The 2016/17 audit of the Scottish Government Consolidated Accounts

AUDITOR GENERAL

Prepared for the Public Audit and Post-legislative Scrutiny Committee
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Introduction

1. The Scottish Parliament's new financial powers are coming into effect at a time of ongoing pressures on public finances and uncertainty about the implications of the UK vote to leave the European Union. The Scotland Acts of 2012 and 2016 have introduced new responsibilities for tax and spending that enhance the Scottish Government's ability to manage and control its spending but also introduce a greater element of financial risk. Comprehensive, transparent and timely reporting of the Scottish Government's budget and financial performance is essential in supporting the Parliament in its important scrutiny role.

2. In December 2015, the Scottish Government published its draft 2016/17 Scottish Budget which set out its spending priorities and plans for the year. The Scottish Government's Consolidated Accounts for 2016/17 provides information on how this budget was managed, how the money was spent and what was achieved.

3. The Consolidated Accounts are a key component of the Scottish Government's accountability to the Scottish Parliament and the public. The accounts reflect the areas for which it has direct responsibility and accountability, including the core portfolios and supporting administration, the executive agencies and NHS bodies. The Consolidated Accounts:
   - cover around 90 per cent of the spending approved by the Scottish Parliament
   - report the amounts the Scottish Government spent against each main budget heading, and the reasons for any significant differences
   - show the amounts distributed to other public bodies including local government
   - report the assets, liabilities and other financial commitments carried forward to future years
   - contain a performance report, in which the Government gives a high-level account of its performance during the year.

4. My independent audit opinion on the 2016/17 Consolidated Accounts is unqualified. This means that I am content they show a true and fair view, follow accounting standards and that the income and expenditure for the year is lawful. My audit opinion is set out at page 46 of the accounts.

5. This report highlights key information in the Consolidated Accounts. It explains what they show about the Scottish Government's management of its budget. The report also provides other information about the budget, and about governance and performance. I also set out significant audit findings and identify matters relating to financial and performance management and report where further action is required.

6. As with previous years, I provide this report on the 2016/17 Consolidated Accounts to support the Scottish Parliament in its important scrutiny role of public finances in Scotland.

Key messages

- **The Scottish Government has published a sound financial report in its Consolidated Accounts for 2016/17 and my opinion on them is unqualified. The accounts show that total net expenditure during 2016/17 was £33,870 million, £85 million less than budget. Budget management during the year was effective in managing total spending against the limit set.**
- **The amount raised from Land and Buildings Transactions Tax and Scottish Landfill Tax in 2016/17 was £633 million, £38 million less than the December 2015 forecast of £671 million included as part of the budget. As with any forecast, actual amounts are likely to differ from those predicted. The Scottish Government managed this shortfall through underspends in its overall budget.**
- **The implementation of new financial powers and changes that will arise from the UK's decision to leave the European Union, mean it is critical that the Scottish Government continues to strengthen its approach to public financial management and reporting. Priorities for the Scottish Government should be to:**
  - **publish a public sector consolidated account for the whole public sector**
  - **introduce a medium-term financial strategy covering the next five years**
  - **finalise policies and principles for borrowing and reserves.**
- **In June 2017, the Budget Process Review Group established by the Finance and Constitution Committee, recommended a revised framework for a new budget process centred on a full-year approach with continuous scrutiny. The Group consisted of parliamentary and government officials alongside external experts. The Group's recommendations provide a real opportunity for the Scottish Government to significantly strengthen its financial reporting and support Parliamentary and public scrutiny as we enter a new environment for public financial management in Scotland.**
- **During 2016/17, the Scottish Government implemented new governance arrangements with the aim that they better reflect the demands created by new financial powers and constitutional change. The success of the new arrangements will be determined by how they operate in practice. Central to this will be the culture and behaviours adopted by those involved to ensure scrutiny and challenge are effective and transparency is exercised.**

Financial management

7. For the second year, the Scottish budget included new tax and borrowing powers set out in the Scotland Act 2012. This meant that the total amount it could spend was affected by amounts raised through devolved taxes and any capital borrowing decisions, as well as the Scottish Block Grant and other funding sources including Non-Domestic Rates (NDR) income and European programmes of financial assistance.

8. The Block Grant was the largest part of the budget. It was adjusted to reflect the devolution of Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) as well as the introduction of the Scottish Rate of Income Tax (SRIT) for the first time in 2016/17. The UK Parliament votes the necessary provision to the Secretary of State for Scotland, who makes grant payments to the Scottish Government into the Scottish Consolidated Fund (SCF). Receipts from devolved tax powers and any borrowing are also paid into the Fund.

9. Each year the Scottish Government has to manage its spending within two budgets:

- **Scottish budget:** approved by the Scottish Parliament each year and used to cover spending by the Scottish Administration and other bodies funded directly out of the Scottish Consolidated Fund.
- **HM Treasury budget:** used by the UK government to manage its spending on the Scottish Block grant. This is different from the Scottish Parliament's budget largely for technical reasons reflecting differences between accounting rules and UK budget rules.

