AUDIT SCOTLAND

Scottish Government: Non-Domestic Rating account

2015/16 Annual audit report

October 2016

Key contacts

Mark Taylor, Assistant Director
mtaylor@audit-scotland.gov.uk

Gordon Smail, Senior Manager
gsmail@audit-scotland.gov.uk

Gordon McAllister, Senior Auditor
gmcallister@audit-scotland.gov.uk

Audit Scotland
102 West Port
Edinburgh
EH3 9DN
Telephone: 0131 625 1500
Website: www.audit-scotland.gov.uk

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 (www.audit-scotland.gov.uk/about/).

Mark Taylor, Assistant Director, Audit Scotland is the appointed external auditor of the NDR Account for 2015/16.

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

The information in it may be used by the Auditor General in support of her wider responsibilities, including reporting to the Scottish Parliament.

Contents

Key messages

Audit of financial statements	• The independent auditor's report on the 2015/16 Scottish Government Non-Domestic Rating (NDR) account is unqualified.
Financial management and sustainability	• Total non-domestic rates collected during the year were £2,628 million, and total sums distributed were £2,843 million. • The deficit for 2015/16 was £215 million resulting in a cumulative, negative balance of £289 million carried forward to 2016/17. This needs to be monitored in the medium-term to ensure the account remains in balance.
Governance and transparency	• Progress in developing governance arrangements for the oversight of the NDR account, with further consideration required in the context of the Scottish Government's revised, over-arching governance arrangements. • Scope to provide further information in the accounts to explain the role of the NDR account in the wider system of budget management and financial reporting.

Introduction

1. This report is a summary of our findings arising from the 2015/16 audit of the Scottish Government Non-Domestic Rating (NDR) account.

2. Scottish Government officials are responsible for:

   - preparing financial statements which properly presents the receipts and payments for the financial year, 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 the financial statements an annual governance statement.

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. Appendix II 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 Scottish Government understands its risks and has arrangements in place to manage them. The Scottish Government Audit and Risk Committee, and the successor committee under the revised governance structure, should ensure that it is satisfied with proposed action and have mechanisms to assess progress and monitor outcomes.

6. 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.

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

Audit of the 2015/16 financial statements

Audit opinions

Financial Statements	• The financial statements properly present in accordance with Schedule 12 of the Local Government Finance Act 1992 as amended by Schedule 13 of the Local Government etc. (Scotland) Act 1994 and directions made thereunder by the Scottish Ministers the receipts and payments of the NDR account for the year ended 31 March 2016 and the balances held at that date.
Regularity	• In all material respects, the sums paid out of the NDR account for the purposes of meeting the expenditure shown in the financial statements were applied in accordance with Section 65 of the Scotland Act 1998 and sections 4 to 6 of the Public Finance and Accountability (Scotland) Act 2000.
Other prescribed matters	• Information given in the Foreword for the financial year for which the financial statements are prepared is consistent with the financial statements and our understanding of the NDR account.

Submission of financial statements for audit

8. We received the unaudited account on 23 June 2016, in accordance with the agreed timetable. The working papers were of a good standard and Scottish Government staff provided the necessary support to the audit team. We substantially completed our audit on 31 August 2016.

Overview of the scope of the audit of the financial statements

9. 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 Scottish Government's Finance, Communities and Strategy Audit and Risk Committee on 25 May 2016.

10. 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 2015/16 agreed notional audit fee was £9,400 and, as we did not carry out any work additional to our planned audit activity, the notional audit fee remains unchanged.

11. The concept of audit risk is of central importance to our audit approach. During the planning stage of our audit we identified 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.

12. 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.

13. 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

14. 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.

15. We summarised our approach to materiality in our Annual Audit Plan. We revised our planning materiality for 2015/16 on receipt of the unaudited accounts to £27.9 million (1% of the Distributable Amount of £2,788 million).

16. 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 £20.9 million (i.e. 75% of planning materiality).

17. No unadjusted misstatements were identified during the audit. A number of presentational adjustments were identified within the financial statements and these were discussed with relevant officers who agreed to amend the unaudited accounts.

Significant findings from the audit

18. 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.
    - 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.

19. There are no matters that we wish to draw your attention in accordance with ISA 260.

Financial management and sustainability

Total Contributions £2,628 m − **Total Distributions £2,843 m** = **Deficit for the Period -£215 m**

Negative balance carried forward to 2016/17 -£289 m

2015/16 financial position

20. The NDR account operates on a receipts and payments basis and is managed by the Scottish Government's Local Government Finance Unit. All NDR income collected by local authorities in Scotland is placed into a notional "pool" and distributed to the local authorities as part of the Scottish Government funding arrangements.

