Update on developing financial reporting

AUDITOR GENERAL

Prepared by Audit Scotland
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Auditor General for Scotland

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

Introduction

1. The framework for Scotland's public finances is undergoing fundamental change. The Scotland Act 2012 introduces new financial powers for the Scottish Parliament from April 2015, and the Smith Commission Agreement will lead to further financial devolution in future.[1]

2. In 2013, we published *Developing financial reporting in Scotland* [PDF], which highlighted the importance of comprehensive, transparent and reliable financial reporting for accountability and decision-making.[2] We reported that while the audited accounts of public bodies across Scotland provide a sound base for financial reporting and scrutiny, there is no single complete picture of the devolved public sector's finances. In a fast changing environment, this report reviews the principles of public financial management and provides an update on the actions the Scottish Government is taking to further develop financial reporting.

The environment for public finances in Scotland is changing

3. The public sector in Scotland provides vital public services, including education, health and care services for people at all stages of their lives. It also invests in the skills and infrastructure needed for sustainable economic growth. Delivering these services involves the use of substantial amounts of public money – a Scottish budget of about £37.5 billion for 2015/16.[3] Public finances are under increasing pressure, with the money available for public services falling while demand for services is increasing.[4]

4. The Scottish Government operates as a devolved administration within a wider UK context. From this year, the environment for public finances in Scotland is changing substantially. The Scotland Act 2012 introduces new financial powers for the Scottish Parliament that will increase fiscal autonomy and strengthen accountability:

- From 1 April 2015, new devolved taxes on land and buildings transactions and disposing waste to landfill, and new borrowing and cash management powers.
- From 1 April 2016, new powers to set a Scottish rate of income tax.

5. These changes will bring closer links between the Scottish Government's policy decisions and the income generated through taxation. The powers in the Scotland Act 2012 are estimated to increase the revenues in which the Scottish Parliament and councils have a direct say from about £4 billion to about £9 billion.[5] From 2016, approximately 21 per cent of devolved expenditure will be funded from amounts raised directly in Scotland from taxation.[6] This includes amounts raised from Council Tax and Non Domestic Rates (NDR), from the Land and Buildings Transaction Tax and the Scottish Landfill Tax, and from the Scottish rate of income tax.

6. Draft clauses to implement the measures agreed by the Smith Commission were published in January 2015.[7] These clauses include changes to Scottish taxation, that would further increase the percentage of the Scottish budget raised directly in Scotland from taxation. The draft clauses also set out changes to the welfare system and further financial responsibilities.

7. As currently proposed, these changes would mean the Scottish budget will incorporate an estimated further £12 billion of revenue raised in Scotland, increasing this to about £21 billion.[8] The Scottish Parliament's spending responsibility is expected to increase from £37.5 billion to about £40 billion each year (Exhibit 1).

Exhibit 1

Smith Commission proposals and the potential implications for Scotland's finances

Revenues

Estimated increase in collected and assigned revenues of about **£12bn**, from:

- The power to set income tax rates and bands on earned income and to retain the tax collected from Scottish taxpayers.
- Devolving further taxes to the Scottish Parliament (to replace the UK-wide air passenger duty and aggregates levy).
- Assigning a share of the Value Added Tax (VAT) collected in Scotland to the Scottish Government's budget.

Spending

Responsibility for benefits worth an estimated **£2.5bn**, including:

- Long-term disability and sickness benefits
- Benefits for older people (eg, Winter Fuel Payment)
- UK Government's Work Programme (to support people into work)

Note: The estimated increases in revenues and spending are based on figures in *Government expenditure and revenue Scotland 2013/14*, Scottish Government, March 2015.

Source: Audit Scotland

8. These changes provide the Scottish Parliament with more control over Scotland's public finances and opportunities for new approaches, but they also bring new financial risks. Revenues from taxes and spending on welfare benefits can be volatile, and both can be difficult to predict. In future, the performance of the Scottish economy will have a bigger impact on the Scottish public finances than it has in the past. An understanding of the overall financial position in Scotland is essential, as is a clear understanding of the components of funding and spending and the impact of fiscal decisions.

Transparent financial reporting is more important than ever

9. The case for comprehensive, transparent, reliable and timely financial reporting has always been compelling. It is crucial to show that public money is used properly and effectively. Clear reporting of government finances, in particular tax revenues and spending, is at the heart of financial transparency (Exhibit 2, page 5).

Exhibit 2
The importance of financial transparency

What is financial transparency...

Comprehensive
Information about the past, present and future finances of the devolved Scottish public sector, in particular tax revenues and spending.