Scottish budget

10. The final budget approved by the Scottish Parliament for 2016/17 permitted total expenditure of £37,580 million for the financial year. This reflects two revisions made to the original budget during autumn 2016 and spring 2017, which added a total of £631 million to the budget. Additions were mainly due to a combination of Barnett consequentials[1] arising from changes to UK spending programmes and technical accounting adjustments.

11. The majority of the budget (90 per cent or £33,955 million) relates to spending programmes and administration costs covered by the Scottish Government Consolidated Accounts. The accounts are an important part of a number of different financial reports laid in Parliament that sets out how the Scottish budget has been used. They reflect the areas that the Scottish Government is directly responsible and accountable for:

- core portfolios and related administration (such as staff costs)
- executive agencies (such as Scottish Prison Service and Transport Scotland)
- NHS bodies (both territorial and national boards)
- Crown Office and Procurator Fiscal Service

[1] Barnett consequentials are changes to funding to a devolved administration as a result of changes to comparable UK spending programmes.

- Mental Welfare Commission.

Further details of the bodies included as part of the Consolidated Accounts are included at page 12 of the accounts.

12. Amounts are also allocated to other parts of the Scottish Administration (£3,460 million) such as NHS and Teachers' Pension Schemes and also to directly funded bodies (£165 million) such as the Scottish Parliamentary Corporate Body. Details of outturn against budget for the bodies not included in the Consolidated Accounts are included at Appendix 1.

13. Separate accounts are also published by individual agencies and bodies whether part of the Scottish Administration, sponsored by the Scottish Government or directly funded bodies. These reflect the accountability each has to the Scottish Parliament. Audit reports relating to these separate accounts are available on Audit Scotland's website.[2]

14. The Scottish Government also publishes the audited accounts of the Scottish Consolidated Fund (SCF) and the Non-Domestic Rating (NDR) Account. The SCF account reports the cash paid in and out of the Fund and the NDR account shows the amounts collected by, and paid out to, local government in relation to non-domestic rates. The Devolved Taxes accounts are produced by Revenue Scotland. The Scottish Ministers also report a Final Outturn statement for the preceding financial year against the final Budget for the Scottish Administration as a whole. This is an important part of the Government's accountability to the Scottish Parliament.

Scottish budget performance 2016/17

15. The Consolidated Accounts show that total net expenditure during 2016/17 was £33,870 million, £85 million less than budget (Exhibit 1). The resource budget was underspent by £28 million (0.1 per cent) against a budget of £31,890 million and capital by £57 million (2.8 per cent) against a budget of £2,065 million. Budget management during the year was effective in managing total spending against the limit set.

Exhibit 1

Total expenditure (resource and capital) against the Scottish Budget approved by the Scottish Parliament

The Scottish Government consolidated total was £85 million under budget in 2016/17.

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Finance and the Constitution	91	104	(13)
Health and Sport	13,353	13,241	112
Education and Skills	3,146	3,190	(44)
Economy, Jobs and Fair Work	320	339	(19)

[2] www.audit-scotland.gov.uk/report/search

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Justice	2,405	2,415	(10)
Communities, Social Security and Equalities	10,959	11,021	(62)
Environment, Climate Change and Land Reform	203	223	(20)
Culture, Tourism and External Affairs	264	272	(8)
Rural Economy and Connectivity	2,835	2,839	(4)
Crown Office and Procurator Fiscal Service	113	115	(2)
Administration	181	196	(15)
Scottish Government consolidated total	**33,870**	**33,955**	**(85)**
Other Scottish Administration	3,442	3,460	(18)
Total Scottish Administration	**37,312**	**37,415**	**(103)**
Directly-funded bodies	160	165	(5)
Total Scottish Budget	**37,472**	**37,580**	**(108)**

Source: Information drawn from the Scottish Government Consolidated Accounts 2016/17 (page 50) and accounts of other bodies, some of which are unaudited at the time of writing. Information on actual against budget performance for bodies not included in the Consolidated Accounts is included at Appendix 1. Further information of individual portfolio spending performance can be found in pages 51 to 61 in the Consolidated Accounts.

16. The Scottish Government manages variations in each portfolio to ensure overall spending remains within budget. The main differences between actual and budgeted spend reported by the Scottish Government were:

- Health and Sport: An overspend of £112 million which mainly related to an increase of £160 million to the provision used to assess legal claims against health boards. The increase was as a result of a technical change in how the claims are assessed. The increase in the provision was partly offset by lower than anticipated charges for property impairments.
- Education and Skills: The underspend within Education and Skills was due to a combination of issues including:
  - Later than anticipated implementation by schools and local authorities of all elements within the Scottish Attainment Challenge programme.
  - Additional income from Disclosure Scotland as a result of retaining English and Welsh disclosure check business longer than planned.

- Re-profiling of Baby Boxes spending to 2017/18.
- Higher than expected income from repayments of Student Loans offset against portfolio spending.