21. The Scottish Government guarantees the combined general revenue grant and distributable NDR income figure, approved by Parliament, to each local authority. A reduction in non-domestic rate income is compensated for by an increase in general revenue grant and vice versa. Weekly payments are made to local authorities. These payments represent total revenue funding less NDR income, and any specific revenue grants that local authorities expect to receive.

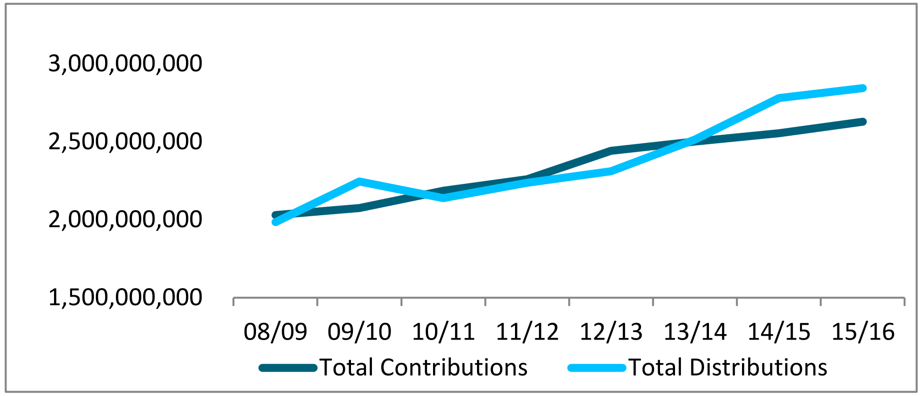
22. Total non-domestic rates collected in 2015/16 was £2,628 million of which £56 million is related to prior years. The total amount distributed for 2015/16 was £2,843 million, which includes £56 million relating to prior years. The net position for 2015/16 was therefore a deficit of £215 million (2014/15: deficit of £227 million) resulting in a negative balance on the account of £289 million carried forward into 2016/17.

23. As explained in the financial statements, there may be a surplus or deficit on the account in any financial year as a result of the NDR pooling arrangements. The deficit in 2015/16 has been carried forward to 2016/17, decreasing the amount available for redistribution in that year.

24. Taking one year with another, all non-domestic rates paid to Scottish Ministers are distributable to local authorities. Our analysis of the trend in contributions, distributions and year-end balance on the NDR account is shown in Exhibits 1 and 2. This indicates that action is required by the Scottish Government in the medium–term to ensure the account remains in balance.

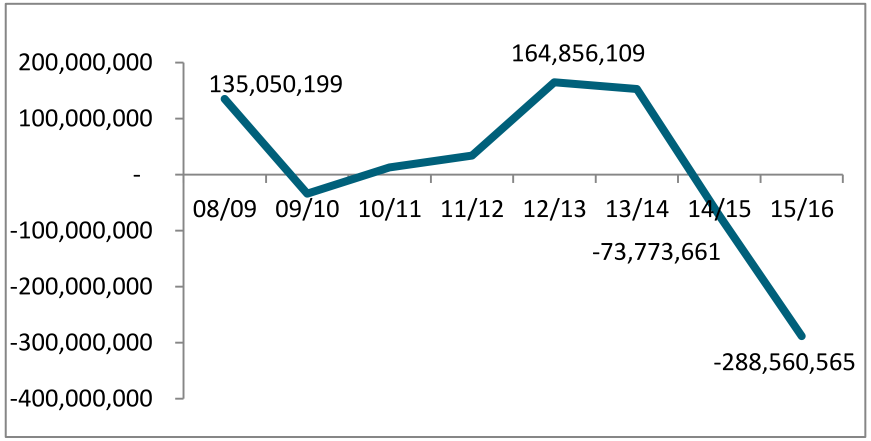
Refer Action Plan No.1

Exhibit 1: Annual Contributions vs Distributions



Source: Audit Scotland from NDR White Paper Accounts

Exhibit 2: NDR year-end balance history



Source: Audit Scotland from NDR White Paper Accounts

2016/17 outlook

25. NDR forms a key part of how the Scottish Government budget is set and in how aggregated funding is distributed to local authorities. The Scottish Government therefore needs to have a good understanding of predicted income from NDR over the coming period. Local government funding detailed in the Budget 2016/17 includes an estimate of NDR income of £2,769 million to be distributed during 2016/17.

26. The Scottish Government established the Scottish Fiscal Commission (SFC) as an independent body in 2014 to provide independent scrutiny of Scottish Government forecasts of receipts and economic determinants from taxes devolved to Scotland. From 1 April 2017, the SFC will take on a statutory remit for producing forecasts.

