Transport Scotland

Annual Audit Report 2014/15

Prepared for Transport Scotland and the Auditor General for Scotland

August 2015

Contents

The Auditor General for Scotland appoints external auditors to central government bodies (www.audit-scotland.gov.uk/about/ags). Audit Scotland is a statutory body which provides audit services to the Accounts Commission and the Auditor General. (www.audit-scotland.gov.uk)

This report has been prepared for the use of Transport Scotland and no responsibility to any member or officer in their individual capacity or any third party is accepted.

This report will be published on our website after it has been considered by the audit committee and the financial statements have been laid before parliament. The information in this report may be used by Audit Scotland in any reporting to the Scottish Parliament.

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Key Messages

Audit of financial statements	• We have given an unqualified opinion on the financial statements.
Financial management	• The financial position of Transport Scotland remains stable with the body operating within its resource budgets for 2014/15 and a similar budget for 2015/16.
Governance and transparency	• Overall we found that Transport Scotland has sound governance arrangements. • Transport Scotland could improve their level of openness and transparency by implementing the recommendations made in the Scottish Government's On Board guidance applicable to executive agencies.
Best Value and Value for Money	• Transport Scotland has a systematic approach to secure Best Value. • The Scotrail franchise bid evaluation process was robust and we identified good practices. • The purchase of Glasgow Prestwick Airport was reasonable within the timescale available. Going forward a clear strategy should be put in place which includes future developments, business and financial plans, risk evaluation and a prospective exit strategy.
Outlook	• Transport Scotland will require to reflect the assets and liabilities associated with the former Forth Estuary Transport Authority within their 2015/16 financial statements.

Introduction

1. This report is a summary of our findings arising from the 2014/15 audit of Transport Scotland.

2. The management of Transport Scotland is responsible for:

   - preparing financial statements which give a true and fair view, in accordance with the relevant financial reporting framework
   - ensuring the regularity of transactions, by putting in place systems of internal control
   - maintaining proper accounting records
   - publishing with their financial statements an annual governance statement and a remuneration report.

3. Our responsibility, as the external auditor, is to undertake our audit in accordance with International Standards on Auditing, the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011 and the ethical standards issued by the Auditing Practices Board.

4. An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. It is the auditor's responsibility to form and express an opinion on the financial statements prepared by management with the oversight of those charged with governance. This does not relieve management of their responsibility for the preparation of financial statements.

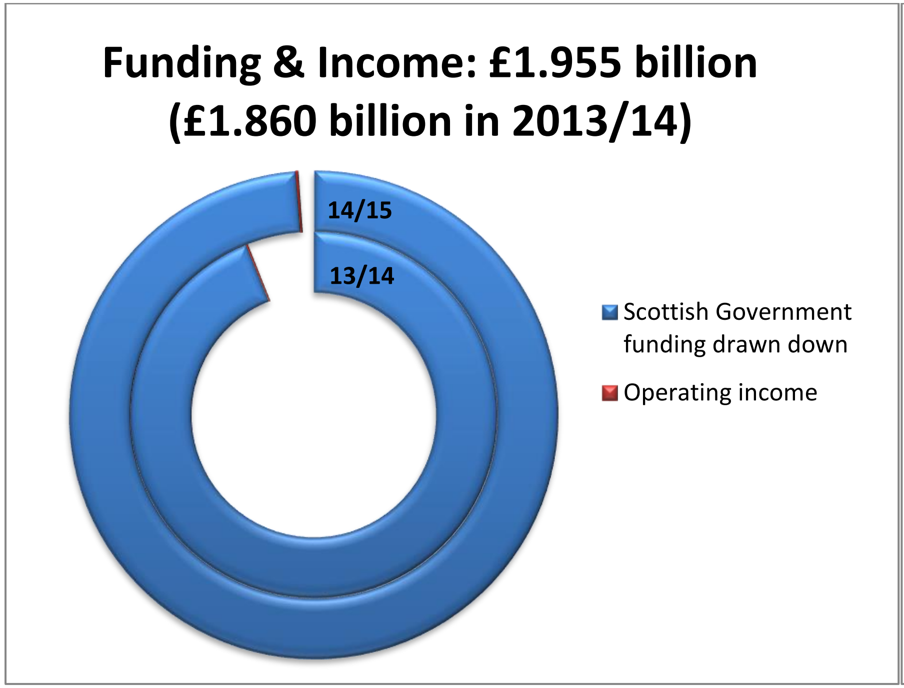
5. A number of reports, both local and national, have been issued by Audit Scotland during the course of the year. These reports are summarised at appendix II and appendix III.

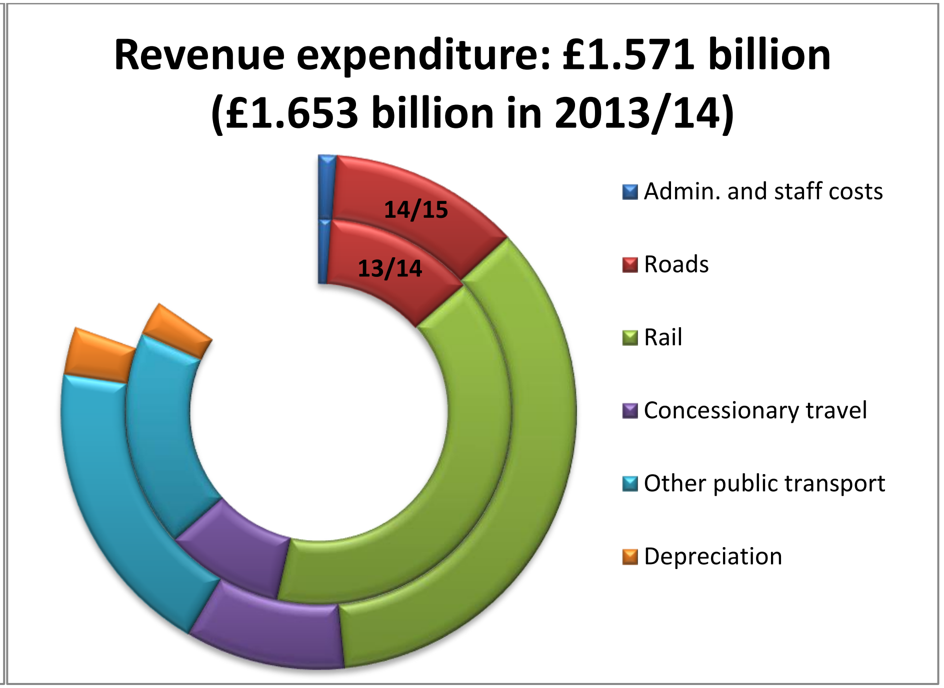
6. Appendix IV is an action plan setting out our recommendations to address the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "Management action/response". We recognise that not all risks can be eliminated or even minimised. What is important is that the Agency understands its risks and has arrangements in place to manage them. The Audit and Risk committee should ensure that they are satisfied with proposed action and have a mechanism in place to assess progress and monitor outcomes.

7. 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.

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

2014/15 financial statements





The Statement of Changes in Taxpayers' Equity in the financial statements shows that Scottish Government funding drawn down during 2014/15 was £95 million more than in 2013/14. However, this simply reflects a higher element of cash required to fund expenditure during the year. Details of the Agency's overall SG allocation for 2014/15 is shown in the table on page 17. The financial statements also show that annual revenue expenditure has reduced from £1.653 billion in 2013/14 to £1.571 billion in 2014/15. This is attributable to a £91 million reduction in rail expenditure in 2014/15 as this is the first year of a new control period (i.e. control period 5) and charges redetermined by the Office of Rail Regulation for fixed access track charges and deed of grant payments that flow to Network Rail have reduced.