- Communities, Social Security and Equalities: The underspend primarily related to capital spending in housing. Higher than expected levels of capital receipts were received which were offset against spending. In addition, spending on the Infrastructure Loan Fund established in 2016/17 was lower than planned as it relies upon sites becoming available from councils and private developers.

17. High-level reasons for significant variances between actual and budgeted spend are included in the Consolidated Accounts (pages 51 to 61). Further information is given in the accounts of other bodies.

HM Treasury budget

18. Total Managed Expenditure (TME) is the total HM Treasury budget for the year. 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 differences between HM Treasury and Scottish budgets are outlined in Exhibit 2.

Exhibit 2

Reconciliation between the Scottish budget and HM Treasury budget 2016/17 (£m)

The main difference between the two budgets is largely due to technical differences between accounting rules and UK budget rules.

	£m
Scottish budget approved	37,580
Add: HMT funding for DEL not in Spring Budget Revision	37
Add: HMT funding for AME not in Spring Budget Revision	254
Add: Judicial salaries	30
Less: Net technical adjustments	(162)
HM Treasury budget	**37,739**

Source: Audit Scotland based on Note 21 in the Consolidated Accounts 2016/17 (page 118)

19. Financial decisions taken by the Scottish Government within the extent of its available powers affect both TME and Scottish budget limits. For example, devolved tax revenues will be affected by tax policies for LBTT, SLfT and NDR. Decisions on the use of borrowing and reserve powers, and the amounts carried forward between years will also affect the aggregate amount of resources available during a particular year.

Performance against HM Treasury budget 2016/17

20. In June 2017, the Cabinet Secretary for Finance and the Constitution announced the provisional outturn figures for 2016/17 showed an underspend of £191 million against the HM Treasury DEL budget of £24,041 million. This included underspends of £138 million against the fiscal DEL budget (£98 million resource, £40 million capital) and £53 million against the financial transactions budget (used to make loans or equity investments into the private sector). The Scottish Government is able to carry forward the full amount of these underspends into 2017/18 using the Budget Exchange Scheme agreed with HM Treasury (Exhibit 3). Non-cash underspends of £108 million are not carried forward into the following year but as these reflect accounting adjustments such as depreciation and impairments, they do not represent a loss of spending power.

Exhibit 3

Provisional HM Treasury budget performance 2016/17

	Provisional outturn (£m)	HM Treasury budget (£m)	Over/(under) (£m)
HM Treasury Departmental Expenditure Limit (DEL)			
Gross Resource DEL	26,108	26,206	(98)
Block grant adjustment for devolved taxes	(5,500)	(5,500)	-
Net Resource DEL	**20,608**	**20,706**	**(98)**
Capital DEL - general	2,927	2,967	(40)
Capital DEL - financial transactions	315	368	(53)
Cash DEL	**23,850**	**24,041**	**(191)**
Non-cash DEL	784	892	(108)
Net block grant	**24,634**	**24,933**	**(299)**
Devolved tax powers revenue	5,533	5,571	(38)
Of which:			
LBTT	*484*	*538*	*(54)*
SLfT	*149*	*133*	*16*
SRIT	*4,900*	*4,900*	-
Capital borrowing facility	333	333	-

	Provisional outturn (£m)	HM Treasury budget (£m)	Over/(under) (£m)
HM Treasury Annually Managed Expenditure (AME)			
Non-domestic rates	2,769	2,769	-
Other AME	4,180	4,133	(47)
Total AME (not carried forward)	**6,949**	**6,902**	**(47)**

Note: HM Treasury outturn figures are provisional. The differences between budget and outturn in non-cash DEL and in AME do not represent a loss in spending power.

Source: Audit Scotland, based on Scotland Office and Office of Advocate General Annual Report & Accounts 2016/17 and provisional outturn statement by Cabinet Secretary for Finance and the Constitution.

Devolved tax powers from Scotland Act 2012

21. The 2016/17 financial year was the first year that all three devolved tax powers from the Scotland Act 2012 were fully implemented. The Scottish Government prepared forecasts for Land and Buildings Transactions Tax (LBTT) and Scottish Landfill Tax (SLfT) revenues for inclusion in the draft budget, while a Scottish Rate of Income Tax (SRIT) of 10 pence was set for the first time.

22. The Scottish Fiscal Commission (SFC) was responsible for providing independent scrutiny of the Scottish Government's tax forecasts. For 2016/17, the SFC assessed the forecasts for LBTT and SLfT as reasonable based on the data available. The amounts raised from LBTT and SLfT in 2016/17 were £484 million and £149 million respectively. This was £38 million less than the total £671 million forecast as part of the 2016/17 budget (Exhibit 4). The SFC reported[3] that variances were due to overestimating the house price forecast within the LBTT forecast; and for SLfT underestimating the level of standard rated waste which led to higher receipts than forecast.