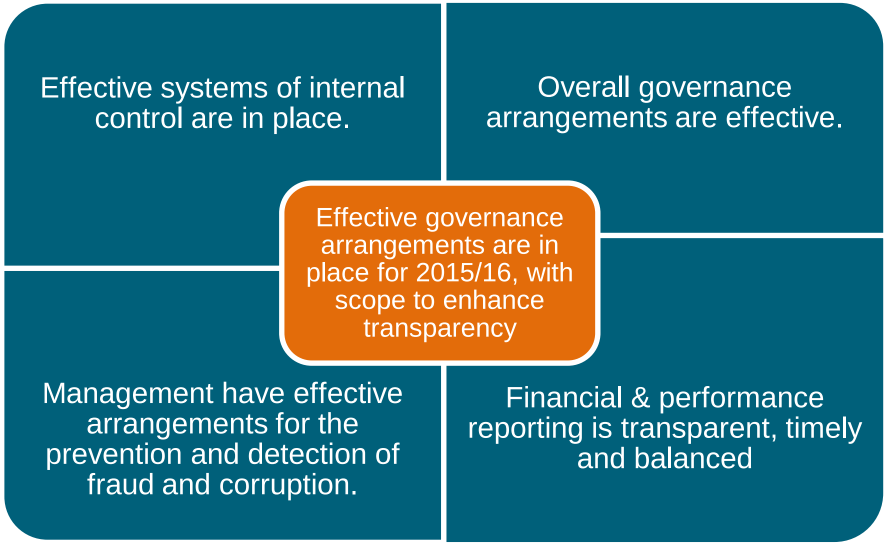
27. As part of its current remit, the SFC undertakes independent scrutiny and assessment of forecasts prepared by the Scottish Government of the economic determinants underpinning Scottish Government's forecasts of non-domestic rate income. When its statutory remit comes into effect, the SFC will be responsible for preparing (and reporting) independent forecasts of Non-Domestic Rate Income.

28. In reporting on the Scottish Government's draft budget for 2016/17, the SFC commented on, and recommended improvement to, the forecasting of 'buoyancy' which impacts on the amount of non-domestic rate income distributed to local authorities. The SFC indicated that the use of macroeconomic data to forecast the buoyancy above historical averages should be discouraged as they found no link between macroeconomic variables and buoyancy. The SFC encouraged Scottish Government forecasters to gather more historical data on buoyancy to improve forecasting.

29. With effect from 1 April 2012 the Scottish Ministers introduced the Business Rates Incentivisation Scheme (BRIS). This scheme is intended to incentivise all local authorities to maximise the non-domestic rates collected from their existing businesses and encourage new businesses to start up in their own local areas. Under the terms of the BRIS any local authority that exceeds its non-domestic rate income target, set by Scottish Ministers, will retain 50% of the additional income.

30. The 2012-13 BRIS targets were delayed due to the Scottish Government and COSLA being unable to agree the targets. It has since been confirmed that local authorities that exceeded the Scottish Government's targets for 2012/13, amounting to £9 million in total, should retain this amount. Local authorities benefiting from this decision were notified of this decision in Local Government circular 6/2014 with the amounts retained as part of the 15/16 returns. The figures for 2015/16 are net of the sums totalling £9.0 million retained by local authorities under the original Business Rates Incentivisation Scheme.

Governance and transparency



Corporate governance

31. The governance arrangements for the NDR account operate within the context of the Scottish Government's overall system of corporate governance. Our audit of the 2015/16 Scottish Government's Consolidated Accounts concluded that Scottish Government has sound overall governance arrangements in place.

32. To date, none of the Scottish Government audit and risk committees has formally considered the NDR account. In the interests of enhanced governance we have previously recommended that the Scottish Government should consider the governance arrangements for the accounts and audit of the NDR account.

33. Recognising that the remit of the Finance, Communities and Strategy Audit and Risk Committee (FCS ARC) included oversight of areas covered by the DG Communities, we provided our draft Annual Audit Plan for the 2015/16 NDR Account audit to that Committee for its information. FCS ARC agreed that Scottish Government Audit and Risk Committee would be the more appropriate forum for the NDR account.

34. The Scottish Government has brought forward proposals to amend its over-arching governance arrangements. As part of the implementation of the new arrangements and in determining the role of the new assurance and audit committee, the Scottish Government should review the governance arrangements for the NDR account.

Refer Action Plan No.2

Transparency

35. We have previously reported opportunities to develop financial reporting to provide the Scottish Parliament and the public with a fuller picture and enhance their understanding of Scotland's public finances.

36. In view of this and the increasing focus on public finances as a result of further financial devolution, there is scope to provide

enhanced information on how the NDR account sits within the wider picture of Scotland's finances.

37. The Scottish Government is developing proposals to improve and enhance its financial reporting. These developments should reflect the role of the NDR account in Scotland's public sector financial framework.

Internal control

38. In its management of the NDR account, Local Government Finance use the Scottish Government accounting and banking systems.