Audit of the 2014/15 financial statements

Audit opinions

Financial Statements	• The financial statements of Transport Scotland for 2014/15 give a true and fair view of the state of the body's affairs and of its net expenditure for the year. • We confirm that the financial statements have been properly prepared in accordance with the 2014/15 FReM and the requirements of the Public Finance and Accountability (Scotland) Act 2000 and directions.
Regularity	• In all material respects, the expenditure and income in the financial statements were incurred or applied in accordance with any applicable enactments and guidance. • The sums paid out of the Scottish Consolidated Fund were applied in accordance with section 65 of the Scotland Act 1998.
Other prescribed matters	• The part of the Remuneration Report to be audited has been properly prepared in accordance with the Public Finance and Accountability (Scotland) Act 2000 and directions made thereunder by the Scottish Ministers. • The information given in the Management Commentary of the Annual Report is consistent with the financial statements.

Submission of financial statements for audit

9. We received the unaudited financial statements on 12 June 2015, in accordance with the agreed timetable. The working papers were of a good standard and staff provided support to the audit team which enabled us to complete our on-site fieldwork on 10 July 2015.

Overview of the scope of the audit of the financial statements

10. Information on the integrity and objectivity of the appointed auditor and audit staff, and the nature and scope of the audit, were outlined in our Annual Audit Plan presented to the Audit and Risk committee on 26 January 2015.

11. As part of the requirement to provide full and fair disclosure of matters relating to our independence, we can confirm that we have not undertaken any non-audit related services. The 2014/15 agreed fee for the audit was £182,000 and, as we did not carry out any work additional to our planned audit activity, the fee remains unchanged.

12. The concept of audit risk is of central importance to our audit approach. During the planning stage of our audit we identified a number of key audit risks which had the greatest effect on the audit strategy, resources and effort. We set out in our Annual Audit Plan the audit work we proposed to undertake to secure appropriate levels of assurance.

13. Appendix I sets out the audit risks identified at the planning stage and how we addressed each risk in arriving at our opinion on the financial statements.

14. Our audit involved obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

Materiality

15. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit procedures. We assess the materiality of uncorrected misstatements, both individually and collectively.

16. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit programme. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

17. We summarised our approach to materiality in our Annual Audit Plan. We revised our planning materiality for 2014/15 on receipt of the unaudited accounts to £173 million (1% of the Net Book Value of the trunk road network).

18. We also set a lower level, known as performance materiality, when defining our audit procedures. This is determined to ensure that uncorrected and undetected audit differences do

not exceed our materiality level. Performance materiality was set at £87 million (i.e. 50% of materiality).

19. As Transport Scotland's trunk road assets dominate the balance sheet and represent more than ten times net operating expenditure, we also set a separate performance materiality level to be applied to all account areas other than the trunk road network. This has been set at 0.75% of gross expenditure and was revised upon receipt of the unaudited accounts to £12 million.

20. We report all misstatements greater than £100,000.

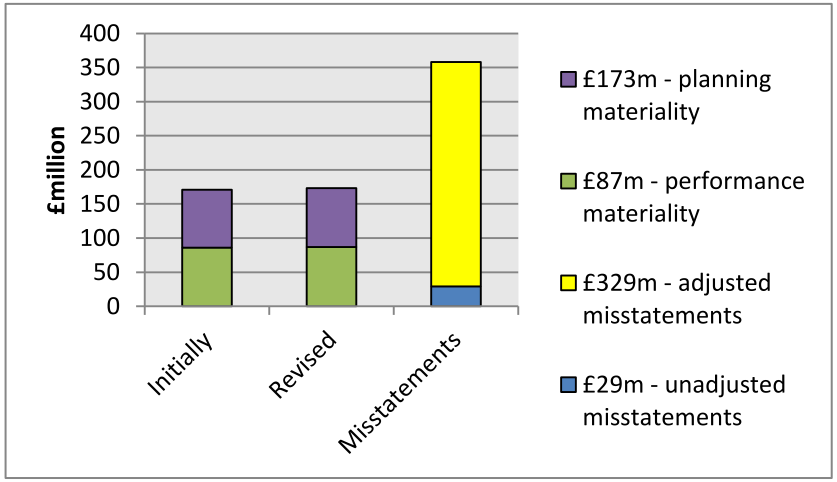


Exhibit 1: Overall materiality and misstatements

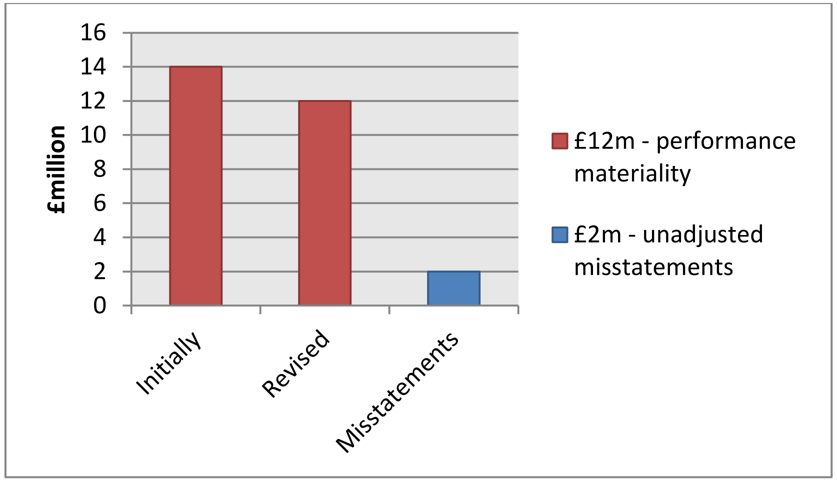


Exhibit 2: Non-Trunk Road performance materiality and misstatements

Evaluation of misstatements

21. We have identified nine misstatements in the unaudited financial statements. Two of these (i.e. application of Q4 Baxter's index – paragraph 25 and reclassification of reserves – paragraph 27) have been adjusted by management in the audited accounts with the net trunk road asset value and the associated reserves decreasing by £329 million. The remaining misstatements are unadjusted and total £29 million, with the majority (£27 million) affecting the trunk roads valuation of assets under construction and the other misstatement (i.e. non-trunk road) resulting in an overstatement of expenditure of £2 million and an understatement of net assets in the statement of financial position by the same amount.

22. The total value of adjustments exceeded our overall performance materiality level of £87 million. However, we consider that the issue with the application of the Q4 Baxter Index is an isolated issue which does not indicate that further systematic errors exist within the account area or more pervasively within the financial statements. We considered the impact of these misstatements on our audit approach and decided that further audit procedures were not required.

Significant findings from the audit

23. International Standard on Auditing 260 (ISA 260) requires us to communicate to you significant findings from the audit as detailed below:

- The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and disclosures.
- Significant difficulties encountered during the audit.
- Significant matters arising from the audit that were discussed, or subject to correspondence with management.
- Written representations requested by the auditor.
- Other matters which in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

24. The following table details those issues or audit judgements that, in our view, require to be communicated to those charged with governance in accordance with ISA 260.