23. More details of devolved tax revenues are reported in the Devolved Taxes Account published by Revenue Scotland.

[3] Scottish Fiscal Commission Forecast Evaluation Report September 2017

Exhibit 4

Devolved taxes collected

	2016/17 Revenue collected (£m)	2016/17 Budget Act Estimates (£m)	2016/17 Higher than forecast/ (shortfall)	2015/16 Revenue collected (£m)	2015/16 Budget Act Estimates (£m)	2015/16 Higher than forecast/ (shortfall)
Land and Buildings Transactions Tax	484	538	(54)	425	381	44
Scottish Landfill Tax	149	133	16	147	117	30
Total	**633**	**671**	**(38)**	**572**	**498**	**74**

Source: Revenue Scotland devolved taxes accounts 2015/16 and 2016/17.

24. As with any forecast, actual amounts are likely to differ from those predicted. For example, in 2015/16, tax receipts from LBTT and SLfT were £74 million higher than forecast. This additional income was transferred to a cash reserve designed to help offset any future shortfalls between forecast amounts and income received. In 2016/17, the Scottish Government managed its £38 million shortfall from LBTT and SLfT through underspends in its overall budget, therefore the cash reserve balance remains at £74 million. In 2017/18, this balance will transfer to a new Scotland Reserve at the same time as the aforementioned Budget Exchange Scheme closes. This is one of the new mechanisms available to the Scottish Government, along with increased revenue borrowing powers, to help it manage the increased risk and volatility its budget is now exposed to. As I reported in March 2017, the Scottish Government urgently needs to finalise policies and principles for borrowing and reserves, and further develop its longer-term financial scenario planning.[4] Making these publicly available will enhance financial transparency and help demonstrate good public financial management.

25. The Office for Budget Responsibility forecast that the SRIT would raise £4,900 million in 2016/17. This was the amount removed from the Scottish block grant and added back to reflect forecast tax income collected by HMRC from Scottish taxpayers. No adjustments will be made to future Scottish budgets should the actual tax received in 2016/17 differ from this forecast. Final outturn figures for 2016/17 will be known in summer 2018. This arrangement was part of the fiscal framework agreement between the UK Government and the Scottish Government in February 2016. From April 2017, SRIT was replaced by non-savings non-dividend income tax. Adjustments will be made in the summer of 2019.

[4] *Managing new financial powers: an update*, Audit Scotland, March 2017.

Capital borrowing

26. 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 accounts and the Scottish Government has applied the correct accounting treatment.

27. In July 2015, the Office for National Statistics (ONS) decided that the Aberdeen Western Peripheral Route (AWPR), which was a Scottish NPD investment project, should be classified as a public sector project in the National Accounts. In accordance with HM Treasury Consolidated Budgeting Guidance, budget treatment of these projects is determined by their position in the National Accounts. In November 2016, the ONS confirmed a similar classification for three further projects (Edinburgh Sick Kids Hospital, Dumfries & Galloway Royal Infirmary and the National Blood Centre). This classification means that capital budget cover is required at the point of initial investment, rather than revenue budget cover for the annual payments over the lifetime of the contract.

28. This resulted in charges against fiscal DEL budgets which required to be managed within budget limits. This meant that spending plans had to accommodate NPD expenditure within overall annual budget limits. In both 2015/16 and 2016/17, the Scottish Government agreed with HM Treasury that it could record these amounts against its capital borrowing limit. In 2016/17, the Scottish Government used its total capital borrowing limit of £333 million for this purpose. Although this did not result in actual borrowing, it removed the Scottish Government's power to borrow for capital purposes in 2016/17.

29. Looking ahead the draft Scottish budget estimates further capital spending of £190 million for these four projects in 2017/18. In March 2017, following discussions with officials, HM Treasury confirmed to the Scottish Government that any capital pressures arising from NPD projects as a result of the ONS classification would have to be absorbed within capital DEL limits with capital borrowing powers to be used as intended. The additional capital borrowing powers introduced in 2017/18 from the Scotland Act 2016 provides the Scottish Government with more flexibility in responding to spending pressures across its capital programme.

Overall financial position

30. The Consolidated Statement of Financial Position (previously known as the balance sheet) (page 62) 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 of taxpayers' money applied that has continuing public benefit. It shows how much of this has arisen from the application of revenues (including the Scottish Block Grant and devolved taxes) and that which has resulted through changes over time in the value of physical assets.

31. In public finances, the annual position of spending against budget 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. It is important that the Scottish

Government can demonstrate how it is managing its overall financial position. The key items in the Statement of Financial Position over the last five financial years are summarised in Exhibit 5.

Exhibit 5

Scottish Government's year end financial position, 2013 to 2017.

	As at 31/3/2017 (£m)	As at 31/3/2016 (£m)	As at 31/3/2015 (£m)	As at 31/3/2014 (£m)	As at 31/3/2013 (£m)
Physical assets	28,852	27,596	26,698	26,153	25,887
Financial assets	8,726	7,484	6,775	6,228	5,775
Receivables	1,277	1,379	1,098	973	921
Total assets	**38,855**	**36,459**	**34,571**	**33,354**	**32,583**
Payables	(6,063)	(4,882)	(4,416)	(4,572)	(4,527)
Financial liabilities	(673)	(679)	(693)	(698)	(705)
Provisions	(948)	(717)	(778)	(636)	(720)
Total liabilities	**(7,684)**	**(6,278)**	**(5,887)**	**(5,906)**	**(5,952)**
Net assets	**31,171**	**30,181**	**28,684**	**27,448**	**26,631**
General fund	21,064	20,623	18,843	17,397	16,468
Revaluation reserve	10,107	9,558	9,841	10,051	10,163
Taxpayers' Equity	**31,171**	**30,181**	**28,684**	**27,448**	**26,631**

Source: Audit Scotland from Consolidated Accounts 2012/13 to 2016/17.

