public sector continues to experience significant financial constraints in providing current levels of service within the resources available. The draft 2015/16 budget sets out the Government's spending priorities.

144. This section outlines some of the financial challenges facing the SG which are of continuing audit interest.

Fiscal devolution

145. The financial environment for government in Scotland is changing. The Scotland Act 2012 introduces new financial powers for the Scottish Parliament that will increase fiscal autonomy and strengthen accountability. These will start to be introduced from 2015.

146. Following the referendum on Scottish independence in September 2014, the UK Government established the Smith Commission to consider what further financial, welfare and taxation powers should be devolved to the Scottish Parliament. The Commission will published its heads of agreement in November 2014, with draft legislation due by 25 January 2015.

147. The Scotland Act 2012 will give the SG more financial powers, but it will also introduce greater volatility in its funding. Scotland's economic performance is likely to influence the amount raised through the new taxes, and the SG will bear the risk of the amounts raised being more or less than budgeted for. This, and the prospect of further devolved powers, has implications for how Scotland's public finances are managed.

Changes to systems, processes and audit arrangements

148. Implementing the financial provisions in the Scotland Act requires changes or additions to a range of financial systems and processes, covering cash authorisation and management, in-year budget management, financial systems development, arrangements for reporting to HM Treasury and accounting for the devolved taxes through the Scottish Consolidated Fund.

149. A programme is in place to manage delivery of these changes and the work is overseen by the Fiscal Capability 2015 Board.

150. Preparations for introducing the Scottish Rate of Income Tax (SRIT) will continue period prior to its introduction in April 2016. They will take account of any developments coming from the discussions on further devolved fiscal powers for the Scottish Parliament following the referendum on Scottish independence. Three main areas of work during 2014/15 are:

- developing systems and processes for identifying Scottish taxpayers
- working with HMRC's IT supplier to estimate IT costs
- developing methods to inform those who the new tax will affect; employers, taxpayers and pension providers.

Block grant adjustment

151. Scotland's block grant will be reduced to compensate for the fact that, receipts from devolved taxes (with effect from April 2015) and from SRIT (on present plans, from April 2016) will be added to the Scottish budget and will no longer be available to HM Treasury for funding general public expenditure.

152. The SG and HM Treasury have still to agree the block grant adjustment for devolved taxes and Scottish and UK Ministers are currently negotiating this. Until then, the SG has assumed that the reduction to the block grant in 2015/16 will allow it to meet the funding requirements of its budget potentially establish the first payment into the cash reserve. Once agreement is reached, any necessary adjustments will need to be reflected in the Budget. Until an agreement can be reached, uncertainty about the implications of the block adjustment in 2015/16 and beyond will remain.

153. The overall approach to the block grant adjustment for SRIT has been agreed. The details of this will be developed as more data becomes available over the period to full implementation.

Forecasting revenues

154. With the devolution of the LBTT and SLfT taxes from April 2015, the SG needs to develop forecasts of the associated revenues. The forecasts must be reliable so the SG can plan its budgets accurately and propose tax rates and bands. They must also be transparent so the Scottish Parliament can scrutinise the forecasts used in the budget.

155. The proposed rates for the two devolved taxes were published in the draft budget for 2015/16, alongside the Scottish Fiscal Commission's report on tax forecasts. The Commission concluded that the SG's forecasts of tax receipts were reasonable, within the constraints of the available data. The Scottish Parliament will approve the tax rates by March 2015.

External Financial Reporting

156. Our 2013 report on *Developing Financial Reporting* highlighted the importance of transparent, comprehensive and reliable public financial reporting – particularly as further financial powers are being exercised. The SG realise the increasing importance of this and is considering various options for developing financial reporting through its Fiscal Capability 2015 programme. We will provide an update on progress in 2015.

Community Planning Partnership audits

157. Since our report *Improving community planning in Scotland* in March 2013, there have been significant national developments in community planning. In September 2013 the SG and COSLA issued an agreement setting out their expectation that partner organisations work together through Community Planning Partnerships (CPPs) to target resources towards the priorities in their Single Outcome Agreements. In June 2014, the SG introduced the Community Empowerment

(Scotland) Bill to the Scottish Parliament, which includes proposals for placing CPPs on a statutory basis, by putting a legal duty on a range of public sector bodies to work together in partnership to plan to improve outcomes.