Significant findings from the audit in accordance with ISA260

Indexation rate for trunk road network

25. Transport Scotland indexes each element of the road network, other than land, using a rate known as the Baxter index to ensure that the depreciated replacement cost of the trunk road network reflects inflation. The Q4 index value isn't known until mid-June each year and so the figure for Q3 is used in the Roads Asset Valuation System (RAVs) to produce the year-end road network valuation for the unaudited accounts. A further calculation is then required each year when the Q4 figure is received, to assess whether a material adjustment is required to the unaudited statements. In 2014/15 the Baxter index movement between these two quarters represented a 2.06% decrease of £329 million. As this is above the overall materiality level an adjustment has been made in the final version of the accounts to reflect the 2014/15 quarter 4 Baxter index figure. This process for adjustment (where the movement is material) is consistent with previous practice.

Appendix IV – Action Plan No. 1

Accounting for Public Private Partnership (PPP) assets during construction phase

26. From this year, the revised Government Financial Reporting Manual (FReM) requires that the value of work on Public Private Partnership schemes is recognised as assets under construction during the build phase. Within the unaudited accounts £116 million was recognised for the Aberdeen Western Peripheral Route and the M8, M73, M74 improvements project, based on the project schedules set out in the original financial models for each scheme. During our audit, the Director of Major Transport Infrastructure Projects (MTRIPs) provided an assessment of the actual progress made and identified that only £89 million of work had been completed at 31 March 2015. Therefore, the amount recognised as assets under construction, and the related payables balance, in the unaudited accounts have been overstated by £27 million. Management consider that this amount is not material and have not adjusted for this in the audited financial statements.

Significant findings from the audit in accordance with ISA260

Revaluation reserve adjustment

27. In previous years, no amount had been released from the revaluation reserve to represent the element of in-year depreciation charge on the trunk road network that is attributable to revaluation. During 2014/15 Atkins, who are responsible for maintaining the RAVs database, were engaged to calculate the required revaluation reserve balance. Based on this the revaluation reserve balance at 31 March 2015 should be £8.854 billion. However, management identified that the calculation did not take into account the impact of any write downs on completed road schemes (i.e. the difference between the cost of the scheme and the value of the resultant asset) which, since the adoption of International Financial Reporting Standards in 2009/10, have been charged directly to the revaluation reserve. Following a review of completed schemes since 2009/10, management identified that £497 million had been charged to revaluation reserve for write downs. Therefore, the required revaluation reserve balance is £8.357 billion. A transfer of £42 million from the revaluation reserve to the general fund has been made in the audited accounts to bring this in line with the calculated value.

Appendix IV – Action Plan No. 2

Provision for impairment of the trunk road damage claims debtor balance

28. In 2013/14 we reported that no provision for impairment of the trunk road damage claims debtor balance had been made to reflect the element where there is uncertainty over full recovery. Management confirmed that this debt was unlikely to be fully recovered and agreed to include a provision for impairment from 2014/15 onwards. A debtor balance for trunk road damage claims of £1.7 million was included in the 2014/15 unaudited accounts but no provision for impairment was again shown. Following discussion with management, we identified that a provision had been calculated as £0.9 million, but the journal to create the provision had been incorrectly posted. Management have identified that this amount is not material to the financial statements and have not adjusted for this in the 2014/15 audited financial statements.

Appendix IV – Action Plan No. 3

Significant findings from the audit in accordance with ISA260

Buchanan House remedial works receivables balance

29. A receivables balance of £0.4 million was recognised within the 2014/15 unaudited accounts for the cost of remedial work to Buchanan House that Transport Scotland anticipate will be recovered from the contractor under the terms of the original collateral warranty. Transport Scotland's share of the overall cost of all remedial works required could be around £3.5 million. As this is still the subject of ongoing court proceedings (i.e. no ruling has yet been made that the contractor has breached the collateral warranty granted to Scottish Ministers) we consider that this is a contingent asset, as defined by IAS37 – Provisions, Contingent Liabilities and Contingent Assets, so should not have been recognised as a debtor/ income within the financial statements. Management have identified that this amount is not material to the financial statements and have not adjusted for this in the 2014/15 audited financial statements.

Appendix IV – Action Plan No. 4

Understatement of road operating contractors' accrual

30. The unaudited accounts included an accrual of £28.8 million for the value of work undertaken by road operating contractors during 2014/15 that had not yet been billed for at the year end. Following a review of the work undertaken by the Agency's Performance Audit Group (PAG) we identified that the actual value of the work undertaken was £0.6 million more than the value of the accrual processed. Management advised that as the final position is not available until July each year the accrual in the unaudited accounts will always be based on an estimate and as this amount is not material to the financial statements they have not adjusted for this in 2014/15.

Overstatement of concessionary travel scheme accrual

31. The concessionary travel scheme expenditure for 2014/15 of £190.7 million includes an accrual for the projected final payments due to bus operators for the year. Based on the forecast outturn position at 10 July 2015 actual payments for 2014/15 are likely to be £189.0 million. Therefore, based on the most up-to-date data, these costs have been over-accrued by £1.7 million. Management advised that due to the timing of the final payments to bus operators the accrual would always be based on projected costs and as this amount is not material they have not adjusted for this in the 2014/15 financial statements.

Significant findings from the audit in accordance with ISA260

Overstatement of Sustrans Scotland accrual

32. An accrual of £15.2 million was made in the unaudited accounts for section 70 grant claim payments due to Sustrans Scotland for 2014/15. This amount was based on an estimate provided by Sustrans Scotland of the level of their outstanding claims for the financial year. A review of the final claims actually submitted identified that these totalled £13.0 million, therefore the amount recognised in the accounts is overstated by £2.2 million. Management consider that this amount is not material and have not adjusted for it in the 2014/15 financial statements.

Other issues from the financial statements audit

Impact of road pavement condition variance smoothing

33. In 2013/14 we agreed that Transport Scotland would apply a smoothing of the road pavement condition variance through the use of a 5-year rolling average. This is intended to remove some of the significant swings in condition valuation adjustments. These resulted from the calculations to assess the remaining life expectancy of the road pavement which are based on measured resistance of the sections of road surveyed in year and the assessed traffic usage. The smoothing process is intended to provide greater year-on-year certainty in the budgeting for this by dampening fluctuations caused predominantly by the effect of changes in traffic measurements in the calculation of remaining life.

34. During 2014/15 the assessed road pavement condition variance for the year was a condition improvement of £54.3 million. However, this has been adjusted in the financial statements to reflect the 5-year rolling average condition deterioration of £12.1 million. Therefore, the in-year impact of applying smoothing was a downward adjustment of £66.4 million to the in-year improvement, as shown in Exhibit 3. We will continue to report the effect of this smoothing methodology during our audit appointment to demonstrate the impact.

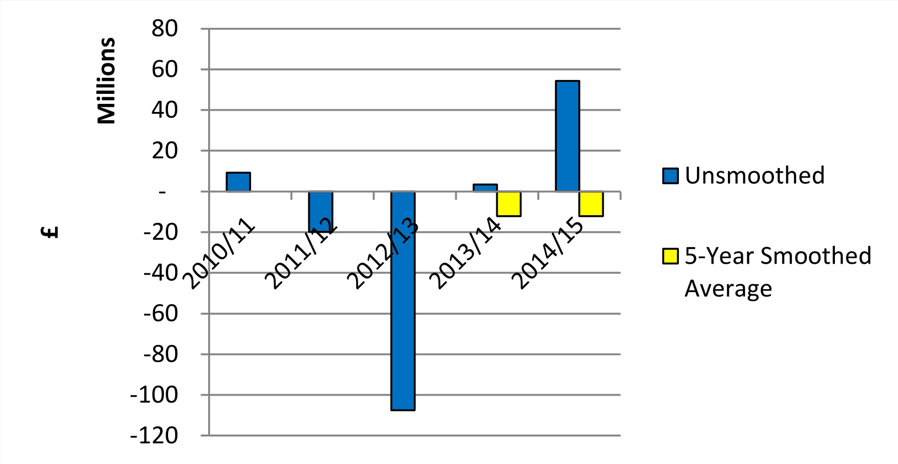


Exhibit 3: The impact of applying road pavement condition smoothing

Concessionary travel scheme expenditure

35. In 2013/14 payments made for the concessionary travel scheme exceeded the £187 million cap set for that year by £1.7 million. The overpayment occurred as Transport Scotland projected, at the end of period 12, that the reimbursement of eligible journeys would not exceed the cap so released payments to medium and small operators prior to all the data being received from the major operators for the final period.