Transparent
Information that is clear, easy to find, and understandable.

Reliable
Information that is independently audited or verified and provides a true picture of the financial position (what is owned and owed).

Timely
Information that is published regularly and is as up-to-date as possible.

Why it is important...

Decision-making
Provides evidence and detail for Parliament, government and public bodies to base decisions on.

Accountability
Enables the government and public sector bodies to be held accountable for their decisions.

Confidence
Provides the public and investors with trust in the decisions of government.

Source: Audit Scotland

10. Financial risks, uncertainties and the quickly changing environment for public finances mean that the case for financial transparency has never been stronger. Difficult decisions need to be made about investment, spending, borrowing and tax-raising, and the public services that they pay for. It is important that the public are able to understand the public finances so that they can be involved in these choices.

11. Transparency will help Scottish ministers, public bodies and others decide how best to use the money available to them, and allow them to be held to account for how the money is used. An overall picture of the financial position, what is owned (assets), what is owed (liabilities), and the composition of annual funding and spending, is essential to understand and manage the risks to financial sustainability. Financial transparency also supports effective Parliamentary scrutiny.

12. The Smith Commission report recommended that the Scottish Parliament should seek to expand and strengthen the independent scrutiny of public finances in Scotland. It also stated that the devolution of further powers to the Scottish Parliament should be accompanied by an updated fiscal framework for Scotland, agreed between the Scottish and UK governments.[9] A financial reporting framework that provides transparency over the public finances in Scotland is an essential component of this. Other critical elements of public financial management such as forecasting and budgeting, parliamentary scrutiny and the management of risk will also require further development.

Principles of good financial reporting

13. Public reporting of financial information can take a number of forms, including audited annual accounts, budget documents, published plans, and statements to Parliament. Budget documents and financial reports should be comprehensive, transparent, timely and reliable. This helps ensure that public bodies have an accurate picture of their financial position; their financial prospects; the long-term costs and benefits of any policy decisions and changes; and the potential risks that they may encounter. It also provides public bodies, ministers and taxpayers with the information they need to understand the financial position and to hold the government to account. The greater fiscal responsibility that a government has, the greater the need for transparency on how much public money it has raised, and how it has spent and invested it.

14. The International Monetary Fund (IMF) produces reports and evaluations demonstrating the importance of transparent financial reporting. Its Fiscal Transparency Code includes the following elements:[10]

- Fiscal Reporting – fiscal reports should provide a comprehensive, relevant, timely and reliable overview of the government's financial position and performance.
- Fiscal Forecasting and Budgeting – budgets and their underlying fiscal forecasts should provide a clear statement of the government's budgetary objectives and policy intentions, and comprehensive, timely, and credible projections of the evolution of public finances.
- Fiscal Risk Analysis and Management – governments should disclose, analyse and manage risks to the public finances and ensure effective coordination of fiscal decision-making across the public sector.

15. The Scottish Government and other public sector bodies in Scotland already demonstrate good and advanced practice in many areas (Exhibit 3, page 7). The Code provides a helpful reference for the Scottish Government to consider as it further develops its financial reporting to reflect increased fiscal responsibilities in a devolved context. Information could be enhanced to show clearly things such as:

- how the different elements of funding (such as block grant, devolved taxation, borrowing) support total spending
- how the performance of the economy is affecting current and future budgets
- the financial position of the Scottish public sector as a whole.

Consolidated Scottish public sector accounts would provide a better understanding of the financial position

16. The Public Finance and Accountability (Scotland) Act 2000 requires public bodies that allocate money and provide services to produce annual accounts. Scottish public sector bodies demonstrate good practice in the way that they prepare their accounts. The Scottish Government's consolidated accounts include its core portfolios and executive agencies, the Crown Office and Procurator Fiscal Service and NHS bodies. Clean audit opinions have been issued in each of the last nine years on the Scottish Government's consolidated accounts and qualified auditors' opinions on the accounts of other public bodies in Scotland are rare. The audited accounts of the Scottish Government and other public bodies therefore provide a good starting point for understanding their financial position.

What they do not show is the overall position of the devolved Scottish public sector as a whole, including the balance between funding and spending and the overall level of borrowing.

