Scottish Government

2017/18 Annual Audit Report

AUDIT SCOTLAND

Prepared for the Scottish Government and the Auditor General for Scotland

December 2018

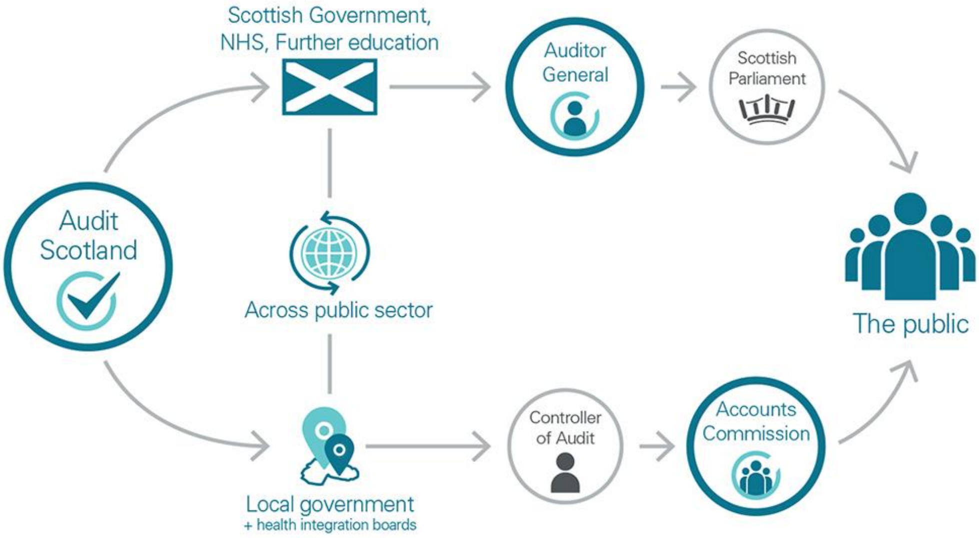
Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- The Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.

- The Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.

- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.



About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money

- reporting our findings and conclusions in public

- identifying risks, making clear and relevant recommendations.

Contents

Key messages

2017/18 annual report and accounts

1 **The financial statements of the Scottish Government give a true and fair view of the financial position and expenditure and income of its core portfolios and bodies within the consolidated accounting boundary. The expenditure and income were incurred or applied in accordance with any applicable enactments and guidance, and the other information in the annual report and accounts was consistent with the financial statements and prepared in accordance with legal requirements.**

Financial management

2 **The Scottish Government operated within its 2017/18 budget. The Consolidated Accounts show that total net expenditure was £34,461 million, £339 million less than budget.**

3 **Other than payroll the Scottish Government's main systems of internal control (SEAS (General ledger), Payables, Receivables and Banking) operate effectively. Improvements are required in some areas, mainly payroll, to ensure controls operate as expected.**

Financial sustainability

4 **Over the last year, the Scottish Government has taken some important steps to improving its financial reporting with the publication of its first medium-term financial strategy, *Scotland's Fiscal Outlook*. The Scottish Government has not yet published a public consolidated account to cover the whole public sector. This is an important commitment that will improve strategic financial management, support Parliamentary scrutiny and enable better decision making.**

5 **The arrival of new borrowing powers has enhanced the Scottish Government's ability to manage and control its spending each year. In March 2018, the Scottish Government borrowed £450 million of capital funds, the maximum allowed in 2017/18. This was in line with plans made as part of the 2017/18 Scottish budget. At the end of 2017/18, the Scottish Government had net borrowings of £1.036 billion against its £3 billion capital borrowing limit (35 per cent).**

Governance and transparency

6 **The governance arrangements are adequate to support good governance and accountability. With the main powers from the Scotland Acts now in operation, there has been slow progress in finalising the roles and responsibilities within the Scottish Exchequer directorate and recruitment is ongoing to fill key posts.**

7 **The Scottish Government made some improvements to its governance arrangements such as greater consistency and standardisation of agendas, minutes and papers, the implementation of a board development programme and the appointment of a Board Secretary to improve connections between corporate groups. Pressure on non-**

executive directors' capacity combined with often late or out-of-date information reduced the opportunity for effective scrutiny.

Value for money

8 **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 launch of the revised National Performance Framework provides the opportunity for the Scottish Government to make progress in this area.**

Introduction

1. This report summarises the findings from our 2017/18 audit of the Scottish Government.

2. The scope of our audit was set out in our Annual Audit Plan presented to the 26 March 2018 meeting of the Scottish Government Assurance and Audit Committee. This report comprises the findings from:

- an audit of the Scottish Government's annual report and accounts
- consideration of the four audit dimensions that frame the wider scope of public audit set out in the *Code of Audit Practice 2016* as illustrated in Exhibit 1.

Exhibit 1
Audit dimensions

Source: *Code of Audit Practice 2016*

3. The main elements of our audit work in 2017/18 have been:

- a review of the Scottish Government's main financial systems
- an audit of the Scottish Government's 2017/18 annual report and accounts including the issue of an independent auditor's report setting out our opinions
- consideration of the four audit dimensions.

4. The Scottish Government has primary responsibility for ensuring the proper financial stewardship of public funds. This includes preparing an annual report and accounts that are in accordance with the accounts direction from the Scottish Ministers. The Scottish Government's annual report and accounts includes the following:

- Performance Report
- Accountability Report (which includes the Corporate Governance Report and Remuneration and Staff Report)
- Financial statements and supporting notes.

5. The Scottish Government is also responsible for establishing effective arrangements for governance, propriety and regularity that enable the Corporate Board to successfully deliver its objectives.

6. Our responsibilities as independent auditor are outlined in the Public Finance and Accountability (Scotland) Act 2000 and the *Code of Audit Practice 2016* and supplementary guidance, and International Standards on Auditing in the UK.

7. These responsibilities include giving independent opinions on the annual report and accounts. We also review and provide conclusions on the effectiveness of the performance management arrangements, suitability and effectiveness of corporate governance arrangements, and financial position and arrangements for securing financial sustainability. In doing this we aim to support improvement and accountability. Further details of the respective responsibilities of management and the auditor can be found in the *Code of Audit Practice 2016* and supplementary guidance.

8. This report raises matters from the audit of the annual report and accounts and consideration of the audit dimensions. Weaknesses or risks identified are only those which have come to our attention during our normal audit work, and may not be all that exist. Communicating these does not absolve management from its responsibility to address the issues we raise and to maintain adequate systems of control.

9. Our annual audit report contains an agreed action plan at Appendix 1. It sets out specific recommendations, responsible officers and dates for implementation. It also includes outstanding actions from last year and the steps being taken to implement them.

10. We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services and therefore the 2017/18 audit fee of £1,076,590 as set out in our Annual Audit Plan remains unchanged. We are not aware of any relationships that could compromise our objectivity and independence.

Adding value through the audit

11. Our aim is to add value to the Scottish Government by increasing insight into, and offering foresight on, financial sustainability, risk and performance, by identifying areas of improvement and by recommending and encouraging good practice. In so doing, we aim to help the Corporate Board promote improved standards of governance, better management and decision making and more effective use of resources.

12. This report is addressed to both the Corporate Board and the Auditor General for Scotland and will be published on Audit Scotland's website www.audit-scotland.gov.uk in due course.

13. We would like to thank all management and staff who have been involved in our work for their cooperation and assistance during the audit.

Part 1

Audit of 2017/18 annual report and accounts

Main judgements

The financial statements of the Scottish Government for 2017/18 give a true and fair view of income and expenditure during the year and the financial position of organisations within the consolidation boundary.

Expenditure and income were in accordance with applicable enactments and guidance.

The audited part of the remuneration and staff report, performance report and governance statement were all consistent with the financial statements and properly prepared in accordance with the accounts direction.

The annual report and accounts are the principal means of accounting for the stewardship of its resources and its performance in the use of those resources.

Audit opinions on the annual report and accounts

14. The annual report and accounts for the year ended 31 March 2018 were approved by the Scottish Government Assurance and Audit Committee on 24 September 2018. We reported within our independent auditor's report that in our opinion:

- the financial statements give a true and fair view and were properly prepared
- expenditure and income were regular and in accordance with applicable enactments and guidance
- the audited part of the remuneration and staff report, performance report and governance statement were all consistent with the financial statements and properly prepared in accordance with the accounts direction.

15. Additionally, we have nothing to report in respect of misstatements in information other than the financial statements, the adequacy of accounting records and the information and explanations we received.