36. To ensure no similar issue occurred in 2014/15 we reviewed the outturn position as part of our financial statements audit and confirmed that final payments were only made once it was confirmed that overall payments would not breach the £192 million cap set for the year.

37. For 2015/16 the cap on the scheme has been increased to £202 million, but through negotiation with the Confederation of Passenger Transport (CPT), Transport Scotland agreed that the reimbursement rate for eligible journeys will be reduced from 58% (i.e. 58p for each £1) to 57.1%. They also agreed that the reimbursement rate will reduce further to 56.9% in 2016/17 while the cap on scheme expenditure will increase by £10 million to £212 million.

RAVs "data cube"

38. During February 2015 we met with the finance officers involved in producing the road network valuation for the financial statements and representatives from Atkins, who maintain the RAVs database, to discuss the potential use of the RAVs "data cube" for the 2014/15 financial statements audit.

39. The RAVs "data cube" has been designed to operate as a live pivot table to enable users to interrogate the records held on the database. Transport Scotland expect that this will streamline the collation of the information required for the accounting, and auditing, process by enabling users to quickly investigate and verify significant movements from the prior year or any other specific records that may be of interest.

40. As the system had only recently been developed, and was still to be fully tested, Transport Scotland agreed that the excel spreadsheets provided in support of the trunk road network would again be produced for 2014/15 but external audit would also be granted access to the RAVs "data cube" to assist with the financial statements audit.

41. The Head of Management Information Services (MIS) arranged access to the system and training on the main aspects of the RAVs "data cube" in June 2015. During the training session a sample of reports were run which demonstrated the totals produced by the system were consistent with the values used to produce the trunk road valuation in the unaudited accounts. However, due to time constraints its use has been limited for the current year's audit. We therefore plan to test the system during 2015/16 using the 2014/15 road network data to identify reports that could be produced to streamline the year-end audit process going forward.

Compliance with EU state aid regulations

42. As reported in our interim report to the Audit and Risk committee in April 2015, Transport Scotland fund Highlands and Island Airports Limited (HIAL) under the European Union's Services of General Economic Interest (SGEI) regime.

43. A new SGEI regulation came into effect during 2014 and the Agency are working to adapt HIAL's funding arrangements to this regulation. As a result, the current funding and monitoring arrangements are not fully compliant with the requirements of the regulation. Both the Scottish Government State Aid Unit and the European Commission are aware of this and Transport Scotland are working towards full compliance and creating a robust reporting and grant payment structure during 2015/16.

44. In July 2015 internal audit issued their Air Services report which included consideration of the Agency's compliance with the new EU State Aid regulations. This highlighted that Transport Scotland require to review the funding and reporting arrangements with HIAL, and that HIAL should develop proposals for a car park charging regime for all airports (currently car parking charges are only in place at 2 of the 11 airports) for discussion with Ministers.

45. Management have advised that they do not believe there are any fundamental state aid issues with the subsidy of HIAL and, as no other operator is obviously disadvantaged, they believe the risk of any legal challenge is minimal. We don't consider that this issue materially affects our regularity opinion.

Future accounting and auditing developments

Revisions to the Financial Reporting Manual (FReM)

46. The financial statements are prepared in accordance with the Government financial reporting manual (FReM). Two significant revisions will apply from 2015/16:

- Simplification and Streamlining Project – changes to the form and content of the annual report and accounts.
- Adoption of IFRS13 *Fair value measurement* for the first time – this also includes IAS 16 and IAS 38 adaptations.

47. **Restructuring of annual report**: the 2015/16 FReM has been extensively re-written to require the annual report to include:

- A performance report which will give a fair, balanced and understandable analysis of performance and will include an overview section and a performance analysis section.
- An accountability report incorporating three main sections:
  - corporate governance report consisting of a directors' report, a statement of the Accountable Officer's responsibilities and a governance statement
  - remuneration and staff report which will cover remuneration policy, payments to directors, staff numbers and sickness absence rates
  - parliamentary and accountability report which will include information on the regularity of expenditure and the independent auditor's report.

Appendix IV – Action Plan No. 5

48. **International Financial Reporting Standards (IFRS) 13 Fair value measurement:** sets out requirements for assets to be to be valued at fair value and is applied in full by the FReM to assets that are not held for their service potential (i.e. investment properties and assets held for sale).

49. IFRS 13 does not apply to operational assets which are in use delivering front line services or back office functions, and surplus assets with restrictions on their disposal. These will be valued in accordance with the adaptions to *IAS (International Accounting Standard) 16 property, plant and equipment.*

Outlook

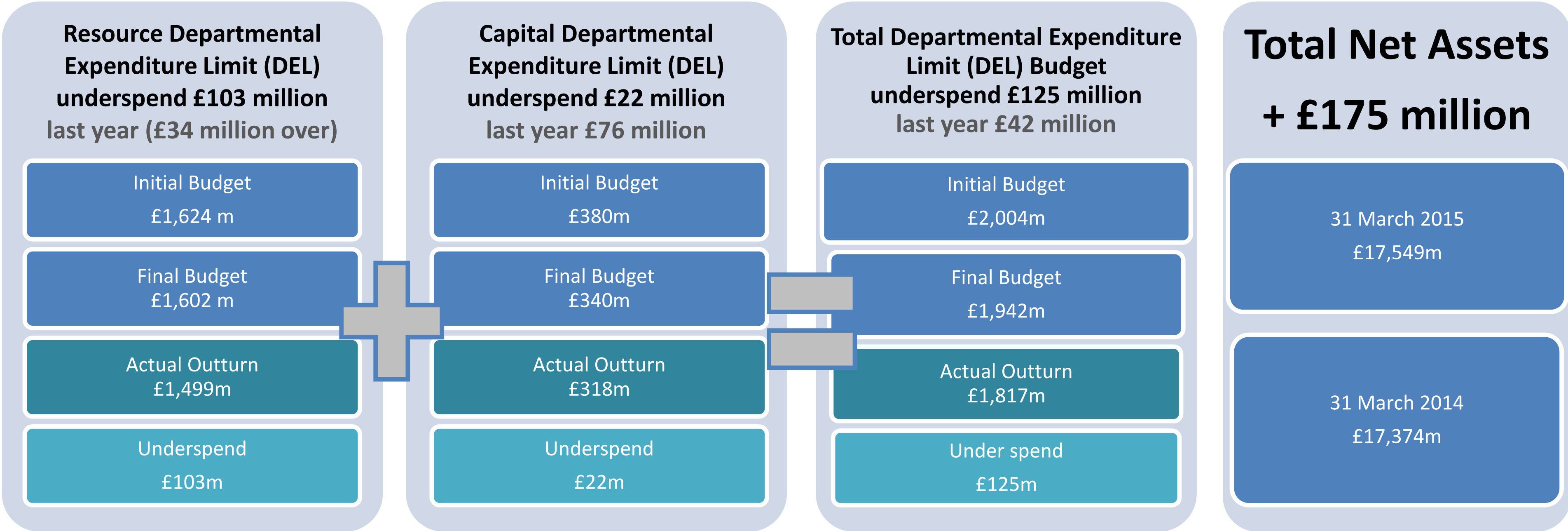
50. Following the transfer of the existing Forth Road Bridge to the Scottish Trunk Road Network, the Forth Estuary Transport Authority (FETA), previously responsible for its upkeep and maintenance, ceased its activities at the end of May 2015. Responsibility for the maintenance of the bridge transferred to Transport Scotland, with a new Forth Bridges Operating Company (FBOC) contract to undertake these responsibilities and those of the new Queensferry Crossing. The existing FETA employees transferred to the new operating company (Amey) under TUPE regulations. Transport Scotland took on the residual FETA assets and liabilities, including the existing liabilities for pensions under the Lothian Pension Fund.