158. In November 2014, we published a national update on community planning, which assesses progress locally and nationally and identifies opportunities for further improvement. We drew upon the findings from audits of community planning partnerships conducted this year in Glasgow, Falkirk, Moray, West Lothian and Orkney. The report looks at leadership and governance; planning for communities; use of resources; and monitoring performance and helping CPPs to improve and includes recommendations for the SG.

Health and Social Care Integration

159. The Integration of health and social care is a substantial programme of reform led by the SG with the aim of improving the support given to people who need access to health and social care services in Scotland. These reforms have major implications for the way all health and social care services are managed and operate and will affect a significant percentage of public sector resources in Scotland. Successful implementation of the revised arrangements will be a key challenge in the period ahead.

Accounting requirements

160. The financial statements of Scottish Government are prepared in accordance with the Government Financial Reporting Manual (the FReM). The main new standards to be adopted in 2014/15 are:

- IFRS 10 Consolidated financial statements
- IFRS 11 Joint arrangements
- IFRS 12 Disclosures of interests in other entities.

161. Compliance with FReM is mandatory; the impact of the adoption of the new standards is expected to be limited overall for the SG. This will be fully considered in advance of the preparation of the 2014/15 consolidated financial statements.

Appendix I – Summary of Audit Scotland reports 2013/ 14

National report – Management of patients on NHS waiting lists - update: The audit update by Audit Scotland provided assurance that progress was being made by NHS Boards in improving audit trails and monitoring how they manage waiting lists.

National report – Scotland's Public Sector Workforce: Overview of information on public sector workforce.

EAFA specific – Summary outcome of EAFA 2013 audit: Findings from the 2013 EAFA audit.

SG specific – Annual Audit Plan: Planned external audit work during 13/14.

SG specific – Review of adequacy of Internal Audit: This provides assurance that internal audit complies with Public Sector Internal Auditing Standards and that we will rely on their work.

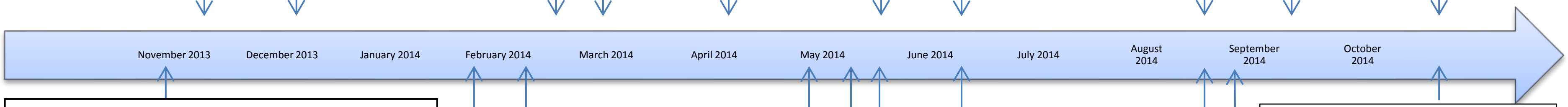
SG specific – Internal controls management letter: Review of corporate governance arrangements and key financial systems.

SG specific – Report to those charged with governance: Highlights significant matters arising from the audit of the financial statements.

SG specific – Service assurance audit: Assurance provided to wider users of SG financial systems.

National report – NHS financial performance 13/14: This review examined the financial performance of the NHS in Scotland in 2013/14.

SG specific – Audit opinion on the financial statements.



National report – Police Reform: Progress Update: Review of planning and implementation of reform of the police service.

National report – Reshaping care for older people: A progress review considered the impact of the Change Fund and is relevant to the integration of health and social care services.

National report – Modern apprenticeships: Assessment of administration and value for money of expenditure incurred by Skills development Scotland on modern apprenticeships.

National report – The 2012 audit of North Glasgow College: Report on issues arising from audit of North Glasgow College.

National report – Accident and emergency: Update on performance against the four-hour accident and emergency waiting times target.

National report – Scotland's public finances – a follow-up: Update on challenges of budget-setting and financial planning across the sector.

National report – Self directed support: Recommendations to help councils fully implement the self-directed support policy.

SG specific – Futures IT programme: Review of programme to implement CAP reforms in Scotland.

Common Agricultural Policy Futures Programme s22 (3) report: draws Parliament's attention to ongoing risks to successful delivery.

SG specific – Preparations for new financial powers: Review of arrangements for implementation of Scotland Act 2012.