Submission of annual report and accounts for audit

16. We received the unaudited core schedules on 8 June 2018 and the first version of the unaudited consolidated accounts on 27 July 2018 in line with our agreed audit timetable.

17. The working papers provided with the unaudited financial statements were of a sufficient standard and finance staff provided good support to the audit team which helped ensure the final accounts audit process ran smoothly.

Whole of Government Accounts

18. The draft Whole of Government Accounts (WGA) pack was provided on 23 August 2018 in accordance with the audit timetable to enable us to meet the

National Audit Office (NAO) deadline of the 28 September 2018. An updated pack to mirror the signed Consolidated Accounts was provided on 27 September 2018 and the audited pack was submitted to the NAO on 9 November 2018.

Risk of material misstatement

19. Appendix 2 provides a description of those assessed risks of material misstatement that were identified during the planning process. These risks had the greatest effect on the overall audit strategy, the allocation of staff resources to the audit and directing the efforts of the audit team. Also included within the appendix are wider audit dimension risks, how we addressed these and conclusions.

Materiality

20. Misstatements are material if they could reasonably be expected to influence the economic decisions of users taken based on the financial statements. The assessment of what is material is a matter of professional judgement. It involves considering both the amount and nature of the misstatement. It is affected by our perception of the financial information needs of users of the financial statements.

21. Our initial assessment of materiality for the annual report and accounts was carried out during the planning phase of the audit. On receipt of the annual report and accounts we reviewed our materiality calculations and concluded that the basis of the calculations remained appropriate and we re-calculated the values based on the draft accounts. The calculation of materiality based on the draft accounts is summarised in Exhibit 2.

22. Specifically, regarding the annual report and accounts we assess the materiality of uncorrected misstatements, both individually and collectively.

Exhibit 2
Materiality values

Materiality level	Amount
Overall materiality This is the calculated figure we use in assessing the overall impact of audit adjustments on the financial statements. It was set at one per cent of gross expenditure for the year ended 31 March 2018.	£360 million
Performance materiality This acts as a trigger point. If the aggregate of errors identified during the financial statements audit exceeds performance materiality, this would indicate that further audit procedures should be considered. Using our professional judgement, we have calculated performance materiality at 20 per cent of overall materiality. Given the specific nature of the Scottish Government audit and the lower materiality levels in respect of individual errors identified, we apply judgement and consider the nature and circumstances of each error identified. Therefore, in practice, we work to much lower materiality levels and any individual error in the range £10 million to £20 million and above may be material depending on its nature and impact.	£72 million
Reporting threshold	£0.1 million

Materiality level	Amount
We are required to report to those charged with governance on all unadjusted misstatements in excess of the 'reporting threshold' amount. This was calculated at one per cent of overall materiality but capped at £0.1 million.	

Source: Audit Scotland

How we evaluate misstatements

23. There were a number of presentational and monetary misstatements identified during the audit. These were discussed with senior officials who agreed to make the necessary adjustments.

24. Gross monetary misstatements (errors) for the Scottish Government core portfolios, in excess of the 'reporting threshold' amount (£0.1 million) totalled £71.6 million. Of this balance £41.84 million relates to adjusted errors and £29.7 million relates to unadjusted errors. The significant adjustments that make up the adjusted balance are:

- £20 million adjustment relating to Common Agricultural Policy (CAP) payments to farmers. Income and expenditure which had been accrued in the prior year was wrongly included in the 2017/18 accounts. This decreased expenditure and income by the same amount and the net effect on the statement of financial position was nil.
- £14.25 million adjustment for an invalid accrual relating to Health expenditure. There was insufficient evidence to justify accruing the expenditure and therefore this was reversed. This decreased expenditure by £14.25 million and increased net assets by the same amount.

25. We are required to report to those charged with governance all unadjusted misstatements which we identified during our audit, other than those of an insignificant small amount. The total of these unadjusted misstatements for the Scottish Government core portfolios is £29.7 million. The total unadjusted errors within the consolidated accounts is £60.783 million. This balance is made up of the core portfolios figure plus £26.9 million relating to NHS bodies and £4.21 million relating to agencies and other consolidated bodies. Appendix 3 shows the unadjusted errors and their impact on the annual report and accounts. If these errors been adjusted, the net impact would have been to increase net assets and decrease net expenditure by £6.1 million.

26. It is our responsibility to request that all misstatements other than those below the reporting threshold are corrected. The final decision on this lies with those charged with governance considering advice from senior officers and materiality.

Significant findings from the audit in accordance with ISA 260

27. International Standard on Auditing (UK) 260 requires us to communicate significant findings from the audit to those charged with governance. These are summarised in Exhibit 3. Where a finding has resulted in a recommendation to management, a cross reference to the Action Plan in Appendix 1 has been included.

28. These findings include our views about significant qualitative aspects of the Scottish Government's accounting practices including:

- Accounting policies
- Accounting estimates and judgements
- Significant financial statements disclosures
- Timing of transactions and the period in which they are recorded
- The impact on the financial statements of any uncertainties
- The effect of any unusual transactions on the financial statements
- Misstatements in the annual report and accounts
- Disagreement over any accounting treatment or financial statements disclosure

Exhibit 3
Key issues from the audit of the financial statements

Issue	Resolution
1. Capital Borrowing In March 2018, the Scottish Government borrowed its full annual capital borrowing limit of £450 million. This was the first year the borrowing powers had been used in full (in the previous 2 years notional borrowing was undertaken). This was not disclosed as a loan liability on the Scottish Government's Statement of Financial Position and instead was disclosed by way of a note in the accounts of Scottish Consolidated Fund (SCF) accounts which is a cash account and therefore does not have a statement of financial position (commonly known as a balance sheet). We considered whether the liability should be shown in the Scottish Government Consolidated Accounts.	Following engagement with officers we agreed that the borrowing should not be included in the Consolidated Accounts as it is classed as parliamentary funding which comes from the Scottish Consolidated Fund, and the liability sits out with the consolidation boundary of the accounts. We concluded that the current accounting structure is limited in fully recognising the assets and liabilities that arise from borrowing. For 2017/18, we requested additional disclosures within the SCF accounts. The issue highlights limitations in the current suite of financial reporting available and further highlights the need for publication of a consolidated account for the whole public sector in Scotland to help provide better information in this area. Recommendation 1 (refer appendix 1, action plan)
2. Impairment of a financial asset We considered whether events after the reporting date meant that the value of a financial asset was fairly stated in the Consolidated Accounts. The Scottish Government did not consider the value to be impaired and did not adjust the accounts. We concluded that events after the reporting period ratified conditions that existed before year end and therefore this was an adjusting event after the reporting period and the value should have been impaired. The Scottish Government did not agree with our judgement.	Based on the latest information available to us (April 2018), we have assessed and estimated the impairment to be £13 million. We have recorded this as an unadjusted error in Appendix 3, Summary of uncorrected misstatements.
3. Rural Payments IT asset The Consolidated Accounts record intangible assets reflecting the costs of the wider Rural Payments and Services System which includes the	We considered the impairment review prepared by the Scottish Government as well as the technical review of the system undertaken by Fujitsu in 2016/17. Based on the information available, our overall conclusion was that the impairment of the

Issue	Resolution
previous CAP Futures system used to administer EU payments to farmers. The cost of the RPSS assets increased from £126 million in 2016/17 to £153 million in 2017/18. An impairment of £1.6 million was processed during 2017/18 to reflect additional expenditure required to allow the system to function as planned. We considered whether the impairment and therefore the value of the asset in the statement of financial position was reasonable	system was reasonable and therefore the value is fairly stated.
4. Health accruals Included in the payables and other current liabilities balance on the Statement of Financial Position were accruals totalling £31.75 million relating to health expenditure. Based on the evidence received we queried whether these accruals were valid.	We concluded that the accruals were not valid as at 31 March 2018. However, we found that part of the balance (£11.6 million) was subsequently acceptable due to events after the reporting period (settlement of a supplier dispute) which indicated the expenditure was required. Of the remaining balance, finance staff agreed to adjust £14.25 million and therefore £5.9 million is considered an unadjusted error. Finance staff did not consider the £5.9 million to be an error.
5. Benefit in Kind The First Minister's use of accommodation at Bute House constitutes a benefit in kind, which is subject to income tax and national insurance. This is disclosed within the remuneration and staff report. The benefit in kind is calculated based on the number of nights in which the First Minister stays at Bute House in a financial year. This year's benefit in kind was £3,187, a significant increase from £334 in 2016/17. During 2017/18, the Scottish Government identified an error in the benefit-in-kind calculation due to the incorrect number of days occupied being applied between 2007/08 and 2016/17. In August 2017, the Scottish Government informed HMRC of the error and arranged for an Employer Settlement payment of £16,765 to be made. This was paid in March 2018.	The Scottish Government have accepted this was an error on their part as the employer. We requested that changes were made to the draft accounts submitted to audit. We requested that the 2016/17 benefit-in-kind figure was restated to make a fairer comparison with 2017/18. We also requested that an explanatory note was included to outline the reasons for the change.