51. Actuarial valuations value the pension liabilities at £5.7 million and work is underway to agree an exit payment to be paid to the pension fund, funded partly by the residual value of FETA reserves. These are currently estimated at £3.5 million and the shortfall of £2.2 million will be funded from Transport Scotland's overall budget in 2015/16.

52. The value of the existing Forth Road Bridge will also need to be reflected within the 2015/16 accounts.

Appendix IV – Action Plan No. 6

Financial management and sustainability



In addition to its resource budget above, Transport Scotland also had an Outside Departmental Expenditure Limit (ODEL) budget of £270 million for on balance sheet PFI schemes and an Annual Managed Expenditure (AME) budget of £10 million in respect of the release of provisions previously created. During 2014/15 there was an underspend on the ODEL budget of £86m and an overspend on the AME budget of £5m.

53. The main financial objective for Transport Scotland is to ensure that the financial outturn for the year is within the budget allocated by Scottish Ministers.

2014/15 financial position

54. Transport Scotland, as an executive agency of the Scottish Government, receives almost all of its funding directly from the Scottish Government.

55. The Statement of Financial Position at 31 March 2015 shows net assets of £17.5 billion. This position is largely attributable to the value of the trunk road network which is subject to an annual valuation process.

56. The financial position of Transport Scotland remains stable with the body operating within its available funding and reporting an excess of assets over liabilities, but a shortfall of current assets against current liabilities.

Financial Planning

57. As funding from the Scottish Government is Transport Scotland's primary source of income there is a greater degree of certainty over future funding streams than for some other public sector organisations who are involved in income generating activities. Therefore, the main focus for Transport Scotland is achieving a balanced financial plan to remain within their annual allocation.

58. Transport Scotland's corporate plan covers a three year period and includes a high level financial plan covering that period based on the assumed level of funding that will be available. It also sets out the cost reductions required to deliver a balanced budget for each year of the plan. Below this the annual business plan sets out how Transport Scotland will achieve their delivery commitments each year.

Financial management

59. As auditors we need to consider whether bodies have established adequate financial management arrangements. We do this by considering a number of factors, including whether:

- the director of finance has sufficient status to be able to deliver good financial management
- standing financial instructions and standing orders are comprehensive, current and promoted within the body
- reports monitoring performance against budgets are accurate and provided regularly to budget holders
- monitoring reports do not just contain financial data but are linked to information about performance
- audit and risk committee members provide a good level of challenge and question significant variances.

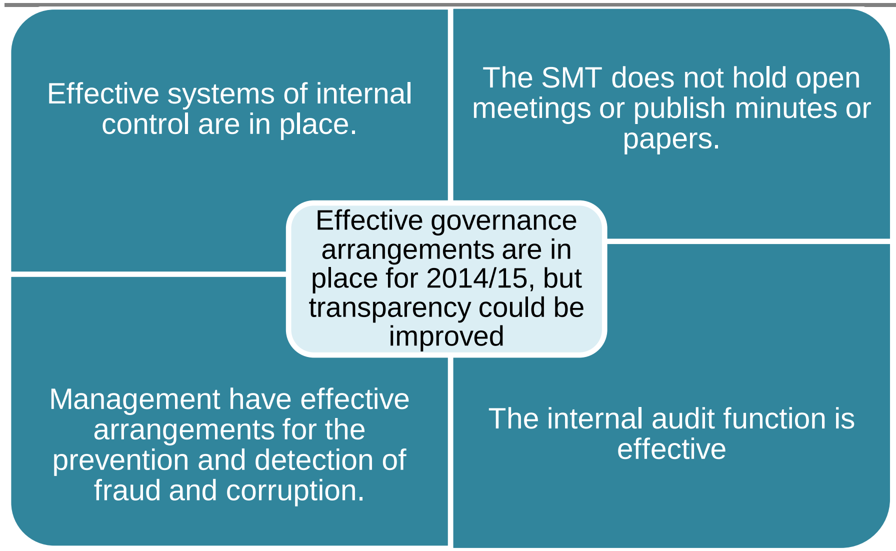
60. Based on our accumulated knowledge, our review of Senior Management Team meeting papers and through our attendance at the Audit and Risk committee we conclude that

Transport Scotland has strong financial management arrangements in place.

2015/16 budget

61. Transport Scotland has an allocated budget of £2.2 billion for 2015/16. This comprises a Scottish Government Departmental Expenditure Limit (DEL) for the year of £2.1 billion and a budget for non-DEL expenditure of £81 million. This is similar to 2014/15.

Governance and transparency



Corporate governance

62. As Transport Scotland does not have a board which operates as a decision making forum, governance of the Agency is provided by the Senior Management Team (SMT), comprising the executive directors. It also has an Audit and Risk committee. This structure reflects the primacy of Scottish Ministers in decisions on Transport Scotland activity. Key decisions are also subject to scrutiny in the Scottish Parliament.

63. The Accountable Officer is responsible for establishing arrangements for ensuring the proper conduct of the affairs of Transport Scotland and for monitoring the adequacy of these arrangements.

64. We concluded that Transport Scotland has effective overarching and supporting governance arrangements which provide an appropriate framework for organisational decision making.

Transparency

65. The Scottish Government's On Board guidance (http://www.gov.scot/Publications/2015/04/9736/0), for board members of public bodies was updated and reissued in April 2015. On Board states that boards should demonstrate high standards of corporate governance at all times including openness and transparency in decision making. It recommends boards should consider:

- holding an annual open meeting
- holding board meetings in public unless there is a good reason not to
- publishing summary reports and/or minutes of meetings
- inviting evidence from members of the public in relation to matters of public concern

- consulting stakeholders and users on a wide range of issues
- making corporate plans and the annual report widely available.

66. Audit Scotland also believes in transparency of financial reporting within the Annual Report and Accounts including:

- A clear reconciliation between expenditure and the outturn against Scottish Government Resource budgets.
- Identification and explanation of any significant movements in budget during the year.

67. Overall we concluded that Transport Scotland could improve their level of openness and transparency by implementing the recommendations made in the Scottish Government's On Board guidance applicable to executive agencies.

Appendix IV – Action Plan No. 7

Internal control

68. No material weaknesses in the accounting and internal control systems were identified during the 2014/15 audit which could adversely affect the organisation's ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

Internal audit

69. Internal audit provides the audit committee and Accountable Officer with independent assurance on the overall risk management, internal control and corporate governance processes. We are required by international auditing standards to make an assessment of internal audit to determine the extent to which we can place reliance on its work. To avoid duplication, we place reliance on internal audit work where possible.

