The 2014/15 audit of the Scottish Government Consolidated Accounts

Prepared by the Auditor General for Scotland
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Contents

Introduction

1. The Scottish Parliament is seeing a substantial increase in its financial powers, with changes as a result of the Scotland Act 2012 and proposals for further devolution contained in the Scotland Bill 2015. New responsibilities for taxes, welfare and borrowing mean that the Parliament's oversight of the Scottish Government needs to be strengthened. This will require enhanced financial reporting by the Scottish Government, underpinned by independent audit to support Parliamentary scrutiny.

2. Effective planning, management and scrutiny of public revenues and spending are key parts of an updated fiscal framework for Scotland, recommended by the Smith Commission. The Scottish budget sets out the Government's spending priorities and plans. Equally important is information about how the Government has managed public money, including how it was spent and what has been achieved. The Scottish Government's Consolidated Accounts are a critical component of its accountability to Parliament and the public.

3. The Consolidated Accounts:
   - cover over 90 per cent of the spending approved by Parliament each year.
   - report the amounts the Government spent against each main budget heading, and the reasons for any significant differences.
   - report the assets, liabilities and other financial commitments carried forward to future years.
   - contain an annual report, in which the Government gives a high-level account of its activities and performance during the year.

4. I provide an independent opinion on the Consolidated Accounts. My opinion on the 2014/15 financial statements is unqualified. This means that I am content they show a true and fair picture, follow accounting standards and that the income and expenditure for the year is lawful. My full report on the accounts is at pages 28 and 29 of the accounts.

5. This report highlights key information in the Consolidated Accounts.[1] It explains what they show about the Scottish Government's management of the Scottish budget, and provides other information, including significant audit findings. Finally, it points to where financial reporting should be developed further.

6. The Scottish Parliament is developing its approach to scrutiny in response to increasing financial powers. The Public Audit Committee has agreed to take evidence each year on the Scottish Government's Consolidated Accounts, piloting this approach for the 2014/15 accounts. This is the right time to strengthen Parliamentary scrutiny of the Consolidated Accounts and I have provided this report to support this process.

[1] This report is made under section 22(3) of the Public Finance and Accountability (Scotland) Act 2000.

Financial management and reporting

Budget performance

7. The Scottish Government's budget is made up of the Scottish Block Grant and other sources including Non-Domestic Rates income and European programmes of financial assistance. The Block Grant is the largest part and is calculated using the Barnett formula. The UK Parliament votes the necessary provision to the Secretary of State for Scotland, who makes grants to the Scottish Government into the Scottish Consolidated Fund.[2]

8. The Scottish Parliament approves the budget to be used by the Scottish Administration and the other bodies whose funding is directly payable out of the Scottish Consolidated Fund. The final budget approved by the Scottish Parliament for 2014/15 permitted total expenditure of £36,906 million for financial year 2014/15.[3]

9. The majority of the budget (90 per cent or £33,016 million) relates to spending programmes and administration costs covered by the Scottish Government Consolidated Accounts. Amounts are also allocated to other parts of the Scottish Administration (£3,720 million) and directly funded bodies (£170 million).[4]

10. The Consolidated Accounts reflect the areas that the Scottish Government is directly responsible and accountable for: the core portfolios and related administration; the executive agencies; the Crown Office and Procurator Fiscal Service; and NHS bodies. Separate accounts are also published by these individual bodies, other parts of the Scottish Administration, other bodies[5] sponsored by the Government and by directly funded bodies.These reflect the accountability each has to the Scottish Parliament.

11. The budget and the Consolidated Accounts are presented in a consistent manner which means comparisons between budgeted and actual spending are clear. The final budget for the expenditure included in the 2014/15 Consolidated Accounts was £33,016 million. The accounts (page 30) show that total net expenditure during the year was £32,669 million, £347 million less than budget. The resource budget was underspent by £207 million (0.7 per cent) and capital by £140 million (7.6 per cent).

12. The Consolidated Accounts also contain individual portfolio outturn statements (pages 34-44) which give more detail of resource spending against budget in each area, and a single outturn statement detailing each portfolio's capital spend against budget (page 32). A summary of the total (resource and capital) amounts spent in each budget area is provided in Exhibit 1.