Source: Audit Scotland

Follow up of prior year recommendations

29. We followed up actions agreed in 2016/17 to assess progress with implementation. We have reported progress of these prior year actions in Appendix 1. They are identified by the prefix b/f (brought forward).

30. Seven agreed actions were raised in 2016/17. Of these:

- Three have been fully implemented
- Two have not been implemented (NFI and Publication of register of interest, see Appendix 1)
- Two have been partly implemented.

31. Overall the Scottish Government has made some progress in implementing these actions. For actions not yet implemented, revised responses and timescales have been agreed with management, as set out in Appendix 1.

Part 2
Financial management

Main judgements

The Scottish Government operated within its 2017/18 budget. The Consolidated Accounts show that total net expenditure was £34,461 million, £339 million less than budget.

Other than payroll, the Scottish Government's main systems of internal control (SEAS (General ledger), Payables, Receivables and Banking) operate effectively. Improvements are required in some areas, mainly payroll, to ensure controls operate as expected.

Financial performance in 2017/18

32. The main financial objective for the Scottish Government is to ensure that the financial outturn for the year is within the budget allocated by Scottish Ministers.

33. The Scottish Government relies on Budget holders and Budgetary Control Liaison Officers (BCLOs) to scrutinise and monitor spend against budgets. The system relies on directorates providing early warning if budgets are likely to be under or over spent. Budgets are monitored on a monthly basis, with scrutiny taking place at People and Finance group meetings and the relevant Director General assurance group meeting.

34. The Scottish Government reported an outturn of £34,461 million remaining within its overall budget for 2017/18 with an underspend of £339 million (0.9 per cent of the final budget). The financial performance against budgets is shown in Exhibit 4.

Exhibit 4
Performance against budget in 2017/18

Performance	Final budget 17/18 £m	Actual outturn £m	Overspend/ (underspend) £m
Resource	32,736	32,449	(287)
Capital	2,064	2,012	(52)
Total	**34,800**	**34,461**	**(339)**

Source: Scottish Government Consolidated accounts 2017/18.

35. Variations in each portfolio are managed by the Scottish Government to ensure overall spending remains within budget. High-level reasons for significant variances between actual and budgeted spend are included in the Consolidated Accounts (pages 52 to 63). Further information is given in the accounts of other bodies.

Funding to local authorities

36. On 31 January 2018, the Scottish Government announced an additional £159.5 million of general revenue grant funding for local authorities at stage one of the 2018/19 Budget Bill. Of this additional sum, £34.5 million was reallocated from projected 2017/18 underspends within other government portfolios and was paid on 28 March 2018. Local authorities were free to spend it from the date of receipt and therefore treated it as income in 2017/18. This meant that local authority accounts showed additional income of £34.5 million in 2017/18, reducing the Scottish Government's overall 2017/18 underspend by the same amount.

37. By including 2017/18 monies as part of its 2018/19 funding allocation to local authorities, the Scottish Government has reduced transparency over local government funding, making it harder to compare funding levels between each year. It is important that funding allocations are transparent and consistently applied across years to allow public bodies to plan and manage their finances effectively and support parliamentary scrutiny.

Funding to NHS boards

38. A number of features of the way that the health system in Scotland currently operates need to be addressed. This includes risks arising from a narrow focus on achieving financial balance each year, coupled with an increasingly tight financial position, late budget allocations at year end and a general need for greater transparency.

39. In April 2018, the Auditor General reported to the Public Audit and Post-Legislative Scrutiny Committee on the retention of eHealth funds by NHS Tayside. Early in March 2018, Scottish Government staff became aware that NHS Tayside was holding money intended to fund eHealth in NHS boards. This came to light when the Scottish Government health finance team were asked to process an allocation adjustment relating to the eHealth national programmes budget. It emerged that an arrangement had been in place since 2012/13 to route eHealth money from Scottish Government through NHS National Services Scotland then on to the NHS boards. Since that time, underspent funds on the eHealth programme had been held by NHS Tayside to fund expenditure and to reduce its annual deficit. It was then returned to the Scottish Government as funding allocation credits the following year.

40. In May 2018, the Scottish Government Health and Social Care Directorates finance team reviewed the funding allocations process. They identified areas of weakness which meant the process was open to potential manipulation. A revised process is now in operation and the Scottish Government Internal Audit Directorate are undertaking a review of the controls in place. Given the pressure on health boards to meet their financial targets, it is important that a robust allocations process is in place to reduce the risk of manipulation of targets. We will review its implementation as part of the 2018/19 audit of the Scottish Government.

Recommendation

The Scottish Government should ensure there is a robust and transparent process in place for funding public bodies, including allocations to NHS boards and local authorities.

Loans to private companies

41. During 2017/18, the Scottish Government entered into new commercial loan agreements with two private sector companies.

42. In September 2017, the Scottish Government provided a commercial loan of £15 million to Ferguson Marine Engineering Limited (FMEL), a ship building and engineering company based in Port Glasgow. The purpose of the loan was to support FMEL's completion of a contract to build two 'dual-fuel' ferry vessels for Caledonian Maritime Assets Limited (CMAL) valued at around £97 million. CMAL is a company wholly owned by the Scottish Government in which Scottish Ministers are the sole shareholders. It does not fall within the consolidated boundary of the Scottish Government Consolidated Accounts. In June 2018, the Scottish Government provided FMEL with an additional £30 million loan to improve their cash flow position to help support the delivery of the CMAL vessels and improve the future prospects of the company and shipbuilding on the Clyde. As at August 2018, FMEL had drawn down £26 million (58 per cent) of the total £45 million loan facility.

43. In November 2017, the Scottish Government entered into an agreement to offer a commercial loan facility of £15 million to Burntisland Fabrications Limited (BiFab), a fabricator of oil, gas and offshore wind structures, to support the completion of two key contracts. On 17 April 2018, the former Cabinet Secretary for the Economy, Jobs and Fair Work informed the Scottish Parliament that the Government had provided BiFab with an expanded commercial loan facility as a result of increasing costs associated with the completion of contracts for the Beatrice Offshore Wind Farm. Included in the agreement with BiFab is a provision for the loan to be converted to an equity stake, not exceeding a 38 per cent shareholding in BiFab. A further £10 million loan was also made available to BiFab in April 2018 to support business restructuring following the completion of the contracts. The profile of BiFab's drawdown of the borrowing facility is not in the public domain as the Scottish Government has maintained that the company needs to ensure commercial confidentiality whilst it is in the process of bidding for new contracts. It is important that the Scottish Government provides full transparency on the loans that it has provided to BiFab as soon as it has completed the current procurement process. The Scottish Government plans to monitor options for when it will sell its shareholding but no decision has been made about when this will take place.

44. The loans to FMEL and BiFab were subject to external due diligence and legal advice and were approved by Ministers with notification of the loans provided, in private, to the Parliament's Finance and Constitution Committee. We became aware of the loans during the course of our 2017/18 audit. The Scottish Government is actively monitoring the performance of both companies including commissioning due diligence work prior to each draw down. The provision of loan facilities to private sector companies highlights the Scottish Government's increasing risk appetite in providing financial support and guarantees to support policy objectives.

45. Publicly available information about the extent of the loans is limited. The consolidated accounts provide only a very brief narrative on the loans issued during 2017/18 (page 19). There is a need for the Scottish Government to be more transparent about its overall approach in providing significant public funds to support private companies. While the business cases for loan support were clear, there is no framework in place to support the Government's decision making or approach in providing loans to private companies.

Recommendation

The Scottish Government should develop a framework that clearly outlines its role in financial interventions in private companies to support decision making over where, when and at what level to invest. Such a framework should provide clear information on financial capacity, risk tolerance and expected outcomes. In doing so, the Scottish Government will provide the Parliament with greater assurance and better information over its strategic objectives in entering these agreements and allow for greater scrutiny of the risks and opportunities that exist, including the opportunity costs involved.