70. As part of our risk assessment and planning process our Scottish Government audit team assessed the Scottish Government Internal Audit Division, Transport Scotland's internal auditors, and concluded that they operate in accordance with the Public Sector Internal Audit Standards (PSIAS). This enabled us to place reliance on the work of internal audit, in terms of our wider code responsibilities.

71. During 2014/15 staffing issues within the Scottish Government Internal Audit Division meant there was significant slippage in the delivery of their annual audit plan for Transport Scotland. As a result the annual assurance statement was not issued until August 2015.

Arrangements for the prevention and detection of fraud

72. Transport Scotland is responsible for establishing arrangements to prevent and detect fraud and other irregularity. We reviewed and reported on these arrangements and have concluded that there are effective arrangements for the prevention and detection of fraud.

National Fraud Initiative in Scotland

73. Transport Scotland participates in the National Fraud Initiative (NFI) through the Scottish Government Payroll Division. 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.

74. As the Scottish Government does not hold a separate record of data matches relating specifically to Transport Scotland, we have not been able to establish the number of data matches identified for investigation. However, the Agency has not been notified of any issues by the Scottish Government in relation to their matches.

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

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

Correspondence referred to the auditor by Audit Scotland

76. As part of our wider Code responsibilities we are required to consider issues raised and follow these up as part of our risk based approach to the audit if they fall within our remit.

77. Early in 2014/15 we received an item of correspondence from a member of the public raising concerns about the process for releasing grant payments to City of Edinburgh Council for the Scottish Government's contributions to the trams project. Following review of the relevant supporting documentation we confirmed that applications for payments were appropriately authorised and in accordance with the minute of agreement.

Best Value and value for money

Arrangements for securing Best Value

78. Accountable officers have a specific responsibility to ensure that arrangements have been made to secure Best Value.

79. During 2014/15 Transport Scotland conducted a best value self-assessment of Efficiency using Audit Scotland's best value toolkit. This identified that the agency has implemented sound practices and has a solid basis on which to build. However, it was also felt that there are a number of areas where improvements could still be made which will be addressed going forward.

80. In 2015/16, management intend to revisit their best value reviews of Financial Management and Governance Reports to test whether the changes and improvements previously proposed have been successfully implemented and to identify any further areas for improvement. They will also undertake a further best value review self-assessment of People Management.

81. From review of Transport Scotland's programme of best value self-assessments we consider this demonstrates a systematic approach to self-evaluation and continuous improvement.

Local performance audit reports

Review of ScotRail passenger franchise bid evaluation process

82. During 2015/16 we conducted a high-level review of the financial and qualitative evaluation process undertaken to award the ScotRail passenger franchise.

83. Our review of the financial evaluation did not identify any weaknesses in the bid evaluation process which could have impacted upon the decision to award the ScotRail passenger franchise contract to Abellio and we were satisfied that the decision to award the franchise to Abellio was consistent with the combined price and qualitative assessment, and the criteria set out in the Invitation to Tender.

84. During the course of our review we also identified a number of areas that we considered good practice which we felt could be applied to other procurement exercises.

National performance audit reports

85. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. During 2014/15, a number of reports were issued as outlined in Appendix III. One of these

reports was the review of the Scottish Government's purchase of Glasgow Prestwick Airport. The key messages from this report are detailed below.

Scottish Government's purchase of Glasgow Prestwick Airport

86. The report identified that the process followed by the Scottish Government in its purchase of Glasgow Prestwick Airport was reasonable within the timescale, and that it now has to develop comprehensive plans to map out potential future development of the airport.

87. Transport Scotland was an important participant in the purchase of the Airport as part of a multi-agency working group, which consisted of the Scottish Government, Transport Scotland, Scottish Enterprise, Scottish Development International and the three Ayrshire councils (East, North and South Ayrshire), to support potential private sector buyers. This is cited as a good example of a number of public bodies working together to achieve a common goal. The Scottish Government's decision was supported by a business case developed by Transport Scotland.

88. The report recommended that public bodies:

- Use a checklist, developed by Audit Scotland, to help inform their approach to future investment decisions.
- Make sure that they have appropriate skills for the preparation of business cases. This should include the ability to challenge the findings provided by external advisers.
- Ensure for any future investment decisions that they fully evaluate all potential risks, quantify the impact these are likely to have, and include this impact in their financial projections.

89. The report also highlighted that a clear strategy should be put in place, which takes into account future development potential, and includes robust business and financial plans, full evaluation of potential risks, and a well-defined, regularly reviewed exit strategy.

Appendix I – Significant audit risks

The table below sets out the audit risks identified as part of our planning process, how we addressed each risk, and our judgement in arriving at our opinion on the financial statements.

Audit Risk	Assurance procedure	Results and conclusions
Risk of material misstatement in the financial statements		
Accounting for Public Private Partnership: The FReM requirements for the recognition of PPP assets have been brought in line with the recognition criteria for all other assets. *There is a risk that capital expenditure up to 31 March 2015 on PPP projects which are still at the build phase will not be accurately recognised within the 2014/15 accounts.*	• We reviewed the completeness and valuation of the assets under construction balance as part of the financial statements audit.	As reported at paragraph 26, the amount recognised as assets under construction, and the related payables balance, in the unaudited accounts has been overstated by £27 million. Management consider that this amount is not material to the financial statements and has not adjusted for this in 2014/15 so this has been recorded as an unadjusted misstatement.
Prestwick Holdco receivables balance: The value of the loans to Prestwick Holdco Limited, and the accrued interest, at 31 March 2015 will require to be recognised in the Statement of Financial Position for 2014/15. *There is a risk that the value of the receivables balance will be incorrectly stated in the 2014/15 accounts.*	• We reviewed the value of the outstanding balance, and the related interest calculation, as part of the financial statements audit.	As at 31 March 2015 loans totalling £10.8 million (£4.5 million in 2013/14 and £6.3 million in 2014/15) have been provided to Prestwick Holdco Limited. As part of the financial statements audit we confirmed that these were included in the Statement of Financial Position.

Audit Risk	Assurance procedure	Results and conclusions
Complexity of trunk road network valuation: The process used to produce the trunk road network valuation for the accounts involves the application of indexation rates and a number of other adjustments to the data produced from the RAVs database. *There is an inherent risk of material misstatement in the trunk road network valuation due to the complexity of the valuation process.*	• We verified the application of the indexation rates and investigated other significant movements in the trunk road network valuation as part of the financial statements audit.	As reported at paragraph 25, an adjustment has been made in the audited financial statements to reflect the 2014/15 quarter 4 Baxter index figure. However, no other issues were identified with the application of the indexation rates used in the annual trunk road network valuation.
Revaluation Reserve adjustment: No amount was released from the revaluation reserve in 2013/14 to represent the element of in-year depreciation charge or disposals on the Roads Asset Valuation System (RAVS) that is attributable to revaluation. *There is a risk that the revaluation reserve balance may be overstated in the 2014/15 accounts.*	• We reviewed the basis of the calculation performed by Atkins Limited to identify the required adjustment for 2014/15.	As reported at paragraph 27, management identified that the calculation did not take into account that £497 million had been charged to the revaluation reserve for write downs on completed schemes. Therefore, the calculation was adjusted to reflect this and a transfer of £42 million from the revaluation reserve to the general fund has been made in the audited financial statements to bring this in line with the calculated value.