39. No material weaknesses in the accounting and banking systems were identified during our audit of the Scottish Government's Consolidated Accounts 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 NDR account.

Arrangements for the prevention and detection of fraud

40. Scottish Government 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 were effective arrangements for the prevention and detection of fraud in 2015/16.

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

41. Based on our review of the evidence we concluded that there are appropriate arrangements in place for the prevention and detection of corruption and we are not aware of any specific issues that we need to record in this report.

Appendix I: Significant audit risks

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

Audit Risk	Assurance procedure	Results and conclusions
Risk of material misstatement		
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.	Financial statements work – detailed testing of journals and evaluation of significant transactions that are outside the normal course of business.	Detailed testing of the amounts in the account revealed no evidence of management override of controls.
Business Rates Incentivisation Scheme (BRIS) disclosure There is a risk that the disclosure does not adequately reflect outcomes of the 2012/13 and 2014/15 BRIS.	Review disclosure in the financial statements and consider appropriateness.	Reviewed the disclosure in the account, being an amount of £9 million. This was agreed back to supporting Local Authority returns which confirmed the total had been retained accurately.

Audit Risk	Assurance procedure	Results and conclusions
Governance arrangements for the NDR Account. At present there is no formal role in the scrutiny of the NDR Account for any of the Scottish Government's audit and risk committees. Scrutiny of annual accounts by an audit and risk committee and/ or a corporate board is a feature of good corporate governance, with formal oversight reducing the risk of fraud and error. It is recommended that the Scottish Government should consider reviewing and enhancing the governance arrangements for the NDR Account.	Evidence that the NDR account has been considered by the Accountable Officer.	The Finance, Communities and Strategy ARC agreed in May 2016 that the NDR account would be overseen by SGARC. See action point 2.

Appendix II: Action plan

No.	Para ref.	Issue/risk/recommendation	Management action/response	Responsible officer / Target date
1.	24	**Financial sustainability** There is a large and increasing negative balance on the NDR account, indicating that amounts distributed are exceeding amounts collected. **Risk** There is a risk that an increasing negative balance will make it increasingly difficult to achieve the year on year balance required to maintain sustainability in the account. **Recommendation** This balance on the NDR account needs to be monitored in the medium –term to ensure the accounts remains in balance.	There is a robust procedure in place for monitoring of this account. NDR income projections are subject to regular monitoring as part of the normal budget cycle/Spending Review process and, as more up to date data becomes available, we check that the forecasts remain on track. In 2015-16 our analytical colleagues received four NDRI returns from individual local authorities (as below) and all of these returns influence our estimates:- • April – The Provisional Contributable Amount returns are received • October – The previous year's Notified and the current year's Mid Year returns are received • December – Audited returns are received For information – We have recently agreed with local government to bring forward the timings for the Notified returns (from Oct to Jun) and Audited returns (from Dec/Jan to Oct) and these revised timings are now in place. The Distributable Amount (DA) is based on available estimates of NDR income at the time. Outturn information is not available at that point. There is a time lag between setting the DA and the final information for the previous year becoming available. For 2015-16 the DA was finalised in February 2015 but the provisional notified income	Bill Stitt Local Government and Analytical Services Division

No.	Para ref.	Issue/risk/recommendation	Management action/response	Responsible officer / Target date
			on the NDR Pool for 2014-15 did not become available until October 2015. Under the NDR legislation, the DA cannot be amended after the beginning of the financial year in question (i.e. in this case 1 April 2015). Going forward, the balance on the pool will be taken into consideration when setting the Draft Budget for 2017-18. From April 2017 the Fiscal Commission will have statutory responsibility for producing forecasts including NDRI; Fiscal Responsibility Division will be ensuring a smooth transition to the new arrangements.	
2.	34	**Governance: oversight of NDR account** To date, none of the Scottish Government audit and risk committees has formally considered the NDR account. **Risk** Without scrutiny of annual accounts by an audit committee or equivalent, the Scottish Government is not meeting recognised good governance practice. **Recommendation**	The new Scottish Government governance arrangements are now in operation and the Scottish Government Audit and Assurance Committee will consider this at its first meeting in December. *[The SG Finance view is that the Non Domestic Rating account is a stand-alone statutory account, quite separate from the annual accounts of the Scottish Government and not an account of the Scottish Government itself. The account covers the breadth of NDR activities which take place primarily in Local Government. The detailed requirements of the account are fully prescribed by statute, as are the requirements for audit, and this means that there is no gap in governance. DG Communities, where Local Government sits in portfolio terms, is the designated Accountable Officer for this account.]*	SGAAC December 2016

No.	Para ref.	Issue/risk/recommendation	Management action/response	Responsible officer / Target date
		The Scottish Government should review the governance arrangements of the NDR account in the context of its revised overarching governance arrangements.		