[2] Established under the Scotland Act 1998 to contain funds for devolved purposes. Separate accounts are prepared and audited that report receipts and payments through the Scottish Consolidated Fund.
[3] The Budget (Scotland) Act 2014, as amended.
[4] Directly funded bodies include: Forestry Commission, Food Standards Agency, Scottish Parliamentary Corporate Body and Audit Scotland.
[5] Other bodies include non-departmental public bodies, and public corporations such as Scottish Water.

Exhibit 1: Portfolio total expenditure (resource and capital) against budget 2014/15

Portfolio	Actual £m	Budget £m	Over/(under) spend £m
Finance, Constitution and Economy	524	537	(13)
Health, Wellbeing and Sport	12,341	12,355	(14)
Education and Lifelong Learning	2,732	2,804	(72)
Fair Work, Skills and Training	252	252	-
Justice	2,585	2,573	12
Social Justice, Communities and Pensioners' Rights	11,223	11,274	(51)
Rural Affairs, Food and the Environment	479	463	16
Culture, Europe and External Affairs	191	194	(3)
Infrastructure, Investment and Cities	2,031	2,252	(221)
Administration	198	199	(1)
Crown Office and Procurator Fiscal Service	113	113	-
Total	32,669	33,016	(347)

Source: Audited Consolidated Accounts 2014/15 (page 30)

13. The Scottish Government manages its budget within the overall limit set by Parliament. Scottish Ministers make decisions about spending priorities based on changing circumstances during the year. Many of these are reflected in budget revisions made in the autumn and spring, which are scrutinised by the Finance Committee. The reasons for significant differences between the final budget and actual spending are summarised in the Consolidated Accounts (pages 45 to 50 and page 76).

14. The main differences between budgeted and actual spending were:
    - An overspend in Justice is largely due to police and fire pension payments being more than anticipated.
    - An overspend in Rural Affairs, Food and the Environment is mainly due to overspending on the Futures Programme to support Common Agricultural Policy (CAP) reforms (see paragraph 47 to 52 of this report).

- An underspend on Infrastructure, Investment and Cities is mainly due to the impact of changes to the rail franchise, savings in the Forth Road Crossing and underspending on other major capital projects, such as motorway improvements.
- An underspend in Education and Lifelong Learning is mainly due to a technical accounting adjustment relating to the value of an element of student loans.

Scottish Administration

15. The figures in the Scottish Government Consolidated Accounts need to be taken together with expenditure included in other accounts to determine whether the Scottish Administration overall has remained within the legal spending limit set by Parliament. Total Scottish Administration spending was within the limit, £369 million (1 per cent) less than budget as summarised in Exhibit 2. Budget management during the year was effective in managing overall spending. Other bodies within the Scottish Administration provide explanations of differences between actual and budgeted spending in their area of responsibility in their own accounts.

Exhibit 2: Scottish Administration outturn against budget 2014/15

Entity	Outturn £m	Budget £m	Over/ (Under) spend £m
Scottish Government Consolidated	32,669	33,016	(347)
National Records of Scotland	19	20	(1)
Teachers' and National Health Service Pension Schemes	3,596	3,617	(21)
Office of the Scottish Charity Regulator	3	3	-
Scottish Court Service	75	75	-
Scottish Housing Regulator	5	5	-
Total	36,367	36,736	(369)

Source: Audit Scotland based on 2014/15 audited accounts (Pension Schemes unaudited at time of writing)

16. The Scottish Ministers lay in Parliament a statement of total audited outturn for the preceding financial year against the final Budget for the Scottish Administration as a whole. This forms an important part of the Government's accountability.

HM Treasury budget

17. Total Managed Expenditure (TME) is the total budget agreed with HM Treasury, and is used by the UK Government to manage its spending through the Scottish Block. This is different from the budget approved by the Scottish Parliament, largely for technical reasons reflecting differences between accounting rules and UK budget rules. The Scottish Government has to

manage spending within both budgets. The differences between them are reported in the Consolidated Accounts (Note 24, page 124 to 125) and summarised in Exhibit 3.