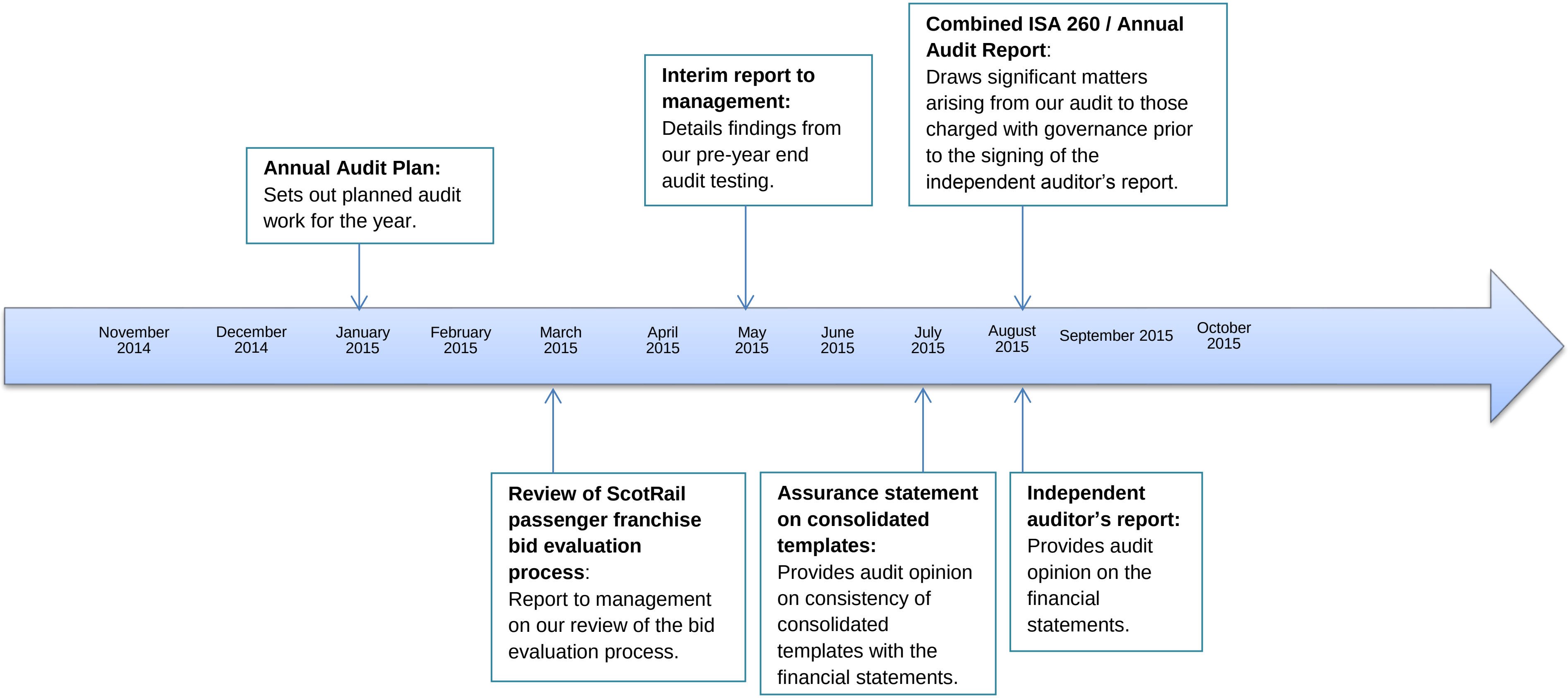
Audit Risk	Assurance procedure	Results and conclusions
Damage claims: During 2013/14 Transport Scotland wrote-off £1.8 million of irrecoverable debt for claims for damage to the trunk road network. *There is a risk that the damage claims receivables balance will be overstated in the 2014/15 accounts.*	• We assessed the effectiveness of the revised arrangements put in place to pursue and monitor damage claim debt. • We reviewed the appropriateness of the provision for impairment of damage claim debt included in the 2014/15 accounts.	We were satisfied with the arrangements put in place to pursue and monitor damage claim debt and the appropriateness of the provision for impairment of damage claim debt calculated. However, as reported at paragraph 28, the journal to create the provision had been incorrectly posted so this was not reflected in the unaudited accounts. Management have identified that this amount is not material to the financial statements and have not adjusted for this in 2014/15 so this has been recorded as an unadjusted misstatement.
Identification and assessment of the Risks of Material Misstatement due to fraud in revenue recognition: There has been a history of fraudulent activity in the area of concessionary fares across the UK resulting in legal action against some bus operators. *There is a residual risk to income/net expenditure in this area.*	• We reviewed the results of internal audit's work in this area with reference to issues identified by other UK audit agencies.	We are satisfied that sufficient arrangements are in place to reduce the risk of fraud through the concessionary travel scheme.

Audit Risk	Assurance procedure	Results and conclusions
Additional account areas for testing: Our preliminary analytical review of the Agency's 2014/15 budget identified that budgeted expenditure for both Support for Sustainable and Active Travel and Scottish Futures Fund Indirect Capital have increased significantly from the prior year. *There is a risk that any errors in these areas would result in a material misstatement in the 2014/15 accounts.*	• We reviewed the level of expenditure for both these areas when determining our 2014/15 testing strategy.	As neither expenditure stream was a material account area in 2014/15 no verification testing of these areas was undertaken as part of our financial statements audit.
Accounting estimates: Transport Scotland's Statement of Financial Position as at 31 March 2014 contained a non-current asset balance of £17.1 billion relating to the Road Network, £0.6 billion for Assets Under Construction and a provisions balance of £126 million. *As these amounts contain estimation uncertainty there is an increased risk of material misstatement related to their susceptibility to unintentional or intentional management bias.*	• We assessed the impact of applying the quarter 4 Baxter factor on the value of the trunk road network. • We substantively tested year-end accruals.	As reported at paragraph 25, an adjustment has been made in the final version of the accounts to reflect the 2014/15 quarter 4 Baxter index figure. As reported at paragraphs 30-32, a number of overstated and understated accruals were identified through testing. As these were not material to the financial statements these were reported as unadjusted misstatements.

<table>
<tr><th>Audit Risk</th><th>Assurance procedure</th><th>Results and conclusions</th></tr>
<tr><td>Risk of management override of controls:
Management have the ability to override controls.
There is an inherent risk that management manipulate accounting records and prepare fraudulent or biased financial statements by overriding controls that otherwise appear to be operating effectively.</td><td>• Detailed testing of journal entries.
• Review of accounting estimates.
• Evaluation of significant transactions that are outside the normal course of business.</td><td>Through the assurance procedures undertaken we did not identify any attempt by management to manipulate the financial position through the override of controls.</td></tr>
<tr><td colspan="3">Audit risks from wider responsibilities under Audit Scotland’s Code of Audit Practice</td></tr>
<tr><td>Scottish passenger rail franchise:
A significant part of Transport Scotland’s annual expenditure is incurred on the ScotRail Franchise through monthly contract payments. This contract has been retendered and a new operator commenced from 1 April 2015.
An auditor has a duty under auditing standards to understand the business. A significant part of Transport Scotland’s annual expenditure is incurred on the ScotRail Franchise through monthly contract payments. There is a risk that any issues with the regularity of the contract letting process will affect the regularity of future contract payments.</td><td>• We conducted a high level review of the financial and qualitative evaluation process undertaken for the ScotRail passenger franchise to provide assurance that the decision to award the contract to Abellio was soundly based.</td><td>As reported at paragraph 83, our review of the financial evaluation did not identify any weaknesses in the bid evaluation process which could have impacted upon the decision to award the ScotRail passenger franchise contract to Abellio and we were satisfied that the decision to award the franchise to Abellio was consistent with the combined price and qualitative assessment, and the criteria set out in the Invitation to Tender.</td></tr>
</table>

Audit Risk	Assurance procedure	Results and conclusions
Prestwick Airport: The Scottish Government purchased Prestwick Aviation Holdings Ltd (the company which owned Prestwick Airport) for £1 in November 2013. Transport Scotland was the key Agency involved in preparing/assessing the business case for the purchase and has an ongoing governance role in the operation of the airport. *As this intervention is unusual there is a risk that the reasons and process for purchase and future development are not robust.*	• During 2014/15 we reviewed the process for purchasing Prestwick Airport. • We reviewed key Scottish Government documents including the business case and plan for the purchase, other information used to inform the purchase such as due diligence checks, and business plans for the development of Prestwick Airport. • We reviewed the financial plans to identify key changes in assumptions since the acquisition. • We interviewed representatives from the Scottish Government (including Transport Scotland) and Prestwick Airport.	As reported at paragraph 86, the report identified that the process followed by the Scottish Government in its purchase of Glasgow Prestwick Airport was reasonable given the timeframes and our National report makes a number of recommendations.