Appendix II: Significant audit risks

The table below sets out the key audit risks identified at the planning stage and how we addressed each risk in arriving at our opinion on the financial statements.

Audit Risk	Assurance procedure
Financial outlook The financial outlook remains very challenging, with further reductions in spending power being budgeted for over the next two financial years. While firm figures have not yet been established, budget reductions are expected to continue well into the medium term. The SG will need to ensure it is able to deliver the plans set out in its budget.	**Work done** We have monitored the SG's budget throughout the year, with specific review of portfolio-level budget monitoring arrangements undertaken during the planning stage. Review of both long and short-term budget planning documents produced by the SG. **Reporting** We have provided an update in our Financial Position section at paragraphs 41-49. **Conclusion** Budget management during the year has been effective.
Referendum White Paper In advance of the constitutional referendum, the SG published the white paper on Scotland's future and funded the accompanying postcard delivery to all households in Scotland. The SG must demonstrate expenditure associated with this is an appropriate use of public funds.	**Work done** This was considered as part of our audit of the accounts, reviewing the regularity of expenditure. We reviewed relevant documentation and conducted interviews with senior officials. **Reporting** We have provided an update in our Financial statements section at paragraphs 20-24. **Conclusion** Based on the evidence obtained, the Auditor General issued an unqualified audit opinion.

Audit Risk	Assurance procedure
Infrastructure Investment Programme (IIP) Capital budgets will decrease by roughly a quarter over the period of the current spending review. The SG will need to deliver their long term programme of infrastructure projects whilst working with the capital funding provided.	**Work done** Attendance at Finance, Infrastructure and Rural Affairs (now Finance, Communities and Strategy) Audit and Risk Committee in 2013/14, and review of associated papers. Review of annual update to the SG's Infrastructure Investment Plan 2011. **Reporting** We have provided an update in our Best Value, use of resources and performance section at paragraphs 123-125. **Conclusion** We will continue to review and report on progress on the SG IIP.
Preparing for increased fiscal autonomy The Scotland Act 2012 gives new tax and borrowing powers to Scotland. Critical issues for the SG include ensuring capacity to support tax administration, the effective forecasting of tax revenues as a basis for future financial planning and development of budgeting, accounting and financial management arrangements.	**Work done** Review of SG's preparation for new financial powers through inspection of key project documents, supplemented with interviews of key personnel from the SG, Registers of Scotland and the Scottish Environment Protection Agency. **Reporting** The outcomes of our findings have been reported via an internal management report considered by SGARC in September 2014. This will be followed by two public reports to be issued later in the year. We have provided an update in our governance and accountability section at paragraphs 94 – 96.. **Conclusion** We will continue to review and report on progress on the implementation of the new tax and borrowing powers by SG, Revenue Scotland and the related partner organisations.

Audit Risk	Assurance procedure
Scottish Government's Futures Programme The overall Futures Programme has experienced long-standing issues in securing essential business change staff with the necessary skills and experience. The build phase for the IT Programme continues to remain behind the original schedule with ongoing difficulties relating to programme management and capacity.	**Work done** Attendance at Finance, Infrastructure and Rural Affairs (now Enterprise and Environment) Audit and Risk Committee in 2013/14, and review of associated papers. Interviews with key SG officials involved in programme, supplemented by extensive review of programme documentation and evaluation against original plans. **Reporting** The outcomes of our findings have been reported under section 22(3) of the Public Finance and Accountability (Scotland) Act 2000. This report was laid alongside the SG Consolidated Accounts in October 2014. We have provided an update in the governance and accountability section at paragraphs 87-93. **Conclusion** We are continuing to undertake audit work on this area with a view to providing a further report to management.
European funding Progress has been made in improving controls in a number of areas, but further work is required to address known and emerging issues. Significant changes to existing arrangements are proposed, although there remains some uncertainty about the final nature of programmes.	**Work done** Attendance at Finance, Infrastructure and Rural Affairs (now Enterprise and Environment) Audit and Risk Committee in 2013/14, and review of associated papers. Interviews with key officers and review of relevant documentation. **Reporting** A summary of outcomes from the EAFA 2013 audit was reported to management in March 2014. Progress was reported in our ISA 260 Report to those charged with governance and was considered by SGARC on 17 September 2014. **Conclusion** Progress in improving controls has continued, but CAP reform raises significant challenges.