Exhibit 3: Comparison of Scottish and HM Treasury budgets for 2014/15 (£ million)

	£m	
Scottish budget approved	36,906	
Add: Barnett consequentials carried forward to 2015/16	13	Allowed for in setting Scottish Budget
Add: HMT funding for DEL not in SBR	389	Includes £300m cover for classification.[6]
Add: HMT funding for AME not included in SBR	115	Relates to additional pension payments to retired police and fire officers
Add: Judicial salaries	30	Met directly from SCF
Less: Net technical adjustments	(220)	Includes £194m NDPB non-cash budgets, £336m adjustments for infrastructure projects and other smaller items.
HM Treasury Budget	37,233	
HM Treasury AME Budget	(7,013)	
HM Treasury DEL Budget	30,220	

Source: Audit Scotland based on Note 24 of audited Consolidated Accounts 2014/15 (page 125).

18. TME is categorised as either Annually Managed Expenditure (AME) or Departmental Expenditure Limit (DEL). AME is not subject to firm multi-year limits and does not affect the Scottish Government's spending power. DEL is subject to greater control, with a particular focus on fiscal DEL as a measure of real spending power. Fiscal DEL excludes capital charges that reflect the consumption of physical assets and other technical accounting non-cash items. The Consolidated Accounts (pages 59 and 60) show how spending is split between each main category.[7] This is taken together with information from other accounts to establish the overall Scottish position.

19. In June 2015, the Cabinet Secretary for Finance, Constitution and Economy announced the provisional outturn, indicating that the fiscal DEL budget was underspent by £192 million (£151 million resource and £41 million capital) against a fiscal DEL carry forward cap of £200 million (£155 million resource and £45 million capital). The Scottish Government is able to carry forward the full amount of this underspend into 2015/16 although this may be affected by the outcome of the national accounts classification issue (see paragraph 60 to 65 of this report).

[6] Additional budget cover agreed with HM Treasury for ONS classification. Details at paras 60 to 65.
[7] Also shows amounts categorised as 'Other' which arise from treatment of PFI/PPP/NPD projects.

Financial position

20. The Consolidated Statement of Financial Position, known previously as the balance sheet, (page 52) is one of the primary financial statements in the Consolidated Accounts. It summarises what is owned and owed by the Scottish Government. This shows taxpayers' equity – an accounting measurement of the amount invested by taxpayers that has continuing public benefit. It shows how much of this has arisen from the application of revenues (including the Scottish Block Grant) and that which has resulted through changes over time in the value of physical assets.

21. The Statement of Financial Position includes:

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

22. 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 important information about the impact of past decisions on future budgets and in turn highlights potential risks to financial sustainability. The key items in the Statement of Financial Position over the last three financial years are summarised in Exhibit 4.

Exhibit 4: Summary of Statement of Financial Position for 3 years to 31 March 2015

	At 31/3/15 £m	At 31/3/14 £m	At 31/3/13 £m
Physical assets	26,698	26,153	25,887
Financial assets	6,879	6,228	5,775
Receivables	1,098	973	921
Total assets	**34,675**	**33,354**	**32,583**
Payables	(4,520)	(4,572)	(4,527)
Financial liabilities	(693)	(698)	(705)
Provisions	(778)	(636)	(720)
Total Liabilities	**(5,991)**	**(5,906)**	**(5,952)**
Net Assets	**28,684**	**27,448**	**26,631**
General Fund	18,822	17,397	16,468
Revaluation Reserve	9,862	10,051	10,163
Taxpayers Equity	**28,684**	**27,448**	**26,631**

Source: Audit Scotland from Consolidated Accounts 2014/15, 2013/14, 2012/13.

23. The value of the assets directly owned by the Scottish Government has been increasing over the last three years, largely as a result of capital investment. At the same time the value of liabilities directly owed by the Scottish Government has stayed broadly consistent.

24. Physical assets are the highest value group of assets in the Consolidated Accounts with a value of £26,698 million at 31 March 2015, of which 64 per cent or £16,997 million relates specifically to the road network. [8] The Consolidated Accounts provide details of changes in the year. [9] There were additions of £970 million that resulted from capital investment, offset by disposals and the net effect of depreciation and revaluations.