Procurement

46. We reviewed a sample of contracts awarded during 2017/18 to confirm evidence of supplier due diligence before the contract was awarded and to confirm that the Scottish Government followed its procurement policies. This testing was satisfactory.

47. We also tested a small sample of established and significant suppliers to understand how the Scottish Government manage supplier risk and to see evidence of contract monitoring on an ongoing basis.

48. Our testing established that contract management arrangements vary for different contracts. High-risk contracts are managed centrally by the Collaborative and Scottish Government Procurement division and are usually identified based on the value of the contract or risk, for example social security contracts are currently managed centrally. Other contracts are managed by individual business areas.

49. This gives rise to a risk that contracts may not be managed consistently and that contract management arrangements within business areas are not as effective as they should be. To try and address this, the Collaborative and Scottish Government Procurement division undertook a review of contracts. Their reports found inconsistencies in a number of contracts and made recommendations for improvement. Reviewing contracts in this way is a positive development in obtaining assurance and should encourage good practice in contract management within business areas.

50. Both our audit work and that of the internal review of contracts found that limited financial due diligence for some contracts is carried out post-contract award. Failure to undertake regular checks on the financial health of the supplier increases the risk to Scottish Government.

Recommendation

The Scottish Government should review and confirm that the level and selection of contracts for financial due diligence assessments during the lifespan of the contract is appropriate to manage this supplier risk to the Scottish Government.

Systems of internal control

51. As part of our audit we identify and inspect the key internal controls in those accounting systems which we regard as significant to produce the financial statements. Our objective is to gain assurance that the Scottish Government has systems of recording and processing transactions which provide a sound basis for the preparation of the financial statements.

52. Our findings were included in our Management Report presented to the Scottish Government Assurance and Audit Committee on 13 July 2018. We concluded that other than payroll, the Scottish Government's main systems of internal control (SEAS (General ledger), Payables, Receivables and Banking) operate effectively. Our controls testing identified a number of cases where controls did not operate as expected and management action to resolve them remains outstanding. In the case of payroll, we increased our testing to obtain the assurance we needed that the financial statements were free from material misstatement. This additional testing found the same control issues we highlighted in our Management report.

53. No significant internal control weaknesses were identified during the audit which could affect the Scottish Government's ability to record, process, summarise and report financial and other relevant data to result in a material misstatement in the financial statements. The issues identified as part of our payroll testing were because of poor administrative controls in practice.

Debt Management

54. The Scottish Public Finance Manual (SPFM) sets out that responsibility for debtors is delegated to individual directorates within the Scottish Government. Despite this, the Aged Debtors listing shows many historic debts. Whilst there were fewer credit balances within debtors this year compared to last year, they numbered 614 with a value of £1.135m. There should be no credit balances sitting in debtor control accounts.

55. Our testing of aged debtors found examples where the debt was more than 60 days old and credit control procedures had not been instigated. Letters following up debts were unclear and issued late (well after the debt had reached 30 days).

56. Directorates should pursue debts until they have been paid. In our testing we saw examples of many invoices being removed from the system by credit note as the debt was either changed or cancelled. This confirms that our recommendation made in our 2016/17 audit has not been addressed across all areas of the Scottish Government. (see Appendix 1, brought forward recommendation 1)

ICT controls

IT security

57. As part of our audit, we carried out a high-level IT security review of the main financial systems (SEAS financial management system, EaseBuy procurement system and HR/Payroll).

58. We found that:

- The Scottish Government IT security policy and Security Policy statement are out of date. Specific guidance (such as documentation and security assessments of systems) for systems connecting to the Scottish Government's main IT system (SCOTS) has not been updated for some time, and the appropriate tools are no longer available. See recommendation below.

- The EaseBuy and HR/Payroll systems do not have access control policies in place which set out the conditions under which access can be given to staff within the Scottish Government and public bodies which use the systems. An access control policy sets out the conditions in which the information asset owner (system owner) allows access to the data.

Sensitive systems should clarify access controls, for administration teams, client organisations, system support and supplier support.

Recommendation

The IT security policy and Security policy statement should be updated so that users have accurate guidance to refer to, so that local decisions and security lapses do not affect the network.

Cyber resilience

59. The Scottish Government launched its Cyber Resilience Strategy in 2015 and Public Sector Action Plan in 2017. The action plan pulls together a Scotland-wide approach to improving cyber resilience. Since the launch of the action plan, a cyber catalyst group has been brought together of public sector organisations, alongside engagement with non-executive leadership of organisations.

60. The Cyber Resilience Framework is still in development. The Framework requires additional work to consider the relationship between the baseline Cyber Essentials scheme of accreditation of security controls and other security accreditation schemes such as ISO 27000 (Information Security Management) and PSN/PSN-P (Public Services Network and Public Services Network for Policing).

61. Some initiatives are behind their planned delivery schedule, such as the public procurement notice on cyber resilience inclusion in contract management terms. As a result, changes to the Scottish Public Finance Manual and associated grant funding are also delayed.

62. A training strategy for cyber resilience is under development. Information and Technology Services (iTECS) are also looking to develop a package of training and awareness raising materials to be made available to all staff.

Business continuity arrangements

63. Within the Scottish Government various directorates and divisions have their own business continuity planning arrangements. Often, such arrangements depend on the availability of the same resources (for example, desk spaces in other Scottish Government office locations). This creates excess demand over supply and may result in ineffective continuity of service.

Recommendation

An overarching view of business continuity arrangements is required to ensure all plans can be executed in the event of an emergency or incident.

Part 3
Financial sustainability

Main judgements

Over the last year, the Scottish Government has taken some important steps to improving its financial reporting. In May 2018, the Scottish Government published its first medium-term financial strategy, *Scotland's Fiscal Outlook*. The strategy aims to provide an assessment of the medium-term outlook for Scotland's public finances as the new financial powers from the Scotland Acts 2012 and 2016 come into effect.

The arrival of new borrowing powers has enhanced the Scottish Government's ability to manage and control its spending each year. In March 2018, the Scottish Government borrowed £450 million of capital funds, the maximum allowed in 2017/18. This was in line with plans made as part of the 2017/18 Scottish budget. At the end of 2017/18, the Scottish Government had net borrowings of £1.036 billion against its £3 billion capital borrowing limit (35 per cent).

The Scottish Government has not yet published a public consolidated account to cover the whole public sector in Scotland. This is an important commitment that will improve overall public financial management and help Parliament's scrutiny and understanding of Scotland's overall financial position including its assets and liabilities and enable better decision making.

Financial planning

64. The Scottish Budget is now intrinsically linked to the performance of the Scottish economy relative to the performance of the rest of the UK's economy. If the Scottish economy performs better than the rest of the UK economy, then Scotland retains any surplus in devolved taxes receipts compared to the block grant adjustment applied.

65. The performance of the Scottish economy is also influenced by macroeconomic policies set by the UK as well as taxpayer's behaviour as a result of tax policies set and applied in Scotland, which in turn also impacts the Scottish Budget. The Scottish Government needs to ensure it has good scenario planning in place taking all these factors into account, when setting budgets to support fiscal decisions such as the level of borrowing. The Scottish Government has recognised the importance of analytical capacity and the need to continue to grow financial expertise.

Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.

2017/18 financial position

66. The Statement of Financial Position summarises what is owned and owed by the core Scottish Government and those public bodies within the consolidated boundary. This shows taxpayers' equity – an accounting measurement of the amount invested that has continuing public benefit. It shows how much of this has arisen from the application of revenues and that which has resulted through changes over time in the value of physical assets.

67. The financial statements show that the core Scottish Government and those bodies within the consolidation boundary, have net assets of £32,606 million an increase of £1,435 million largely attributable to increased valuations in financial investments and property, plant and equipment.

68. There are no significant concerns about the overall financial position of the consolidated accounts. The performance report (which forms part of the annual report) includes a commentary on the statement of financial position and its components.

Capital borrowing

69. Under the terms of the Scotland Act 2016, the Scottish Government's capital borrowing limit was extended to £3 billion (previously £2.2 billion under the 2012 Act). The annual borrowing limit was also increased to 15 per cent (£450 million) of the overall borrowing cap. The extended limits provide the Scottish Government with more flexibility in responding to spending pressures across its capital programme.