Audit Risk	Assurance procedure
Audit and Risk Committees There remain opportunities to work toward greater consistency between committees in the balance between support and challenge offered to senior officials.	**Work done** Regular attendance at SGARC and various other committees during the year. Pre-meetings held with non-executive directors to discuss any concerns or issues. Minute reviews undertaken of the Scottish Government's key Audit & Risk Committees and Boards throughout the year. **Reporting** We have provided an update in the governance and accountability section at paragraphs 79-82. **Conclusion** There has been an improvement in consistency of approach and effectiveness.
Organisational Change and Capacity The SG will need to ensure that effective management arrangements are in place to manage the impact of budget pressures, public sector pay restraints and pension reforms on its core programme of work. The SG continues to manage a range of pressures on the core finance function including new work demands and staff capacity.	**Work done** Regular attendance and review of papers at SGARC and various other committees during the year. Review of internal audit work and relevant internal audit papers. Review of internal controls as part of annual audit work. **Report** We provided a service assurance report on both central finance systems and payroll system. We have provided an update in the governance and accountability section at paragraphs 97-101. **Conclusion** Capacity both in general terms and for specific functions, (finance/IT) is being stretched. This will continue to be reviewed and reported on.

Audit Risk	Assurance procedure
Internal audit resourcing Reducing resources and increasing demands from European work have been challenging to the work of internal audit. Internal audit has revised its approach to planning. There remain ongoing resourcing issues within the current year. The one remaining audit manager will leave in March 2014. A number of additional vacancies have yet to be filled and/or are being filled on a temporary basis.	**Work done** Regular meetings with Internal Audit where we receive an update on progress with the IA plan, as well as information on resourcing. Annual review of Internal Audit function provides us with assurance that it is operating effectively and, where appropriate, areas which we are able to place reliance upon their work. **Reporting** We reported our Annual review of internal audit to management in May 2014. We have provided an update in the governance and accountability section at paragraphs 102-106. **Conclusion** Internal audit resources and management capacity have remained under pressure. If not resolved quickly this may impact on delivery and effectiveness of internal control.
Monitoring Internal Control The SG will need to consider the effectiveness of internal control arrangements, taking action as necessary to ensure that there is no reduction in the overall controls in place.	**Work done** Regular attendance and review of papers at SGARC and various other committees during the year. Assessment of the Internal Audit role and function, as well as review of relevant internal audit papers. Our own testing of internal controls provided reasonable assurance that adequate arrangements were in place, with the exception of concerns in the operation of specific controls within the payroll function. **Reporting** Our service assurance report on the payroll system identified control weaknesses. We have provided an update in the governance and accountability section at paragraphs 97-101. **Conclusion** Key controls were operating effectively and there were adequate systems of internal control in 2013/14. However, the overall effectiveness of controls has fallen from previous years.

Audit Risk	Assurance procedure
NHS Bodies - equal pay claims As more information becomes available, we would expect it would become possible for the Scottish Government to prepare a sufficiently reliable estimate of probable liabilities arising from equal pay claims in the NHS.	**Work done** We, via Audit Strategy, have been in contact with NHS Boards and the NHS Scotland Central Legal Office (CLO) regarding this issue. Regular updates are provided as the claims develop. Consideration was given at final accounts stage with regards to appropriate accounting disclosure. Attendance at Health & Wellbeing Audit and Risk Committee (HWARC), as well as review of minutes and associated papers of the Scottish Government Health & Social Care Management Board. **Reporting** We have provided an update in the financial results section at paragraphs 65-67. **Conclusion** Accounted for appropriately in 2013/14. The number of cases now less than 6,000 which has reduced likelihood of a material amount impacting on the financial statements.