25. Most physical assets are 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 other means (such as PFI[10], NPD[11] and borrowing)

[8] Physical assets include: Property, Plant and Equipment, Inventories and Assets Classified as Held For Sale.

[9] Note 6a on page 79, Note 6c on page 83, Note 7 on page 84 and Note 9 on page 92.

[10] A Private Finance Initiative (PFI) is a partnership between public sector and private company for the building and maintaining of a public sector asset. The private company pays the up front costs and on-going maintenance in return for an annual payment from the public sector body. Contracts are usually for 20 to 30 years after which the asset either remains with the private sector or transfers to the public sector.

also lead to liabilities representing the amounts that will require to be met from future resource budgets. Only physical assets that are deemed surplus and 'held for sale' (£42 million, page 84) will release resources previously invested for future use.

26. Financial assets include loans made directly to other organisations and individuals, investment funds used to deliver development programmes and investments in nationalised industries and fully or part owned companies. These assets are of continuing benefit to the Scottish Government, 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.

27. The Consolidated Accounts show that the largest financial assets are loans of £2,617 million that have been made to Scottish Water, to finance its capital investment programmes, and student loans valued at £2,685 million.[12] The latter are made under the terms of the student loans scheme, administered by the Student Loans Company Limited. Loans to Prestwick Airport of £11 million are also included here.

28. Financial liabilities are almost all long-term borrowing of £690 million from the national loans fund - for Scottish Water - inherited when the Scottish Parliament was established.[13] Other payables include £1,989 million due under PFI contracts. Both of these amounts will fall to be met from future budgets in line with agreed terms. There was no other significant borrowing by the Scottish Government at 31 March 2015, immediately prior to the introduction of new borrowing powers.

29. Provisions are obligations which are of uncertain timing or amount at the balance sheet date. Total provisions as at 31 March 2015 were estimated at £778 million. The main elements are set out in the Consolidated Accounts: NHS Clinical and Medical Negligence Claims of £302 million; early departure costs of £155 million; and included within other provisions, £99 million which relates mainly to land and property acquisitions by Transport Scotland.[14] The impact for future budgets depends on what actual amounts turn out to be and when provisions were recognised following a change of budget rules in 2010/11. Amounts provided for before this have already been charged to DEL, but those recognised since have not and will require to be met as they fall due.

30. Some categories of asset, debt or financing activity are not shown on the balance sheet under accounting rules; these are known as 'off-balance sheet' items. This may be because of the high level of uncertainty involved. This includes potential liabilities, such as unfunded pension schemes, contingent assets and liabilities and government guarantees.

[11] Non Profit Distributing (NPD) schemes were introduced as an alternative to PFI. Private sector returns on projects are capped with any surpluses generated by the private sector company being reinvested in the public sector

[12] Note 8 on pages 85 to 91.

[13] Payables and other financial liabilities are shown in note 12a on page 96 of the accounts.

[14] Note 14 on pages 100.

31. A contingent asset is a possible asset and a contingent liability is a possible obligation, whose existence will be confirmed only by uncertain future events not wholly within the Scottish Government's control. The Scottish Government has reported various contingent assets and liabilities in the Consolidated Accounts. [15] Only some of these can be quantified, totalling £361 million of liabilities and £4 million of assets. Some of these amounts may need to be funded from future budgets, but this is by no means certain.

32. The information provided in the Consolidated Accounts complies with accounting requirements. It is important that the Scottish Government can also show how it is managing its overall financial position. It should provide clearer information about the opportunities and risks that arise from balance sheet and 'off-balance sheet' items, and how these are affecting annual budgets over time. For example, it could provide explanation of significant movements in overall balances and the main components, and what this means for budgets. This would enable scrutiny of this important area to be strengthened.

Developing Financial Reporting

33. The Scottish Government's Consolidated Accounts meet the legal requirements and comply with accounting requirements. They show the financial position and budgetary performance from the perspective of the Scottish Government's role in managing the budget it directly controls, including the distribution of resources to other public bodies such as local government. This covers the majority of public spending in the Scottish budget.