17. The Public Finance and Accountability (Scotland) Act 2000 gives ministers the power to prepare consolidated accounts for any financial year for the 'Scottish Administration together with such bodies and office holders… as they may designate'. Consolidated accounts for the whole of the Scottish public sector would help provide an overall picture of the financial position. In the absence of easily accessible, aggregate information in one place on what the Scottish public sector owns (assets acquired from taxes) and owes (liabilities due in the short or long term that will have to be met from future taxes) overall, it is difficult for the Scottish Parliament, taxpayers and others to get a full picture and understanding

Exhibit 3

Fiscal transparency through financial reporting: examples of good practice in the Scottish public sector

Good practice

- Accounts are prepared on an accruals basis (ie, revenues and expenditure are recognised when the transaction occurs rather than when the money is paid or received).
- The Scottish Government's consolidated accounts provide a comparison between the budget approved by the Scottish Parliament and the subsequent actual income and expenditure.
- Scottish public sector bodies' audited accounts are presented to the Scottish Parliament each year, within nine months of the financial year end. Separate but similar arrangements exist for local government bodies.
- The Scottish Government's budget documents are prepared on an accruals basis, which makes it easier to compare the budget and actual spend.
- The Scottish Government set up the Scottish Fiscal Commission to independently scrutinise and report on its tax forecasts.
- The Scottish Government published revenue forecasts for the devolved taxes in the draft budget for 2015/16, along with a separate paper outlining the methodology used. The Scottish Fiscal Commission's report on the forecasts was published at the same time.

Advanced practice

- Accounts are prepared to International Financial Reporting Standards (IFRS).
- Accounts are audited by independent auditors who give assurance that the figures show a true and fair picture of how the money was used.
- The Scottish Government's audited consolidated accounts are presented to the Scottish Parliament each year, usually within six months of the financial year end.
- The Scottish Government presents a draft budget to the Scottish Parliament six months prior to the start of the financial year. The budget is then approved by the Scottish Parliament two months before the start of the financial year.

Source: Audit Scotland

about where money is spent and the longer-term implications for public finances. This type of information is also essential to those making decisions about public finances.

18. For example, if parts of the Scottish public sector built up debts that were not affordable this would potentially place a financial burden on the Scottish Government or other parts of the public sector. This might be the direct cost of servicing those debts or other costs of securing key public services. While there are clear differences in the organisation of government and financial circumstances between Spain and Scotland, in Spain, poor information about the total borrowing of regional governments contributed to the crisis for the public finances as a whole.

19. The balance sheet provides a snapshot of the financial position of an organisation at a point in time and is an important element in financial reporting.[11] In public finances, the position at a point in time is helpful but the most valuable insight comes from an analysis of trends in assets and liabilities over time. This provides essential information about the impact of past decisions on the financial position and implications for future budgets, which in turn highlights potential risks to financial sustainability. Public sector consolidated accounts would provide a whole system balance sheet for the Scottish public sector, increasing the level of transparency and insight over the appropriate use of finances.

20. It is important to emphasise that the audited accounts of the Scottish Government and other public bodies are, and will continue to be, a vital element for the accountability of different parts of the public sector. Aggregate financial information that provides an overall picture of the devolved Scottish public sector would in no way diminish these well-established accountability arrangements.

The Scottish Government is further developing its approach to financial reporting

21. Financial reporting is well established in the Scottish Government and across the individual bodies that make up the Scottish public sector, including NHS boards and councils. With the implementation of the Scotland Act 2012 and the further powers that are expected to flow from the agreement set out in the Smith Commission report, the Scottish Government acknowledges the need to review and build on how it currently manages and reports its finances.

22. The Scottish Government has also recognised the benefits of a full understanding of the overall financial position and the associated risks and opportunities. It is building on current good practice to further develop its approach to financial reporting. In December 2014, the Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy told the Scottish Parliament's Finance Committee that he has asked officials to develop proposals to improve and enhance financial reporting.[12]

23. The Scottish Government is assessing various options for developing financial reporting through its Fiscal Capability 2015 programme, which is one of the four programmes of work overseen by the Fiscal Responsibility Steering Group (Exhibit 4, page 9). The continued development of financial reporting will help improve fiscal transparency.