32. The accounts also provide information about some categories of asset, debt or financing activity not shown on the statement of financial position, largely because of the high level of uncertainty involved. This includes potential liabilities, contingent assets and liabilities and government guarantees. 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.

33. The Scottish Government has reported various contingent assets and liabilities in the Consolidated Accounts. Only some of the liabilities can be quantified, with amounts totalling an estimated £429 million. Some of these amounts may need to be funded from future budgets, but this is by no means certain. Similarly, the Scottish Government has a number of

financial guarantees where the likelihood of settlement is more remote and therefore is not classed as a contingent asset or liability. For example, in December 2016 the Scottish Government entered into a guarantee relating to the hydro plant and aluminium smelter at Lochaber in relation to a power purchase agreement. In 2016/17 this guarantee was valued at £21.4 million. Although settlement is remote, this reflects the Scottish Government's increasing activity and risk appetite in providing financial support and guarantees to support policy objectives.

34. As detailed in Exhibit 5, taxpayers' equity has increased in each of the last five years. This increase is due largely to an increase in physical assets and financial assets. It is important to note that whilst taxpayers' equity as reported in the Scottish Government Consolidated Accounts is increasing, the position does not reflect all the assets and liabilities of the Scottish public sector. For example, key liabilities over and above those detailed in the consolidated accounts including local government borrowing or all public sector pension liabilities funded from the Scottish budget. As detailed in paragraph 39 of this report, publication of a consolidated account for the whole of the public sector in Scotland will give a more comprehensive view of the assets and liabilities of the public sector as a whole.

35. The Consolidated Accounts provides some narrative on the components of the Statement of Financial Position. This is largely in line with improvements noted last year. There remains scope for the Scottish Government to build on these improvements by outlining the opportunities and risks over potential future assets and liabilities and their impact on annual budgets and the overall financial position. This would strengthen transparency and help support the Parliament in their scrutiny of the potential impact of Scottish Government's budget plans and policy choices.

Financial and performance reporting

Financial reporting

36. The Scottish Parliament has seen its financial powers increase substantially, with new responsibilities for taxes, social security and management of finances flowing from the 2012 and 2016 Scotland Acts. These changes have significant implications for public financial management in Scotland and how public finances are reported. A more strategic approach is required that is underpinned by a strong understanding of the economic context at both Scottish and UK levels. This requires comprehensive information to be available that links economic performance with financial information covering income, borrowing and spending.

37. In March this year, I reported that the Scottish Government is taking steps to enhance financial reporting of Scotland's public finances, but more work is required to provide a clear overall picture.[5] The increasingly complex nature of Scotland's public finances means there is an expectation and responsibility on the Scottish Government to provide clear and consistent budget and financial reporting. It is important that information is presented in such a way that

[5] *Managing new financial powers: an update*, Audit Scotland, March 2017.

is easy to understand and navigate. This will encourage greater public engagement and help the Parliament to build a comprehensive picture of Scotland's public finances. This allows the potential consequences of policy choices and decisions on long-term financial sustainability to be better understood and contribute to public trust and confidence in Government.

38. The Scottish Government reports financial information in a variety of documents including the Consolidated Accounts. The Scottish Government has made some improvements to the presentation of this year's consolidated statements, which should help the reader's understanding of individual Scottish Government portfolios' financial performance. I welcome this but there is scope to go further to make the accounts more accessible to the public and Parliament.

39. The Scottish Government has established a programme of work to develop its public financial reporting. As part of this, it has committed to producing a consolidated account to cover the whole public sector in Scotland including local government borrowing and public sector pension liabilities. It is expected this will provide information on total assets, liabilities, borrowing and investments across the Scottish public sector. The Scottish Government has designated 2016/17 as a 'shadow-year' with a view to publishing the account during 2018. This is a welcome development and should aim to allow for the Parliament and others to see a comprehensive picture of the financial health of the public sector in Scotland.

40. In December 2016, the Scottish Government published its first Open Government National Plan.[6] The plan aims to give the public a better understanding of how government works so that they can have more influence in holding them to account. One of the commitments in the plan aims to clearly explain how public finances work, so people can understand how money flows into and out of the Scottish Government, to support public spending in Scotland. By April 2018, it aims to have undertaken a review of the content and format of the information that it currently publishes on its website to then allow greater clarity and wider access to the information that is published. In addition, the Scottish Government has committed to consider what new financial reporting information it needs to publish to reflect a more open approach to public finances alongside the introduction of new financial powers. It aims to make any changes in 2018/19.