70. In March 2018, the Scottish Government borrowed its full annual capital borrowing limit of £450 million. This was in line with plans outlined by Scottish Ministers as part of the 2017/18 Scottish budget. The loan, from the National Loans Fund, was used to support the capital programme with repayments of the principal loan to be made over the next 25 years at an interest rate of 1.9 per cent. The borrowing term is normally ten years as outlined in the Fiscal Framework unless the lives of the assets being purchased reflect a different time period. The Scottish Government reported that 2017/18 borrowing was used to support its overall capital programme including major projects such as the completion of the Forth Replacement Crossing and therefore agreed a longer time for repayment with the National Loans Fund.

71. The Scottish Government borrowed the full amount of £450 million in March 2018 with the view that unused amounts would be carried forward to future years using the Scotland Reserve. The Scottish Government needs to finalise the policies and principles within which it will manage its borrowing powers. This will help to improve decision making on capital budget management such as the level, type and timing of borrowing and will help to avoid any excess borrowing and the associated interest costs. Details of the overall loan, repayments and interest payments are outlined on page 20 of the consolidated accounts.

72. The Scottish Government's borrowing and associated repayments are made via the Scottish Consolidated Fund. Borrowed amounts and repayments are made between the Scottish Consolidated Fund and HM Treasury with the corresponding adjustments made to funding received by the Scottish Government from the SCF. This means there is no associated liability disclosed in the Statement of Financial Position within the Scottish Government's consolidated accounts. Details of the amount of capital borrowing and the associated liability are set out within a separate account prepared for the Scottish Consolidated Fund.

73. In 2015/16 and 2016/17, the Scottish Government used its capital borrowing limit to accommodate the financial impact of decisions by the Office for National Statistics (ONS) to reclassify some major Non-Profit Distributing (NPD) investment projects as public-sector projects. Projects such as the Aberdeen Western Peripheral Route and the Edinburgh Royal Hospital for Sick Children were reclassified meaning that capital budget cover was required at the point of initial investment, rather than revenue budget cover for the annual payments over the lifetime of the contract. Although this did not result in additional borrowing, the Government agreed with HM Treasury that these amounts would be recorded against its capital borrowing limit. At the end of

2017/18, the Government had net borrowings of £1.036 billion against its £3 billion capital borrowing limit (35 per cent).

74. The use of capital borrowing powers for the first time in 2017/18 reinforces the need for the Scottish Government to improve the reporting of its overall financial position. The current structure and boundary of the Scottish Government's consolidated accounts provides information on the core portfolios of the Scottish Government and those bodies within the consolidated boundary such as Transport Scotland and the Scottish Prison Service. The Scottish Consolidated Fund Account is a receipts and payments account reflecting the flows of money into, and out of, the fund. There is currently no appropriate audited account that sets out all the assets and liabilities, including borrowing by Scottish Ministers.

75. The Scottish Government has committed to producing a consolidated account to cover the whole public sector in Scotland including total assets, investments and liabilities such as local government borrowing and public sector pension liabilities. The Scottish Government had designated 2016/17 as a 'shadow year' with a view to producing the account for audit during 2018 but this has not yet happened. The use of the new borrowing powers increases the need for a public consolidated account to provide a comprehensive and transparent assessment of the state of Scotland's public finances. This is important for decision making over the longer term as it will provide important information about the impact of past decisions on future budgets, the scale of liabilities, and potential risks to financial sustainability. The Scottish Government needs to quicken the pace of its development and should aim to publish the account, using 2017/18 financial information, before the end of 2018.

Recommendation

The Scottish Government should finalise the internal policies and principles within which it will manage its borrowing powers. This will help to improve decision making on capital budget management such as the level, type and timing of borrowing and will help to avoid any excess borrowing and the associated interest costs.

Recommendation

The Scottish Government should produce a Public Consolidated Account for the whole of the Scottish public sector to outline total assets, liabilities, borrowing and investments. They should aim to publish this, using 2017/18 financial information, before the end of 2018.

Common Agricultural Policy loan schemes

76. The Scottish Government provides financial support to farmers and other rural businesses as part of the Common Agricultural Policy (CAP). The Scottish Government established two loan schemes during 2017/18 to help farmers and rural businesses receive money more quickly. This is the third year that loans have been paid. The 2017/18 loan schemes were funded from the Scottish Government's financial transaction budget which supports loan schemes that go beyond the public sector. The Consolidated Accounts discloses that loan payments of £369 million were made in 2017/18. Loans of £317 million were paid during 2017/18 for the Basic Payments Scheme 2017 Scheme. The remaining £52 million related to Less Favoured Area Support Scheme (LFASS) 2016 scheme, of which £50 million was recovered. Delays in processing payments meant that £150 million of loans remained outstanding at the year end and additional financial transaction budget cover was required.

77. A further loan scheme of up to £55 million for the LFASS 2017 scheme was announced in February 2018 and payments for these loans started being made in April 2018. Substantively, our testing of CAP loans was satisfactory.

Workforce capacity

78. In March 2018, we published an update report on Managing the implementation of the Scotland Acts. The report found that the Scottish Government needs to develop the capacity and capability to deliver the significant changes arising from new financial and social security powers alongside delivering its continuing responsibilities and preparing for the implications of the UK's withdrawal from the European Union. It has taken some important steps to assess its workforce and priorities, but it remains challenging for the Scottish Government to get the number of people and skills it needs in time.

79. The Scottish Government recognises that the required skills have changed from generalist skills to more specialist skills. For example, it has always needed people with skills in finance and economic analysis. But there is now greater demand for specialised skills across directorates to assist with medium and long-term financial planning. This is increasingly important as Scotland's public finances are more closely tied to how the Scottish economy performs.

80. There is competition for skills within the Scottish Government itself. The new social security directorate is attracting staff from across government, including senior finance and IT roles. This transfer of staff is putting pressure on other Scottish Government directorates to deliver business-as-usual activities, other new powers, and plan for the impact of the UK's withdrawal from the EU as they seek to find replacements. The number of staff being recruited by the Scottish Government has also placed additional pressures on corporate functions such as HR, payroll and IT in ensuring appropriate support is in place as people are recruiting into, or move between, different posts.

81. Workforce capacity and the pressures arising from new financial and social security powers and planning for EU withdrawal are a constant theme in corporate meeting and all DG assurance group meetings. The Scottish Government is currently undertaking an internal review of the wider opportunities and risks to the Scottish Government's capacity as a result of the ongoing implementation of the largescale social security programme.

Medium to long term financial planning

82. Over the last year, the Scottish Government has taken some important steps to improving its financial reporting. In May 2018, the Scottish Government published its first medium-term financial strategy, Scotland's Fiscal Outlook. The strategy aims to provide an assessment of the medium-term outlook for Scotland's public finances as the new financial powers from the Scotland Acts 2012 and 2016 come into effect. The strategy, to be updated annually, provides an explanation of the fiscal framework and outlines potential funding scenarios for the Scottish budget over the next five financial years to 2022/23 based on independent forecasts carried out by the Scottish Fiscal Commission.

83. In September 2018, the Scottish Government published its first Fiscal Framework Outturn Report. This report is intended to support the Parliament's 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 includes details of the reconciliation process between forecasts and outturn, use of the Scotland Reserve and borrowing powers. Together, the medium-term financial strategy and the Fiscal Framework Outturn Report are significant developments in the Scottish Government's annual financial reporting and form a key component of the Scottish Parliament's new budget process, following recommendations made by the Budget Process Review Group in June 2017.

84. In October 2018, Audit Scotland will publish a briefing paper on key issues and risks in managing public finances as a result of the Scottish Parliament's new financial powers. This is intended to support the Parliament's scrutiny of the forthcoming 2019/20 draft Scottish budget.

UK withdrawal from the European Union

85. There remains significant uncertainty about the detailed implications of the UK's withdrawal from the European Union (Brexit). It is critical that the Scottish Government and public bodies are working to understand, assess and prepare for the impact on their business in three broad areas:

- Workforce – the extent to which changes to migration and trade policies are likely to affect the availability of skilled and unskilled labour.
- Funding – the extent to which potential changes to funding flows are likely to affect the finances of the organisation and the activity that such funding supports.
- Regulation – the extent to which potential changes to regulation across a broad range of areas overseen at an EU level are likely to affect the activities of the organisation.

86. The Scottish Government have a coordinated approach to EU withdrawal with various programmes led by the Constitution and Europe Programme office, reporting to the Constitution and Europe Programme Board. The board is viewed as a key corporate board and meets monthly and is chaired by the DG Constitution and External Affairs.