34. It is becoming increasingly important to also understand the overall position of the devolved Scottish public sector as a whole, but there is currently no single set of accounts that shows the position. In the absence of easily accessible, aggregate information on what the devolved 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 about public spending and the longer-term implications for public finances.

35. For example, there is no readily accessible information about the aggregate pension liabilities, the largest commitment on Scotland's devolved public sector balance sheet. The Scottish Government's Consolidated Accounts include the amounts it has paid during the year, but it is necessary to look at the individual accounts of public sector pension schemes to establish the aggregate liabilities that will need to be met over time.

36. Similarly, there is no clear overall picture of the commitments arising from investment in public assets such as hospitals and schools. The Consolidated Accounts provide information about the direct commitments of the Government, for example in relation to NPD, PPP and PFI schemes (pages 107 to 113) but it is necessary to look at the accounts of other bodies, including those published by councils, to understand the total level of borrowing and other

[15] Note 19 on pages 114 to 116.

investment commitments across the Scottish public sector.[16] A full picture across the public sector would assist understanding about the potential impact of investment on future budgets, alongside the benefits of the investment.

37. I have previously reported on the importance of consolidated accounts for the whole of the Scottish public sector.[17] These would help provide an overall picture of the financial position, including in the areas highlighted above. They would also provide the Scottish Parliament, taxpayers and others a fuller picture and understanding about public spending and the longer-term implications for public finances. This is a key area for further development, linked closely to the updated fiscal framework recommended by the Smith Commission and to the work of the Scottish Fiscal Commission, which is to be established on a statutory basis.

38. 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. The Scottish Government is working to deliver changes in the context of the new financial powers and an updated fiscal framework. It should now set out clear plans and timescales on how it proposes to further improve and enhance its financial reporting in this changing financial environment.

Corporate governance

39. A Governance Statement (pages 22 to 27) prepared by the Permanent Secretary is a key feature of the Consolidated Accounts. It summarises how the core Scottish Government organisation is controlled and directed. The statement reports that it complies with relevant guidance about corporate governance. It also highlights some of the main risks and opportunities for the organisation and any significant internal control issues in 2014/15. I am content that the Governance Statement has been prepared in accordance with guidance on this issued by the Scottish Ministers.

40. The overarching governance arrangements in place during 2014/15 were generally effective and provided an appropriate framework for organisational decision-making. I highlight a number of issues that are reflected in the Governance Statement in the section on 'Other significant audit issues' below.

Performance

41. The Consolidated Accounts (pages 2 to 11) contain an annual report which summarises financial performance for the year, with particular emphasis on performance against budget. It also contains some specific performance information which is required by current guidance, such as supplier payment performance compared with policy targets and workforce sickness

[16] Councils operate independently of the Scottish Government, but the current funding model means that the Scottish Government has a clear interest in the overall level of council borrowing and the position in individual councils. The Scottish Government provided £7,849 million through its Communities portfolio in 2014/15 (page 39 of the Consolidated Accounts).

[17] *Developing financial reporting in Scotland,* Audit Scotland, July 2013, and, *Update on developing financial reporting,* Audit Scotland, March 2015

absence rates. The annual report also signposts where more performance information is available in some areas e.g. Scottish Government websites which provide details on sustainability and environmental performance.

42. The annual report refers to the Scottish Government's National Performance Framework (NPF) which sets out the purpose, objectives and national outcomes which describe in more detail what the Scottish Government aims to achieve. The report provides a link to the Scotland Performs website where progress against the measures set out in the NPF is regularly updated. The NPF was a major step forward in setting out the Scottish Government's aims, and audit work has demonstrated in some policy areas its potential in aligning resources and actions in different parts of the public sector.

43. 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 Scottish Government discussed this with the Finance Committee of the Scottish Parliament and how best it might be achieved. The work was 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.