41. In 2016, the Finance and Constitution Committee established a Budget Process Review Group to carry out a fundamental review of the budget process in light of the Scottish Parliament's new financial powers. The Group consisted of parliamentary and government officials alongside a panel of external experts including me as Auditor General. The Group published its final report in June 2017, making detailed recommendations to significantly change the existing budget process.[7] This included a recommendation that the revised process should:

- have a greater influence on the formulation of the Scottish Government's budget proposals;

[6] *Open Government Partnership Scottish Action Plan*, Scottish Government, December 2016.
[7] *Budget Process Review Group, Final Report*, June 2017.

- improve transparency and raise public understanding and awareness of the budget;
- respond effectively to new fiscal and wider policy challenges;
- lead to better outputs and outcomes as measured against benchmarks and stated objectives.

42. The Group recommended a revised framework for the Scottish Parliament and Government to agree a new budget process. This centres on a full-year approach with continuous scrutiny allowing for a better understanding of the impact of decisions over a number of years. It also recommends there should be a greater focus on outcomes and the interdependencies and prioritisation of policies considering both financial constraints and an increased demand for public services.

43. To support improvements to the budget process, the Group's recommendations include some significant changes to the Scottish Government's financial reporting. These include:
    - The introduction of an annual Fiscal Framework Outturn Report. This is to support scrutiny of the operation of the Fiscal Framework agreed between the UK and Scottish governments in relation to the arrangements for new tax and social security powers and how this affects the Scottish budget. The report should include details on the reconciliation process between forecasts and outturn, use of Scotland Reserve and borrowing powers.
    - The introduction of a Medium-Term Financial Strategy to outline the Scottish Government's high-level financial plans and projections for at least five years. The strategy should be published on an annual, rolling basis to help inform detailed budget proposals in each year.
    - A presumption that the Scottish Government returns to publishing multi-year spending reviews following the equivalent publication at UK level. This would provide support to public bodies in developing and setting medium-term priorities and plans.
    - The introduction of a mid-year report to Parliament on revenue and spending up to the end of December of the current financial year to accompany any proposed budget amendments in the Spring Budget Revision.

44. I welcome and support the Group's findings and recommendations, which are consistent with themes I have reported to Parliament in recent years. A key aspect is that the scrutiny of public finances moves towards a whole-cycle approach rather than its current annual focus that follows the publication of the draft budget. This would provide more space and time for year-round scrutiny of value for money decisions and inform future spending proposals. Longer-term planning and a clear financial strategy are fundamental elements for effective policy decision making. The principles of financial sustainability, transparency and accountability should be demonstrated in the Government's financial reporting on the current financial position, future forecasts and its plans to address any emerging pressures. This is necessary to enable the Parliament to take a broader perspective to hold Government to account for its approach to spending and tax-raising and its overall management of public finances.

45. Relevant recommendations are to be reflected in a revised Written Agreement between the Scottish Government and the Finance Committee.

46. The recommendations together with the need to finalise policies for borrowing and reserves, and the Scottish Government's plans to develop a whole public sector consolidated account, provide a real opportunity for the Scottish Government to significantly strengthen its financial reporting. This will help support both Parliamentary and public scrutiny as we enter a new environment for public financial management in Scotland. I will continue to examine and report on the Government's progress in this area.

Performance reporting

47. The Consolidated Accounts are required to comply with the accounting principles and disclosure requirements of the Government Financial Reporting Manual (FReM).[8] A direction by the Scottish ministers to that effect is set out in the Consolidated Accounts (page 120). In Scotland, the form and content of the annual report and accounts is a matter for the Scottish Parliament, which in practice involves an agreement between the Scottish ministers and the Public Audit and Post-Legislative Scrutiny Committee on a format based on the principles contained in the FReM.

48. The 2016/17 Consolidated Accounts comply with the principles of the FReM, including a performance report and an accountability report. The performance report (pages 6 to 21) 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 on supplier payment performance compared with policy targets and signposts where more information is available on sustainability and environmental performance. For information on the Scottish Government's progress towards its overall aims and objectives, users of the accounts are directed to the National Performance Framework (NPF). The NPF 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.

49. Consequently, while the performance report provides analysis of some key aspects of financial performance, the Consolidated Accounts focus on the Government's finances. They do not report on the performance of individual portfolios or the Scottish Government as a whole, limiting the reader's ability to see the Government's own contribution to national outcomes.

50. As Scotland's fiscal responsibilities continue to grow, expectations are increasing for the Scottish Government to produce more detailed and transparent performance reporting, that better links spending with outcomes. The Budget Process Review Group recommended that the Scottish Government strengthens their performance planning and reporting to provide a greater focus on the delivery of outcomes. This includes providing better information about

[8] *Government Financial Reporting Manual 2016/17*, HM Treasury.

what activity public spending will support, its aims, and the contribution it expects to make to national outcomes.