87. There are 8 individual work programmes currently being undertaken, detailed below:

- Capacity and Capability
- Communications and Engagement
- EU Negotiations
- Fiscal Implications
- Legislative Consequences
- Trade
- UK Frameworks
- Workforce Impact

88. Each programme reports to the Programme Board monthly. We have considered the project brief for each of these projects and are content that the Scottish government are considering the potential workforce, funding and regulation implications noted above. The Permanent Secretary noted in the Governance Statement that while she was assured that Scottish Government directorates are well-focussed on readiness work, she was not yet fully assured of readiness for withdrawal from the EU whose terms and timings remain subject to significant uncertainty.

89. Since November 2017 the Scottish Government has undertaken an EU withdrawal 'Organisational Readiness' project coordinated by the Constitution and Europe programme office. This is a self-assessment questionnaire completed by directors across all Scottish Government directorates aimed at identifying progress in managing the key issues and risks arising from EU withdrawal.

Part 4

Governance and transparency

Main judgements

The Scottish Government's governance arrangements are adequate to support good governance and accountability. During 2017/18, the Scottish Government made further changes to its corporate governance structure, including a new role of Director General Scottish Exchequer. With the main powers from the Scotland Acts now in operation, there has been slow progress in finalising the roles and responsibilities within the Scottish Exchequer directorate and recruitment is ongoing to fill key posts. Until arrangements are finalised, the harder it will be for the Scottish Government to effectively manage the fiscal risks and opportunities that may arise in the interim period.

The Scottish Government made some improvements to its governance arrangements such as greater consistency and standardisation of agendas, minutes and papers, the implementation of a board development programme and the appointment of a Board Secretary to improve connections between corporate groups. Pressure on non-executive directors' capacity combined with often late or out-of-date information reduced the opportunity for effective scrutiny.

The Scottish Government has made some improvements in its transparency of information but there remains scope for further progress, particularly through its commitments to the Open Government Partnership.

Governance arrangements

90. During 2017/18, the Scottish Government made further changes to its corporate governance structure following new arrangements established in October 2016. In February 2018, approval was given to create a new Economy Board, chaired by Director General Economy, and includes the Permanent Secretary and all Directors-General. The role of the Economy Board is to focus on Scotland's productivity and economic performance rather than policy implementation. In July 2017, a new role of Director General Scottish Exchequer was created to better reflect Scotland's new fiscal responsibilities with a Chief Financial Officer role to cover financial management and operations. With the main powers from the Scotland Acts now in operation, there has been slow progress in finalising the roles and responsibilities with the Scottish Exchequer directorate and recruitment is ongoing to fill key posts. Until arrangements for the Scottish Exchequer are finalised, it will be harder for the Scottish Government to effectively manage the fiscal risks and opportunities that may arise in the interim period.

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision-making and transparent reporting of financial and performance information.

91. In November 2017, an independent review of governance arrangements led by the Director of Internal Audit and the Crown Agent reported that the structures introduced in October 2016 were appropriate for an organisation of the scale and complexity of the Scottish Government. It also found that the structures were enabling accountabilities, decision making, challenge, risk management and assurance to take place, and overall were considered fit for purpose. The report made a number of recommendations intended to support the further development and performance of the structures.

92. The Scottish Government is working towards implementing the majority of the Review's recommendations. One recommendation was not taken forward. This was to create a non-executive chair of the Corporate Board to balance the power of the Permanent Secretary (in other organisations this would be the Chief Executive) which is considered good practice. We would recommend that the Scottish Government continue to keep this recommendation under review.

93. The Scottish Government made some improvements to its governance arrangements during 2017/18 such as greater consistency and standardisation of agendas, minutes and papers, the implementation of a board development programme and the appointment of a Board Secretary to improve connections between corporate groups. The success of the new arrangements will be determined by how they operate in practice and the culture and behaviours adopted by those involved including the contributions made by non-executive directors. In 2017/18, pressure on non-executive directors' capacity, combined with late or out-of-date information provided to meetings meant that scrutiny and challenge was not as effective as it needed to be. It is important that non-executive directors and other participants are given up-to-date information in sufficient time to allow effective support and challenge. This is particularly important at a time of significant change for the Scottish Government as it takes on new powers and seeks to manage the uncertainty and risks associated with the UK's withdrawal from the European Union. The Scottish Government is currently recruiting additional non-executive directors and hope to have these posts filled by the end of 2018.

94. The current governance arrangements with the pairing of a Non-Executive Director to a Director General mean that a lot of responsibility is placed on one person to provide challenge and scrutiny on each agenda item in DG Assurance meetings. Peer challenge provides a good way to support scrutiny and thought should be given to how this can be fostered in current governance forums to support assurance and decision-making processes.

95. The governance arrangements are adequate to support good governance and accountability. We recommend that the Scottish Government continues to improve its governance arrangements and strengthens the opportunity for greater scrutiny and challenge through improving information provided to key groups within its governance structure.

Recommendation

The Scottish Government should seek to finalise the roles and responsibilities of the new Scottish Exchequer as soon as possible. With the main powers from the Scotland Acts now in operation, the longer it takes to develop and finalise the arrangements for the Scottish Exchequer, the harder it will be for the Scottish Government to effectively manage the fiscal risks and opportunities that may arise in the interim period.

Transparency

96. Transparency means that the public have access to understandable, relevant and timely information about how the board is taking decisions and how it is using resources such as money, people and assets.

97. The Scottish Government has made commitments to increase transparency through the Open Government Partnership. There is some evidence of the Scottish Government's commitment to transparency such as:

- minutes of Corporate Board meetings are publicly available on the Scottish Government's website.
- it has sought to widen public understanding through the publication of Scotland's Fiscal Outlook, the Fiscal Framework Outturn Report and responses to various reviews including the Budget Process Review Group and the Barclay Review of Non-Domestic Rates.

98. There continue to be areas where the Scottish Government could enhance transparency. For example,

- Publishing other meeting minutes such as the Scottish Government Assurance and Audit Committee on the Scottish Government website.
- Being more transparent about its overall approach in providing loan facilities to support private companies.
- Ensuring a robust and transparent allocations process is in place for funding public bodies, including allocations to NHS boards and local authorities.
- Publishing the register of interests for Board members on the Scottish Government's website.

Risk management

99. The Scottish Government has continued to develop its risk management arrangements during the year in line with changes to its governance arrangements. Risk registers are considered at the appropriate governance groups, but more could be done to improve the level of information they contain. For example, risks registers do not give trend information making it difficult to assess which risks are escalating or which risks have reduced. Similarly, in some cases, greater detail about proposed and planned actions in place to help mitigate risks is required. Improving risk information will provide the opportunity for greater peer challenge and identification of cross-cutting risks and allow for more informed decision making.

Governance Statement

100. HM Treasury's Financial Reporting Manual (the FReM) states that the Scottish Government must prepare an annual governance statement within the annual report and accounts. Guidance is set out within the SPFM for the content of the governance statement and provides assurances around the achievement of the organisation's strategic objectives.

101. The SPFM does not prescribe a format for the annual governance statement but sets out minimum requirements for central government bodies. The process undertaken by management included conducting an assurance mapping exercise and working to an assurance plan that assessed the evidence underpinning the preparation of the governance statement.

102. We concluded that the 2017/18 governance statement complies with the guidance issued by the Scottish Ministers and, based on our knowledge and work performed, presents a comprehensive picture of governance arrangements and matters.

Internal audit

103. The Scottish Government's internal audit function is carried out by Scottish Government Internal Audit Directorate. Each year, we consider whether we can rely on internal audit work to avoid duplication of effort and we undertake an overview of the Scottish Government's internal audit arrangements as part of our appointment as external auditors in accordance with International Standard on Auditing 610 *Using the work of internal audit*. Our work found that the Internal Audit Directorate meets some of the Public Sector Internal Audit Standards (PSIAS), but also does not comply with significant aspects of the standards.

104. Our review found that significant improvements are required in audit planning, audit documentation, audit reporting and management review. Based on the available evidence, we did not identify any internal audit reports where the underlying evidence would suggest an incorrect audit opinion or conclusion. The Internal Audit Directorate are currently undertaking a 'Back to Basics' project aimed at embedding best practice across IAD in line with Public Sector Internal Audit Standards. The project provides an opportunity to take forward the recommendations made in our review. Central to its success will be the culture adopted by IAD in complying with PSIAS and ensuring that good practice is embedded across all its audit activity.