44. The Scottish Government has been building on its arrangements to better report how it is directing resources toward desired outcomes and the impact this is having. Outcomes by their nature are long-term. There is scope for more systematic use of output measures that describe in more specific terms what intermediate aims the Scottish Government has in making progress towards its desired outcomes. These are more able to be aligned to specific budgets. There is also scope to set out clearer plans for how outputs and outcomes will be improved in budget documents. Such an approach would help strengthen Parliamentary oversight of Government spending.

45. Guidance on what should be contained in the annual report is changing. [18] The Scottish Government should take account of the guidance in providing a more extensive analysis of the Scottish Government's overall performance and development during the year, drawing on relevant performance data including key financial information from the financial statements. A more rounded account of the Scottish Government's overall performance as part of an expanded annual report would enhance reporting to the Scottish Parliament and the public, and help strengthen accountability and scrutiny.

[18] HM Treasury Government Financial Reporting Manual (FReM) 2015/16

Other significant audit issues

46. The following significant matters arose from the audit of the 2014/15 Consolidated Accounts.

European funding - CAP Futures

47. The Scottish Government provides financial support to farmers and other rural businesses as part of the Common Agricultural Policy (CAP). The 2014/15 Consolidated Accounts include expenditure of £62 million on the Futures Programme, an IT enabled change programme to implement CAP reforms in Scotland. The relevant amounts are reflected appropriately in the Consolidated Accounts.

48. The programme is costing significantly more and taking longer to implement than planned. Capital spending in 2014/15 was £50 million, £32 million more than budgeted (page 76). The total forecast cost of the programme is now £178 million, 74 per cent above the amount included in the original business case. The largest element of spend relates to the IT delivery partner, £45 million in 2014/15, more than twice the amount forecast.

49. The Scottish Government highlights in the Governance Statement (pages 22 to 27) that the programme has proved significantly more complex and challenging than anticipated, with limited availability of in-house expertise and experience. The programme team has had to prioritise the delivery of IT systems to ensure CAP compliance. As a consequence, other intended benefits of the programme have not yet been delivered. The Scottish Government is improving internal processes, including those for making payments to the delivery partner, following recommendations by internal and external audit. Work is ongoing to deliver the programme and further IT software releases are scheduled throughout 2015 and 2016.

50. There remain significant risks to successful delivery. The timescale for implementing the remaining elements of the IT system for direct support payments is now very tight. Any inadequacies in the control system implemented are likely to have significant financial consequences arising from the potential disallowance of European funding.

51. The Futures Programme involves substantial change; the complexity of the CAP scheme, the regulatory requirements and the timescales for implementation add further challenges. The programme has carried a significant level of risk from the outset, and risks will remain until full implementation and beyond. Successful implementation is key to ensuring timely and accurate payments to farmers and other rural businesses.

52. I reported on the Futures Programme in October 2014 to draw Parliament's attention to the ongoing risks to delivery and overall value for money. I provided an update to Parliament in April 2015 and I am keeping CAP Futures under review. I will continue to assess progress and will report further to the Scottish Parliament's Public Audit Committee in spring 2016, in advance of the EU payment deadline of June 2016.

European funding - structural funds

53. The Scottish Government manages European Structural Funds (ESF) programmes that provide financial assistance to help improve transport and internet links, boost business

growth, invest in a cleaner environment, and improve education and skills. The 2014/15 Consolidated Accounts include £81 million of ESF expenditure and related funding. The relevant amounts are reflected appropriately in the Consolidated Accounts.

54. The Scottish Government highlights in the Governance Statement included in the Consolidated Accounts (pages 22 to 27) that the European Commission (EC) has suspended three European Structural Fund (ESF) programmes for 2007-13; the EC has also interrupted the remaining programme. [19] This procedure is set out in European Regulations. It aims to avoid EU funds being paid over to member states where there is a risk that European rules on how the Funds are spent may not have been followed. Payments by the EC are stopped until it considers such risks have been removed:

- interruptions are relatively common across Europe and are applied where the EC considers that there may be a serious deficiency in the functioning of the management and control system. They are usually resolved by member states correcting the expenditure declared as programme expenditure.
- suspensions represent an escalation where the EC considers that there is a serious deficiency in the management and control system or there is a serious irregularity in expenditure declared. This requires the Scottish Government to provide the EC with further assurances about the extent and effectiveness of controls, and correct declared expenditure.