51. Greater transparency around the Scottish Government's own performance towards meeting its strategic objectives would provide greater accountability for the use of financial resources outlined in the Consolidated Accounts. This would provide a more rounded account of the Scottish Government's overall performance and would enhance reporting to the Scottish Parliament and the public, and help strengthen accountability and scrutiny.

Governance

52. A Governance Statement (pages 23 to 30) prepared by the Permanent Secretary is a key feature of the Consolidated Accounts. It forms part of a wider accountability report and summarises how the core Scottish Government organisation is controlled and directed. The statement reports that it complies with relevant guidance on corporate governance. It also highlights some of the main risks and opportunities for the organisation and any significant internal control issues in 2016/17. I am content that the Governance Statement is consistent with the financial statements and has been prepared in accordance with guidance on this issued by the Scottish Ministers.

53. In October 2016, the Scottish Government implemented new governance arrangements with the aim that they better reflect the demands created by new financial powers and constitutional change. This followed a review undertaken by the Permanent Secretary to explore options for streamlining arrangements while ensuring the principles of effectiveness and transparency are maintained. In July 2017, further changes were made at executive team level including the creation of a Director General role to better reflect Scotland's new fiscal responsibilities and a Chief Financial Officer role to cover in-year financial management and operations. The changes provide an opportunity for the Scottish Government to strengthen oversight of public financial management during a period of significant change for Scotland's public finances.

54. In June 2017, an independent review of the governance arrangements commenced led by the Director of Internal Audit, supported by the Crown Agent and a former non-executive director. The review aims to assess whether the design principles and governance tests of the new arrangements are being met or if any further measures are required. It is good practice to undertake an early review of new arrangements in order to address any concerns or to identify any lessons learned can be identified. The review is due to be reported to the Scottish Government in October 2017.

55. The success of the new arrangements will be determined by how they operate in practice. Central to this will be the culture and behaviours adopted by those involved including the contributions made by non-executive directors to ensure scrutiny and challenge are effective and transparency is exercised. It is important that non-executive directors are able to provide an appropriate balance of support and challenge and their level of engagement should reflect this independent role. I will keep the revised governance arrangements under review as part of our continuing work and engagement with the Scottish Government.

56. In implementing these new arrangements it is also important to recognise the Scottish Government's leadership role for other bodies. In my view, the new approach must remain, and be seen to remain, aligned with what it expects of other public bodies and that in developing its new arrangements it demonstrates the culture and behaviours that support the principles of good governance including transparency.

Other significant audit matters

European Funding - CAP Futures

57. The Scottish Government provides financial support to farmers and other rural businesses as part of the Common Agricultural Policy (CAP). The 2016/17 Consolidated Accounts include resource expenditure of £10.6 million on the CAP Futures programme, an IT-enabled change programme to implement the CAP reforms in Scotland. Capital spending was £29.4 million.

58. In June 2017, I reported that the CAP Futures programme closed as planned on 31 March 2017.[9] Significant parts of the system continue to be delivered by the Agriculture and Rural Economy directorate. The directorate expects to deliver the minimum required scope to comply with European Commission (EC) regulations within the £178 million budget.

59. The Governance Statement in the Consolidated Accounts notes that delivering the CAP payments remains extremely challenging and that there remains a significant risk to meeting EC regulatory requirements. In my June 2017 report I estimated potential financial penalties of up to £60 million, but I highlighted that the Scottish Government had not undertaken a detailed analysis of potential financial penalties. My estimate was based on a combination of the financial impact of findings from the 2015/16 audit of European Agricultual Funds Accounts, penalties relating to the late payment of 2015 single application form claims and the failure to meet other deadlines. The Consolidated Accounts show provisions and contingent liabilities relating to potential penalties from the European Commission. Note 12 of the Consolidated Accounts (page 94) includes a provision of £2.5 million in relation to penalties. An unquantifiable contingent liability in respect of potential future liabilities is also included in Note 17 (page 108). The relevant amounts are appropriately disclosed in the Consolidated Accounts. A provision is a liability of uncertain timing or amount where there is an obligation based on a past event, it is probable it will mean a payment to settle the obligation and the amount is based on a reliable estimate. A contingent liability is more uncertain in both timing and amount, and is dependent on a future event to confirm its existence; or no reliable estimate can be made for it.

60. The Consolidated Accounts also show an unquantifiable contingent liability for the potential penalty from the missed extended payment deadline for 2015 payments. There is an accrual of £1 million in relation to this missed deadline as well as a contingent liability for the potential penalty that is to be negotiated. The liability is probable, however a reliable estimate cannot be made and therefore we accepted the treatment as a contingent liability.

[9] *Common Agricultural Policy Futures programme: further update*, Audit Scotland, June 2017.

61. There is also a contingent liability disclosure for a number of European Commission audits which may result in disallowance of grant or penalties, but these cannot be quantified because of the uncertainty in timing and estimates as they can change through negotiations with the European Commission. Negotiations on disallowance with the European Commission can last for many months and the agreed disallowance or penalty can sometimes be significantly different from initial notification of potential penalty. Consequently, the £60 million estimate of potential financial penalties does not appear in the Consolidated Accounts.