105. At the time of reporting, 8 vacancies existed within the directorate from a staffing establishment of 60. IAD's recently completed training and development strategy and plan for 2018/19 should help provide clarity over IAD's aim of ensuring the right skills are in place to meet increasing demand.

National Fraud Initiative

106. The National Fraud Initiative (NFI) in Scotland is a counter-fraud exercise coordinated by Audit Scotland. It uses computerised techniques to compare information about individuals held by different public bodies, and on different financial systems, to identify 'matches' that might suggest the existence of fraud or irregularity.

107. NFI activity is summarised in Exhibit 5. The NFI exercise in 2016/17 identified a total of 3,689 matches of which 800 were recommended for further investigation. The Scottish Government investigated, and closed off, a total of 917 matches. Not all matches investigated were recommended matches with 42 recommended matches relating to procurement incomplete. The Scottish Government confirmed they carried out a high-level review of these matches in June 2018 and decided no follow-up action was required at this time.

Exhibit 5
NFI activity

3,689

Matches

800

Recommended for investigation

917 (of which 758 were recommended matches)

Completed/closed investigations

Source: NFI secure website: www.nfi.gov.uk

108. There were no identified instances of fraud in the NFI exercise. Two errors were identified from matches, and both were investigated and resolved. The Scottish Government Assurance and Audit Committee receives information on NFI by way of escalation. As highlighted in our 2017/18 Management Report, there is no routine reporting on NFI results through the year. The Scottish Government should consider a more joined-up approach for completing the NFI exercise to co-ordinate the match investigation work ensuring that results are reported across the Scottish Government.

Standards of conduct for prevention and detection of fraud and error

109. We have reviewed the arrangements in place to maintain standards of conduct including the Staff Handbook and Civil Service and Members' Codes of Conduct. There are established procedures for preventing and detecting any breaches of these standards including any instances of corruption.

110. Based on our review of the evidence we concluded that the Scottish Government has appropriate arrangements in place for the prevention and detection of bribery corruption. We are not aware of any specific issues that we need to bring to your attention.

General Data Protection Regulation

111. The new General Data Protection Regulation (GDPR) came into force on 25 May 2018. This replaced the UK Data Protection Act 1998. As a Regulation, all EU member states must implement it in the same way. GDPR sets out more requirements than the DPA and has introduced new and significantly changed data protection concepts.

112. GDPR introduces a wide range of new rights for individuals in respect of their personal data. These include the right to be forgotten, the right to object to certain processing activities and to decisions taken by automated processes. Failure to comply with new GDPR data handling arrangements could result in the Scottish Government incurring significant fines.

113. The Scottish Government Internal Audit Directorate reviewed governance and readiness arrangements for GDPR and provided a reasonable assurance opinion. They highlighted that improvements are required to enhance the adequacy and effectiveness of procedures. We reviewed Internal Audit's work on GDPR and found there was sufficient evidence to support this conclusion.

Part 5

Value for money

Main judgements

As Scotland's fiscal responsibilities continue to grow, there is an increasing need for the Scottish Government to produce more detailed and transparent performance reporting, that better links spending with outcomes. The launch of the revised National Performance Framework provides the opportunity for the Scottish Government to make progress in this area.

Performance management

114. The National Performance Framework sets out the overall aims of the Scottish Government including a series of indicators against which performance is monitored against national outcomes. Performance against these indicators is reported publicly via the national performance website.

115. In June 2018, the Scottish Government launched a revised NPF, which sets out the purpose, objectives and national outcomes that the Scottish Government aims to achieve. The performance report included within the Consolidated Accounts provides a link to the national performance website where progress against the measures set out in the NPF is regularly updated.

Value for money is concerned with using resources effectively and continually improving services.

116. Overall responsibility for the delivery of performance targets lies with the Corporate Board. The Performance Board which reports to the Corporate Board has responsibility for taking this forward. The Performance Board also considers Programme for Government commitments alongside progress to deliver national outcomes.

117. Within the current performance reporting and monitoring which is for the whole of the public sector in Scotland, it is difficult to see the performance of individual portfolios and the contribution made to national outcomes. The Consolidated Accounts 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.

118. As Scotland's fiscal responsibilities continue to grow, there is an increasing need for the Scottish Government to produce more detailed and transparent performance reporting, that better links spending with outcomes. The Parliament's new budget process, commencing for the 2019/20 draft budget, places a greater emphasis on the need for better performance reporting to provide a clearer focus on the delivery of outcomes. This includes providing better information about what activity public spending will support, its aims, and the contribution it expects to make to national outcomes. The launch of the revised National Performance Framework provides the opportunity for the Scottish Government to make progress in this area.

119. The Scottish Government also has its own internal corporate performance monitoring and reporting which considers indicators such as dealing with official and ministerial replies and responding to parliamentary questions and Freedom of Information (FoI) requests.

120. Performance metrics on FoI have been presented to each director general Assurance meeting during the year for monitoring performance against interim targets set by the Information Commissioner. In June 2018, the Information Commissioner reported that there has been a significant improvement in the Scottish Government's performance in meeting the statutory timescales over the period since the Commissioner's intervention but noted there was variable performance across Government directorates. The Commissioner's report makes a number of recommendations and has requested that the Scottish Government submits a draft action plan for approval by September 2018.

Recommendation

The Scottish Government should prepare a performance report that clearly links to the financial resources outlined in the Consolidated Accounts. Greater transparency around the Scottish Government's own performance towards meeting its strategic objectives would provide greater accountability for the use of its financial resources.

National performance audit reports

121. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. In 2017/18 several reports were published which are of direct interest to the Scottish Government. These are outlined in Appendix 4.

Appendix 1

Action plan 2017/18

2017/18 recommendations for improvement

No.	Issue/risk	Recommendation	Agreed management action/timing
1	**Public Consolidated Account** The use of capital borrowing powers in 2017/18 reinforces the need for the Scottish Government to improve information about its overall financial position. There is currently no appropriate audited account that can provide full transparency over the assets and liabilities associated with borrowing by Scottish Ministers. Publishing a public consolidated account will give a more comprehensive view about what is owed and owned by the Scottish Government beyond those bodies that fall within the consolidated boundary. **Risk** There is a risk of poor financial decision-making as it is not clear what is owned and owed by the wider public sector in Scotland.	The Scottish Government should publish a Public Consolidated Account for the whole of the Scottish public sector based on 2017/18 data, before the end of 2018.	The Scottish Government complies with all financial reporting and auditing requirements and is developing its financial reporting to support transparency and the understanding of the financial picture: there have been improvements each year to the timing and presentation of the sets of accounts which make up the full reporting on the Scottish Budget. The Foreword to the Consolidated Accounts explained the 2018 developments: https://beta.gov.scot/publications/scottish-government-consolidated-accounts-year-ended-31-march-2018/pages/1/ and also noted the position in relation to the commitment to produce a further consolidated account “once the complete set of audited financial data for the relevant bodies is available”. SGAAC and Audit Scotland have been kept informed of our progress in determining what can be produced, establishing processes to collect and collate the necessary information and consideration of options to present that information. In our view, an account which first brings together the revenue-raising and spending elements of the Scottish Budget will provide the appropriate picture of the finances for the Scottish Parliament's interest, before widening that out. This work is in progress, building on the work done with financial year 2016-17 data. The Public Finance and Accountability Act 2000 requires consolidated public accounts to be audited before they can be laid and published. In our view, there would be benefit in being able to consult with interested stakeholders to ensure that what is produced will add value. We are progressing a plan to achieve audit and publication of a 2017-18 product by

No.	Issue/risk	Recommendation	Agreed management action/timing
			the end of this financial year: in the new year we will share proposed accounts with key stakeholders. Deputy Director, Financial Management Directorate Mar 2019
2	**Loans to private companies** During 2017/18, the Scottish Government entered into new commercial loan agreements with two private sector companies. There is a need for the Scottish Government to be more transparent about its overall approach in providing significant public funds to support private companies. There is no framework in place to support the Government's decision making or approach in providing loans to private companies. **Risk** There is a risk that the Scottish Government provides financial support to private companies without understanding its overall financial capacity, risk tolerance or expected outcomes, potentially increasing the risk to of poor decision making.	The Scottish Government should develop a framework that clearly outlines its role in financial interventions in private companies to support decision making over where, when and at what level to invest. Such a framework should provide clear information on financial capacity, risk tolerance and expected outcomes.	Scottish Ministers make decisions in accordance with policy objectives and alignment with the Government Economic Strategy and to respond to particular, often rapidly evolving, needs and circumstances. While there is not a specific framework for decision-making on situations of financial intervention, the decision-making in relation to private companies takes place within the SG's overall governance arrangements and in particular the framework in the Scottish Public Finance Manual for all decisions on the use of resources to ensure regularity, propriety and value for money. As summarised in the Medium Term Financial Strategy: • preparing and refining a business case to ensure that proposals are in line with strategic objectives the evaluation of options, detailed analysis of costs and benefits and all relevant commercial and financial consideration, including the affordability and balance of risks; • carrying out due diligence to substantiate the assessment where relevant; • acting within EU State Aid rules • and where appropriate, consultation with and scrutiny from the Scottish Parliament. An assessment of risk and potential financial impact is a key element – and this is monitored carefully as part of regular financial management activity. Internal guidance already exists to steer decision-making by Accountable Officers in making recommendations to Ministers in business intervention situations, taking account of the policy and legislative frameworks/guidance set out above. This will now be revised for publication as part of a wider review of the Scottish Public