Appendix III – Action plan

Action plan point/page	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
1.	**Clinical Negligence and other Risk Indemnity Scheme (CNORIS)** In the course of the 2013/14 audit of the consolidated accounts we identified concerns that the consolidation process had not removed all relevant inter-entity transactions associated with CNORIS. **Risk** There is a risk that CNORIS is not properly reflected within the consolidated accounts. **Recommendation** We recommend that a full review of the present CNORIS scheme should be undertaken. The financial framework for Health Boards should be amended as necessary.	Active full review of CNORIS scheme, with involvement from Scottish Government, NHS Boards and Audit Scotland is underway. Expect to confirm an agreed approach with Audit Scotland in relation to how both the Scottish Government and NHS Boards account for the scheme in 2014/15 by the end of December 2014.	Deputy Director: Finance Health and Wellbeing	December 2014

Action plan point/page	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
2.	**Asset valuations** Inconsistencies were identified in the application of VAT to police and fire assets. This was required to ensure consistency in the application of VAT to the college depreciated replacement cost (DRC) building valuations. **Risk** There is a risk that the incorrect application of VAT rules will impact on the current valuations of certain assets within the SG accounts. **Recommendation** The approach to commissioning DRC valuations should be reviewed to ensure appropriate and consistent instructions are issued in relation to the treatment of VAT.	Future DRC valuation commissions by Scottish Government Property Division will specify that VAT is separately identified for commercial and residential components to ensure consistent treatment.	Scottish Procurement and Commercial Directorate: Chief Property Advisor	December 2014

Action plan point/page	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
3.	**Whole of Government Accounts (WGA)** The reported counter party information was incomplete and inaccurate in respect of the intra-government transactions and balances that should be eliminated. **Risk** There is a risk that the SG does not maintain reliable information to allow completion of required WGA information. **Recommendation** The SG should undertake to improve the completeness and accuracy of the reported counter party information in respect of intra-government transactions and balances to support WGA reporting.	The recognition and matching of intra-government transactions and balances is a UK-wide problem. SG Finance has continued to make progress. Scottish Government and Audit Scotland will agree further proportionate progress that is practical to achieve in future iterations.	Deputy Director: Finance Corporate Reporting	By 31 March 2015

Action plan point/page	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
4.	**NHS Bodies- Equal pay claims** The Central Legal Office has stated that claims still do not provide sufficient detail about the comparator jobs to allow an estimate to be made of the success of claims or the financial impact that they may have. **Risk** There is a risk that the lack of progress in resolving this issue will create increased uncertainty. **Recommendation** As more information becomes available the SG should prepare a reliable estimate of probable liabilities arising from equal pay claims in the NHS.	There is a well-established approach that involves the Central Legal Office, the NHS Equal Pay Unit, Audit Scotland and Scottish Government Health Finance who meet each year to review current developments relating to NHS equal pay and to agree an appropriate disclosure in NHS Board annual accounts. This group will consider and agree the best approach for 2014-15.	Deputy Director: Finance Health and Wellbeing	March 2015

Action plan point/page	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
5.	**Funding of SPA and SFRS** Police reform expenditure was included within grant in aid to the SPA. Fire reform expenditure was included within core justice expenditure and paid by grant to the SFRS. There was an element of grant in aid paid to the SPA unspent at 31 March 2014. **Risk** There has been an inconsistent approach to the funding and accounting treatment of police and fire reform expenditure in 2013/14. Inconsistent approaches to funding had a knock-on impact on accounting both for SG and between recipient bodies. **Recommendation** The SG should review its arrangements to ensure that a consistent approach to funding is adopted across sponsor departments to ensure that is taken, and it is clear when a departure from the general approaches described in the SPFM may be approved.	The SPFM allows some flexibility, and the relevant Finance Business partner was involved in the relevant decision-making. Similarly, the treatment of year end transactions was dealt with on individual merit and compliance with SPFM tested at the time. Ongoing review of activity in these new bodies continues during 2014/15 and will take account of the points raised. Financial Management Directorate will also consider this as part of a current project on grants which will lead to refreshed guidance on grants.	Financial Management Directorate	Ongoing, with the specific grants project to be delivered by the end of the financial year.