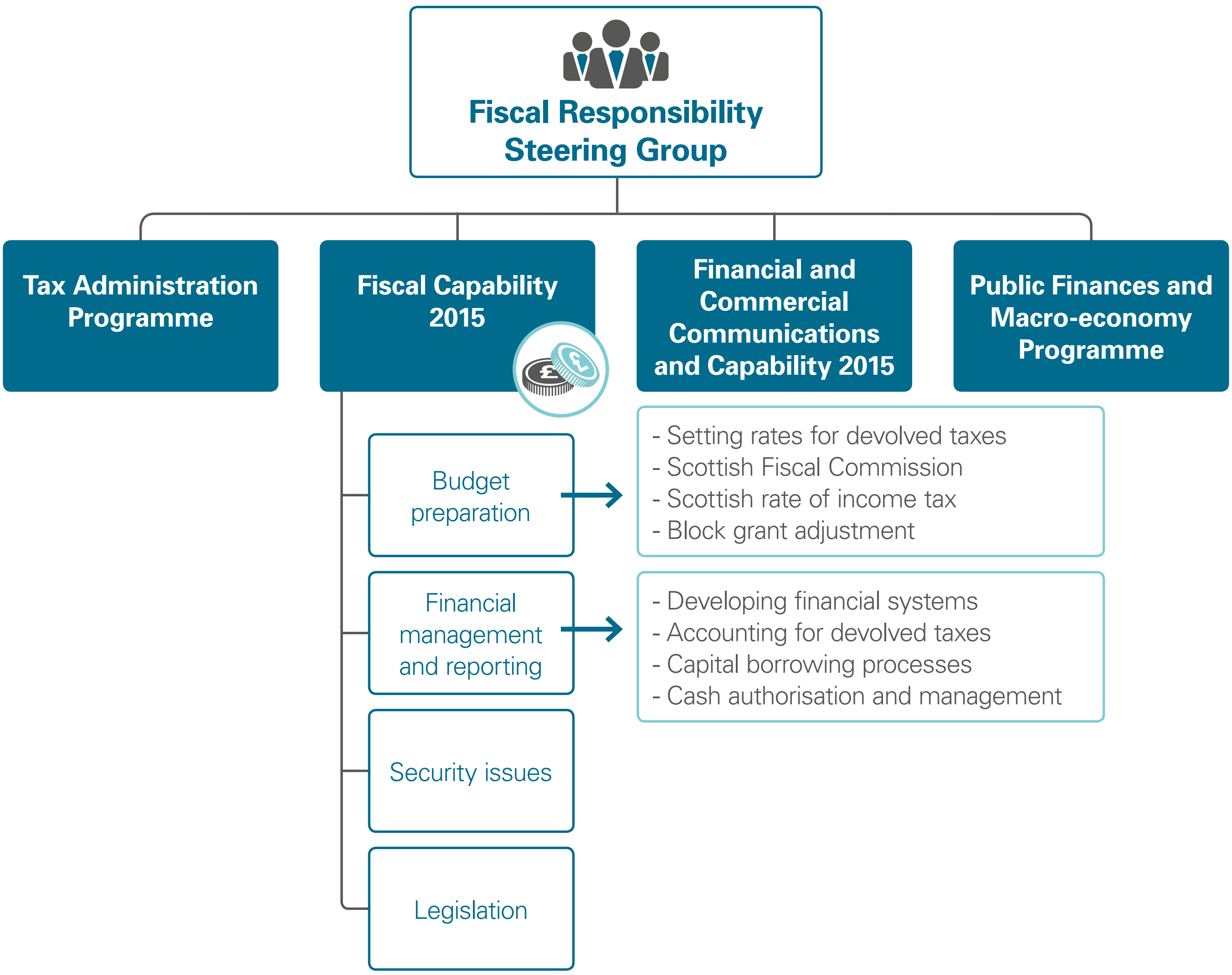
24. In 2014, the Scottish Government set up an independent body, the Scottish Fiscal Commission, to scrutinise and report on tax forecasts included in its draft budget for 2015/16. The Scottish Fiscal Commission's reports are intended to provide the Scottish Parliament and taxpayers with independent assurance that the forecasts are soundly based and reasonable. The Scottish Fiscal Commission published its report at the same time as the draft budget. The Scottish Government has announced its intention to bring forward legislation during 2015/16 to establish the Scottish Fiscal Commission on a statutory basis.[13]

25. The Scottish Government has acknowledged the increasing importance of good economic forecasting as part of its budget process. The UK Government's tax forecasts are independently prepared by the Office for Budget Responsibility (OBR). The Scottish Government's tax forecasts are prepared by economists within the Scottish Government and are quality assured by the Office of the Chief Economic Advisor. The Scottish Government published revenue forecasts for the devolved taxes in the draft budget for 2015/16, along with a separate paper outlining the methodology used.

Exhibit 4

The Scottish Government's Fiscal Capability 2015 programme

The Scottish Government established the Fiscal Capability 2015 programme in May 2014 to oversee the implementation of devolved fiscal powers.



Source: Scottish Government

Conclusion

26. The case for comprehensive, transparent, reliable and timely reporting of public finances, as part of a strong fiscal framework, has never been stronger. It supports fiscal transparency and is essential for a clear understanding of financial opportunities and risks. This in turn informs decisions about how public money is used to deliver services. Fiscal transparency is increasingly important because of the continuing changes to Scotland's public finances. The Smith Commission agreement has far-reaching consequences for public finances in Scotland, and further underlines the need for strong financial reporting.