Appendix II – Summary of local audit reports 2014/15



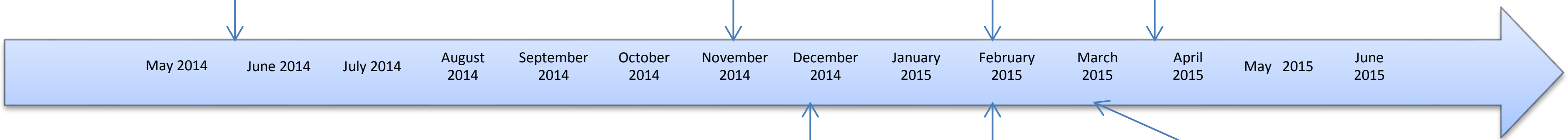
Appendix III – Summary of national reports 2014/15

Scotland's public finances - a follow-up audit: Progress in meeting the challenges -Provides a high-level update on the financial position and on how public bodies are meeting the challenges of reduced public spending.

Community planning: Turning ambition into action - Provides a national update on community planning in Scotland since March 2013. The report assesses progress locally and nationally and identifies opportunities for further improvement.

Superfast broadband for Scotland: a progress report: assesses whether the Scottish Government and HIE have clear plans and arrangements in place to build their superfast broadband network in Scotland.

Update on developing financial reporting - reviews the principles of public financial management and provides an update on the actions the Scottish Government is taking to further develop financial reporting.



Preparations for the implementation of the Scotland Act 2012: Reports progress in preparing for the Land and Buildings Transaction Tax (replacing the current stamp duty arrangements), Scottish Landfill Tax and other financial powers for the Scottish Government from 1 April 2015.

The Scottish Government's purchase of Glasgow Prestwick Airport: Assesses if the Scottish Government's approach to the purchase of Glasgow Prestwick Airport was reasonable, considers the future plans for the airport's development and the governance arrangements that have been put in place.

Commonwealth Games 2014: third report: third report on the Games. The overall aim was to answer the question: Was the Commonwealth Games 2014 delivered within budget and is it achieving value for money?

Appendix IV – Action plan

No.	Paragraph	Issue/Recommendation	Management action/response	Responsible officer	Target date
Financial audit Issues					
1.	25	**Baxter Index and unaudited accounts adjustments.** The unaudited financial statements were provided to audit on 12 June. The Q4 Baxter index value isn't known until mid-June each year so the figure for Q3 is used to produce the unaudited accounts. This results in a material change to the unaudited financial statements most years. Consideration should be given to this issue in the timetabling of the process to deliver the financial statements in 2015/16 and whether the information can be obtained sooner or whether the unaudited financial statements should be submitted later.	We will review whether the Q4 Baxter index can be provided earlier but highlight this is not something we can influence. We will also consider rescheduling production of draft accounts to allow the Q4 index to be reflected. If we are unable to advance receipt of the data for the Q4 index or agree an achievable extension we suggest we continue with the current arrangements whereby the Q3 index is used to produce the unaudited statements and if Q4 index results in a material movement we adjust the accounts during the audit process as in previous years.	Financial Controller	30 November 2015

No.	Paragraph	Issue/Recommendation	Management action/response	Responsible officer	Target date
2	27	**Revaluation reserve adjustments.** Each year an amount should be released from the revaluation reserve to represent the element of the in-year depreciation charge on the trunk road network that is attributable to revaluation. Following a review in 2014/15 Transport Scotland has been able to identify the adjustments from RAVS and for the write downs on completed road schemes. As this calculation will need to be undertaken each year Transport Scotland should ensure that Atkins can continue to provide the RAVs report as part of the year-end working papers, and that they maintain a list of write downs on completed schemes.	We will confirm that Atkins will continue to be able to produce the revaluation reserve report for the remainder of their period as contractor and will specify this as a requirement for the replacement contract. We will continue to maintain the schedule of amounts charged to the revaluation reserve in respect of write downs each year.	Financial Controller	31 May 2016
3.	28	**Provision for impairment of the trunk road damage claims debtor balance** There is no provision for impairment of the trunk road damage claims debtor balance included in the 2014/15 accounts. A provision for impairment should be created in 2015/16.	We will reflect any required provision in future accounts. The provision was calculated for 2014/15 but incorrect coding was used. We will ensure training and clarification of coding is implemented for future accounts.	Senior Financial Accountant	31 May 2016

No.	Paragraph	Issue/Recommendation	Management action/response	Responsible officer	Target date
4.	29	**Contingent asset recognised as a debtor** A receivables balance was recognised within the 2014/15 accounts for the cost of remedial work to Buchanan House that Transport Scotland anticipate will be recovered from the contractor under the terms of the original collateral warranty. We consider that this should be treated as a contingent asset. The accounting treatment should be revisited in 2015/16 in light of the outcome of the current court action.	We will review the accounting treatment in light of the outcome of the court action in the course of 2015/16.	Senior Financial Accountant	31 May 2016
5.	47	**Future changes to the financial reporting framework** The 2015/16 FReM has been extensively re-written and includes significant changes to the form and content of the annual report and accounts. Transport Scotland should review the revised requirements to identify the impact upon their 2015/16 financial statements.	We will review the revised requirements and reflect their impact in the 2015/16 financial statements. We review the FReM each year as a matter of course and note and action any changes. We have already commenced work with colleagues in Communications and Business Improvement to take forward the anticipated changes and prepare for 2015/16 accounts process.	Senior Financial Accountant	31 May 2016

No.	Paragraph	Issue/Recommendation	Management action/response	Responsible officer	Target date
6.	50-52	**Transfer of assets and liabilities from FETA** The Forth Estuary Transport Authority (FETA) ceased operating in June 2015 with its staff transferring to the new Forth Bridge Operating Company (FBOC) and Transport Scotland taking on the residual assets and liabilities of FETA. Transport Scotland should ensure that appropriate arrangements are in place to account for these assets and liabilities in 2015/16.	We will ensure that appropriate arrangements are in place to account for the residual assets and liabilities of FETA in 2015/16.	Financial Controller	31 May 2016
Wider audit issues					
7.	65-67	**Scottish Government's On Board guidance.** Transport Scotland should implement the recommendations made in the Scottish Government's On Board guidance applicable to executive agencies.	We will ensure that the recommendations of the On Board guidance are adopted. Where appropriate, the recommendations will be adapted to reflect the governance structure of Transport Scotland whilst maintaining the highest standards of governance.	Director of Finance	31 March 2016