55. This follows concerns and projected error rates reported by Scottish Government Internal Audit Division in their role as Audit Authority for ESF. The auditor highlighted a number of concerns, including the robustness of information being retained by some grant recipients about how ESF funds were being spent.

56. The Scottish Government has been working to provide the EC with the assurances it requires about how it and the bodies in receipt of funds are addressing the control weaknesses identified. It has also estimated the correction it thinks is required (in the order of £1 million to £2 million).

57. European Regulations provide for member states to make self-corrections to the expenditure they declare for funding. If the EC is content, available grant may be applied to other eligible projects not previously funded (‘re-cycled within the programme’).

58. Where the EC does not initially agree that corrections proposed by member states are sufficient, there are provisions for dispute resolution aimed at reaching an agreed position. These are likely to take a number of months to conclude. If ultimately agreement cannot be reached the EC can impose the correction it determines is appropriate. In such circumstances the funding affected cannot be ‘re-cycled’.

[19] The three suspended programmes 2007-13 are: Lowlands and Uplands Scotland (LUPS) European Social Fund, LUPS European Regional Development Fund (ERDF), Highland and Islands (H&I) European Social Fund. The remaining programme is the Highland and Islands European Regional Development Fund

59. The matter remains unresolved, and ESF funding will not resume until the EC is satisfied. In the meantime, the Scottish Government continues to make grant payments to approved projects. We will continue to monitor progress and report as appropriate. It is critical that the Scottish Government ensures that its arrangements for ESF and those of the other bodies receiving funds are fully robust.

National accounts classification

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

61. The Office for National Statistics (ONS) assesses bodies and transactions against international rules to decide how they should be classified in the National Accounts statistics.[20] The National Accounts statistics are used by HM Treasury to inform guidance on UK fiscal budgets. Publicly classified capital projects currently require HM Treasury capital budget cover (capital DEL). For privately classified capital projects, HM Treasury revenue DEL budget is required to cover the spending over the lifetime of the contract.

62. ONS is considering a number of Scottish NPD projects. In relation to the Aberdeen Western Peripheral Route (AWPR) project, ONS concluded in July 2015 that it should be classified as a public sector project. The Scottish Futures Trust is in discussions with ONS and other parties to clarify the basis for this classification with a view to re-classification as private sector.

63. Two other NPD projects will be reviewed – Dumfries and Galloway Royal Infirmary and the Edinburgh Royal Hospital for Sick Children. There is a risk that these may also be classified as public sector, with further potential implications for capital budgets. In addition, there is a risk of potential delays to other projects in the capital programme in the short term.

64. The Scottish Government recognises the risk and is taking action to mitigate this. It is currently in discussion with HM Treasury on contingency arrangements and how these will be applied in practice. The Scottish Government will need to balance the financial and governance implications of its mitigating actions.

65. Looking beyond this, if the AWPR and other NPD projects are classified as public sector capital projects then they will need to be managed within HM Treasury annual capital budgets. If this is the case, the SG will have less capital DEL budget to spend elsewhere and will face a choice of progressing fewer capital projects, or finding alternative ways of funding them. We are keeping the position under review.

[20] *European System of Accounts* 2010, European Commission 2010

Conclusion

66. The Scottish Government provides a robust and audited financial report in its Consolidated Accounts for 2014/15. It reports spending against budget and the things it owns and owes being carried to future years. The accounts are prepared from the perspective of the Scottish Government's role in managing the budget it directly controls and cover the majority of public spending in the Scottish budget. This is a critical component of its accountability to Parliament and the public.

67. The Scottish Government has a good record of financial management and reporting, governance arrangements are generally effective and the National Performance Framework is well established. Together, these form a strong base to meet the challenges of tighter budgets and increasing financial powers. My audit work has identified a number of areas for improvement. The Scottish Government should further develop its financial reporting, including consolidated public sector accounts to provide a fuller picture of Scotland's public finances, and performance reporting. It also highlights risks relating to the management and control of European funding. We continue to support the independent scrutiny of Scotland’s public finances through all of our audit work.