27. The Scottish Government, and the Scottish public sector generally, have a good record of financial management and reporting. The Scottish Government has continued to improve and develop its reporting framework since we reported in July 2013. We welcome the Scottish Government's plans to further develop its financial reporting.

28. The Scotland Act 2012, and the changes anticipated to flow from the Smith Commission Agreement, mean the Scottish Government will be responsible for generating more of its revenue, and will have more responsibilities in terms of spending. The Scottish Government's budget will become more dependent on Scotland's economic performance. The amount the Scottish Government raises through taxation and spends on welfare will be affected by its policy decisions. This means that the Scottish Government will have more control over, and responsibility for, its finances. It has recognised the need to further develop its budget documents and annual accounts to reflect these new responsibilities.

29. The Smith Commission agreed that the Scottish Parliament should 'seek to expand and strengthen the independent scrutiny of Scotland's public finances in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budgeting process'. An important part of this will be scrutiny of economic forecasts and the increasing link between economic activity and Scottish Government revenues and spending. This report highlights that transparent financial reporting of the public finances in Scotland is also an essential component of an updated fiscal framework for Scotland. As the Scottish Parliament seeks to expand and strengthen scrutiny, it will be critical that this is underpinned by comprehensive and reliable financial information. This will lay the foundations for sustainable public finances and help the Scottish Government make policy decisions that are affordable in the long term. It will improve scrutiny, giving the Scottish Parliament and taxpayers the tools required to understand the Scottish public sector's finances and Scottish Government policy decisions. Developing a good fiscal reporting framework is fundamental to ensuring appropriate accountability in Scotland as more powers are devolved.

30. The Scottish Government now needs to set out details of how it proposes to further improve and enhance its financial reporting in this changing financial environment. We are committed to playing our part in helping Scotland develop a high-quality fiscal framework that reflects the Scottish Parliament's growing financial autonomy and the opportunities and challenges of the future. We will continue to monitor progress and report publicly as the Scottish Government develops its plans and as the new financial powers are introduced. We also continue to support the independent scrutiny of Scotland's public finances through all of our work.

Endnotes

1 Following the referendum on Scottish independence in September 2014, the UK Government established the Smith Commission to consider what further powers should be devolved to the Scottish Parliament. *Report of the Smith Commission for further devolution of powers to the Scottish Parliament*, The Smith Commission, November 2014.

2 *Developing financial reporting in Scotland* [PDF], Audit Scotland, July 2013.

3 Public bodies' spending is also supported by fees and charges, council tax and grants in addition to amounts provided for in the Scottish budget.

4 The Scottish Government's Departmental Expenditure Limit (DEL) is the element of the Scottish budget that covers programme expenditure and running costs. The Scottish Government's total DEL budget will decrease by ten per cent in real terms between 2010/11 and 2015/16, from £31 billion to £28 billion. Looking ahead, finances remain tight. Most public bodies anticipate further reductions, with estimates indicating a four and five per cent reduction in 2016/17 and 2017/18 respectively.

5 The increase in revenues is as a result of the introduction of two devolved taxes (Land and Buildings Transaction Tax and Scottish Landfill Tax) in April 2015 and the introduction of a Scottish rate of income tax in April 2016. The estimated increase is based on figures for 2013/14 from *Government expenditure and revenue Scotland 2013/14*, Scottish Government, March 2015.

6 The estimate of the percentage of devolved expenditure that will be funded from amounts raised directly in Scotland from taxation is based on figures for 2013/14 from *Government expenditure and revenue Scotland 2013/14*, Scottish Government, March 2015.

7 *Scotland in the United Kingdom: an enduring settlement*, UK Government, January 2015.

8 The estimated increase in revenue is based on figures for 2013/14 from *Government expenditure and revenue Scotland 2013/14,* Scottish Government, March 2015.

9 *Report of the Smith Commission for further devolution of powers to the Scottish Parliament,* The Smith Commission, November 2014.

10 *How does the IMF encourage greater fiscal transparency*? International Monetary Fund, September 2014. The IMF Fiscal Transparency Code is primarily intended for jurisdictions with full fiscal responsibilities.

11 The balance sheet is also known as the statement of financial position.

12 *Official report*, Scottish Parliament Finance Committee, 1 December 2014.

13 *Official report,* Scottish Parliament Finance Committee, 28 January 2015.

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