62. Exhibit 6 below shows the time it takes for a potential liability to crystallise to a payment.

Exhibit 6

Time lag between CAP scheme year and repayment to the European Commission

Source: Audit Scotland

63. The Scottish Government established two loan schemes during 2016/17 to help farmers and rural businesses receive money more quickly. These included funding from the Scottish Government's financial transactions budget which supports loan schemes that go beyond the public sector. Note 9 (page 87) of the Consolidated Accounts discloses that loan payments of £370 million were made in 2016/17, with £239 million recovered by 31 March 2017. The Scottish Government managed in-year loan funding to minimise the risk of overspending its 2016/17 capital budget. At the same time, the Government ensured any underspend did not exceed its budget exchange limit which would have reduced the level of carry forward available in 2017/18.

64. Due to the continued delays developing the software for 2016 Less Favoured Area Support Scheme payments, the Cabinet Secretary for Rural Economy and Connectivity announced a £50 million loan scheme in April 2017. In addition, a further loan scheme in relation to the 2017 Basic Payment Scheme (BPS) was announced in September 2017.

European Structural Funds

65. The Scottish Government manages four European structural fund programmes (two programmes funded by the European Social Fund and two funded by the European Regional Development Fund). These programmes provide financial assistance to, for example, help improve transport links, support business growth and improve skills.

66. In my report last year on the 2015/16 Consolidated Accounts, I highlighted that the European Commission had lifted the suspensions and interruption imposed on the 2007-13 programmes. While the suspensions and interruptions remained in place, amounts due from the EC accumulated. Following their removal, £165 million receipts were received during 2016/17. The 2016/17 Consolidated Accounts show that the £14 million provision created in 2015/16 crystallised into a liability of £31 million as a result of the 2007-13 programme closure representing grant payments received over and above expenditure declared to the EC. Taking into account all receipts in year, the net cost to the Scottish Government is £21 million, subject to final EC checks.

67. Closure of the 2007-13 programmes also identified that the Scottish Government overpaid project sponsors a total of £16 million as a result of errors identified by Internal Audit and the subsequent application of penalties. The Scottish Government has started to raise invoices for these amounts owed to them by sponsors. The Consolidated Accounts include an unquantified contingent asset as there remains uncertainty over whether the amounts will be recovered as they may be subject to appeal.

Conclusion

68. The Scottish Government has published a sound financial report in its Consolidated Accounts for 2016/17. It covers spending against budget for the financial year and sets out what it owns and owes as at 31 March 2017. The accounts are prepared from the perspective of the Scottish Government's role in managing the budget it directly controls and covers the majority of public spending in the Scottish budget. This is a critical component of the Scottish Government's accountability to the Parliament and the public.

69. The Scottish Government has a good record of financial management and reporting. In 2016/17 improvements were made to the Consolidated Accounts in its presentation and narrative. Governance arrangements continue to evolve and the National Performance Framework provides details on what the Government aims to achieve and performance against national outcomes. My audit work has highlighted a number of areas for further improvement to help support the Parliament and the public in their scrutiny of public finances. Priorities for the Scottish Government should be to:

- publish a public sector consolidated account for the whole public sector to outline total assets, liabilities, borrowing and investments;
- introduce a medium-term financial strategy to outline high-level financial plans for the next five years; and
- finalise policies and principles for borrowing and reserves.

70. The implementation of new financial powers and changes that will arise from the UK's decision to leave the European Union, mean it is critical that the Scottish Government continues to strengthen its approach to public financial management and reporting. These challenges provide a unique opportunity for the Scottish Government to engage with both the Parliament and the public about the risks and opportunities facing Scotland's public finances. The increasingly complex nature of public finances means there is a growing expectation and responsibility on the Scottish Government to provide clear and consistent budget and financial reporting. This will help support the Parliament, as it implements its new budget process, to build a comprehensive picture of Scotland's public finances and will help foster greater public trust and confidence in Government.

71. Working with Audit Scotland and the Accounts Commission, I will continue to support the independent scrutiny of Scotland's public finances through all of our audit work.

Appendix 1

Scottish budget 2016/17: outturn against budget for bodies not included in the Consolidated Accounts.

Entity	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Scottish Government Consolidated Accounts	33,870	33,955	(85)
National Records of Scotland	25	26	(1)
Teachers' and NHS Pension Schemes	3,282	3,300	(18)
Office of the Scottish Charity Regulator	3	3	-
Scottish Courts and Tribunal Service	108	107	1
Scottish Housing Regulator	4	4	-
Revenue Scotland	5	5	-
Food Standards Scotland	15	15	-
Total Scottish Administration	**37,312**	**37,415**	**(103)**
Forestry Commission	54	57	(3)
Scottish Parliamentary Corporate Body	98	100	(2)
Audit Scotland	8	8	-
Total Scottish Budget	**37,472**	**37,580**	**(108)**

Source: Audit Scotland based on 2016/17 audited accounts where available at the time of writing.

The 2016/17 audit of the Scottish Government Consolidated Accounts

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