Action plan point/page	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
6.	**Common Agricultural Policy Futures programme** The IT component of the Futures programme remains behind schedule. A revised Business Case for the programme issued in March 2014 set out estimated costs that were £23 million in excess of original projections, along with a reduced project scope. **Risk** There are ongoing risks to achieving successful delivery of the programme and value for money. **Recommendation** The SG should ensure issues identified in respect of the futures programme are addressed effectively.	In response to the May 2014 independent assurance review, the Directorate for agriculture, food and rural communities has implemented an action plan which has included: • strengthening of the Programme leadership team, including appointment of a Programme Director and Commercial Manager. • introduction of governance improvements which have strengthened the Programme wide approach to planning and change control. A recent Gateway Review (November 2014) noted that significant progress had been made to turn round the Programme and develop a more mature working environment. Further planned action includes procurement of a Programme assurance call-off contract; strengthened commercial management of suppliers; and assessment of an off the shelf IT solution as a viable contingency option.	Senior Responsible Office, Futures-Agriculture, Food & Rural Communities	February 2015

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<tr><th>Action plan point/page</th><th>Issue, risk and recommendation</th><th>Management action/response</th><th>Responsible officer</th><th>Target date</th></tr>
<tr><td>7.</td><td>Scotland Act 2012
The Scotland Act 2012 includes new financial powers for the Scottish Parliament that aim to strengthen accountability. These powers will be introduced over the next two years
Risk
There has been slippage in a number of key areas that may impact on the collection the new taxes from 1 April 2015.
Recommendation
The SG should:
closely monitor how recruitment to the operational team, and in particular to the prioritised posts in the operational team, is progressing to inform its decision on whether to implement its contingency plans
clarify what progress needs to be made to ensure the IT system to collect the devolved taxes will be in place by 1 April 2015, to inform its decision on whether to implement its contingency plans
finalise its contingency plans and ensure that the points at which contingencies would be activated allow sufficient time for effective tax collection from 1 April 2015.</td><td>The programme for delivery of the collection of the new taxes from 1 April 2015 continues to be monitored actively. All risks continue to be managed under the governance arrangements for the programme.
Recruitment plans are in place for operational staffing and are reviewed on a weekly basis to ensure the staff required by 1 April are in place for 1 April.
Contingency plans are in place. These are part of good programme management practice and reviewed on an ongoing basis. The last date on which the contingency plans can be invoked are the end of Feb 2015. The Head of Revenue Scotland will update the Public Audit Committee on progress at that time.
Progress against the programme plan is currently on track for collecting the devolved taxes from 1 April 2015.</td><td>DG Finance
Chief Executive, Revenue Scotland</td><td>Ongoing until delivery on 1 April 2015</td></tr>
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Action plan point/page	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
8.	**Monitoring internal control** We review the high level controls in all of the SG's central systems that impact on the financial statements. The review identified a number of specific control issues. **Risk** This is a risk staff capacity and skill gaps exist in key areas (including ICT and Finance) which adversely impact on the overall control environment. **Recommendation** The SG should • review the overall internal control arrangements, taking action as necessary to ensure that there is no reduction in effectiveness • staff capacity and expertise in key areas of control	Internal control arrangements are and will continue to be monitored on a routine basis by management and by Internal Audit, and specifically as part of the annual management assurance process. The People strategy addresses in principle corporate capacity and capability needs and strands of this work are ongoing within the corporate areas. A successful external recruitment exercise for Finance posts recently took place with new colleagues in post by the end of December 2014.	DG Finance Director, People	Ongoing, with annual review in September 2015

Action plan point/page	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
9.	**Resourcing of IAD** IAD has operated below establishment for the 2013/14 audit year. **Risk** Resourcing issues mean that there is a continuing risk that: • work will be delayed or dropped • control weaknesses within the organisation are not identified • postponed work will impact on the level of assurance provided • expectations of Executive Agencies will not be met. **Recommendation** Review IAD capacity and capability to ensure availability of resource.	The structure and resourcing options for IAD will be reviewed as part of the forward audit planning arrangements for 2015-16.	DG Finance/ Head of Internal Audit	By 31 March 2015