No.	Issue/risk	Recommendation	Agreed management action/timing
			Finance Manual that is already underway in order to satisfy the recommendation. Chief Financial Officer/DG Economy Mar 2019
3	**Capital borrowing** In March 2018, the Scottish Government borrowed its full annual capital borrowing limit of £450 million. This was in line with plans outlined by Scottish Ministers as part of the 2017/18 Scottish budget. The Scottish Government borrowed the full amount with the view that unused amounts would be carried forward to future years using the Scotland Reserve. The Scottish Government needs to finalise the internal policies and principles within which it will manage its borrowing powers. **Risk** There is a risk that the Scottish Government may undertake excess borrowing resulting in unnecessary interest costs.	The Scottish Government's should finalise the internal policies and principles within which it will manage its borrowing powers. This will help to improve decision making on capital budget management such as the level, type and timing of borrowing.	The overall quantum of borrowing and an annual maximum amount is dictated by the Fiscal Framework. Any remaining discretion for the Scottish Government is considered in the context of the importance of maintaining fiscal sustainability and informed by economic circumstances. The Scottish Government will seek to address the Auditor General's recommendations when it updates its approach to Borrowing in the next Medium Term Financial Strategy in Spring 2019. Director of Budget and Sustainability Spring 2019
4	**Funding allocations to NHS boards and local authorities** In May 2018, the Scottish Government Health and Social Care Directorates finance team reviewed the current funding allocations process to NHS boards following issues arising from NHS Tayside holding money intended to fund eHealth in NHS boards. They identified areas of	The Scottish Government should ensure there is a robust and transparent process in place for funding public bodies, including allocations to NHS boards and local authorities.	**NHS Boards** SG Internal Audit have completed their review of the system for allocating funding to NHS Boards. Enhanced control procedures have been put in place for 2018-19 and the cut-off date for issuing allocations has been brought forward to the end of September, with any requests beyond this date requiring prior approval from Health Finance. Deputy Director, Health Finance and Infrastructure 31 Oct 2018

No.	Issue/risk	Recommendation	Agreed management action/timing
	weakness which meant the process was open to potential manipulation. A revised process is now in operation and the Scottish Government Internal Audit Directorate are undertaking a review of the controls in place. On 31 January 2018, the Scottish Government announced an additional £159.5 million of general revenue grant funding for local authorities at stage one of the 2018/19 Budget Bill. Of this additional sum, £34.5 million was reallocated from projected 2017/18 underspends within other government portfolios and was paid on 28 March 2018. **Risk** Late allocations and reduced transparency over the funding process increases the risk of manipulation of financial targets or funding levels.		**Local Authorities** The Scottish Government always aims to give local government as much advance notice as possible of their budget allocations. The Scottish Parliament has an essential scrutiny and decision role on the content of the Scottish Budget and as such key agreements are not solely within the Scottish Government's hands. In this particular instance, the Cabinet Secretary for Finance, Economy and Fair Work wrote to all Council Leaders on the day of the Budget Bill Stage 1 announcement (31 January) setting out their share of the additional allocations to be paid in both 2017-18 and 2018-19, indicating that these would be subject to final Parliamentary approval of the Budget Bill and the Local Government Finance (Scotland) Order 2018. The amounts were then included in the LG Finance Order that was subsequently approved by Parliament. Head of Local Govt Finance team
5	**Procurement** The procurement team's contract review reports and our review of the evidence highlighted that limited financial due diligence for some contracts, managed by business areas, is carried out post-contract award. **Risk** Failure to undertake regular checks on the financial health of the supplier increases the risk to the Scottish Government.	The Scottish Government should review and confirm that the level and selection of contracts for financial due diligence assessments during the lifespan of the contract is appropriate to manage this supplier risk to the Scottish Government.	The next stage of the contract management improvement plan is to include those contracts, deemed to be higher risk and managed by business areas, on our contract management system. The information recorded on the system will include dates of when financial due diligence assessments should be carried out. This will act as a trigger/prompt for business areas to ensure that such diligence is carried out. All business areas will be reminded of the need to carry out assessments more generally and further training for staff on interpreting company accounts will be delivered across 2019. Deputy Director for Collaborative and Scottish Government Procurement December 2018

No.	Issue/risk	Recommendation	Agreed management action/timing
6	**IT security** The Scottish Government's IT Security Policy and Security Policy Statement are out of date. **Risk** This highlights a number of risks such as: guidance is not available for users to consult; tools that used to be available to assess security of applications is no longer available; and risk of local decisions and security lapses impacting on the network.	The Scottish Government should update both the IT Security Policy and the Security Policy Statement.	Outcomes 2 and 3 of the SG Cyber Security Strategy deal specifically with our processes for assessing cyber security risks and the provision of advice. As part of the above, SG has appointed a number of Senior Information Risk Advisers (SIRAs) whose primary function is to provide users with advice and guidance in relation to IT security. A new tool - CARE (Cyber Assurance & Risk Evaluation) is available for the use of users and business areas with the support of a SIRA. The move towards individual risk assessments instead of blanket guidance means the IT Security Policy is being heavily redeveloped in line with ISO 27001 and revised National Cyber Security Centre guidelines. This will be completed in January 2019. In light of the above, revised guidance for users will be published on the corporate Internet in early 2019. It will also form an integral part of our wider user education and security awareness campaign at SG level. Chief Operating Officer for Information & Technology Services 31 March 2019
7	**Business Continuity Arrangements** Within the Scottish Government, various directorates and teams have their own business continuity planning arrangements. **Risk** These arrangements depend on the availability of the same resources, (for example, desk spaces in other Scottish Government office locations). There is a risk that this creates excess demand over supply and may result in	An overarching view of business continuity arrangements is required to ensure all plans can be executed in the event of an emergency or incident.	Strategic oversight of the Business Continuity function is by the Security and Business Continuity Governance Board, chaired by the Director, Communications, Ministerial Support and Facilities which meets quarterly and has external representation, including the Head of the Government Business Security Profession in the UK; and Security and Business Continuity executives from RBS. At its meeting in September 2018 this Board discussed the scope and future direction of business, agreeing priorities as part of a more extensive programme of work. The corporate Business Continuity team is currently being strengthened and is providing an overarching strategic approach. Directorate Business Continuity plans from across the Scottish Government are currently being scrutinised for coherence and for their

No.	Issue/risk	Recommendation	Agreed management action/timing
	ineffective continuity of service delivery.		identification of their most critical functions, which need to be resilient and prioritised in the event of disruptions and incidents of whatever duration. In addition, in December the Business Continuity team is working with key stakeholders across the Scottish Government to identify corporate critical functions and assets. It will then produce a consolidated list of the Scottish Government's critical functions and assets which will be considered by the Executive Team in February 2019 together with other strategic business continuity issues. Deputy Director, Security and Business Continuity
8	**Scottish Exchequer** In July 2017, a new role of Director General Scottish Exchequer was created to better reflect Scotland's new fiscal responsibilities. The roles and responsibilities within the Scottish Exchequer directorate have yet to be finalised and recruitment is ongoing to fill key posts. **Risk** Until arrangements for the Scottish Exchequer are finalised, it will be harder for the Scottish Government to effectively manage the fiscal risks and opportunities that may arise in the interim period.	The Scottish Government should seek to finalise the roles and responsibilities for the new Scottish Exchequer as soon as possible.	Roles and responsibilities for senior posts within DG Scottish Exchequer were finalised by late spring / early summer 2018, and recruitment for two new director posts has now concluded: the Director of Performance and Strategic Outcomes has now taken up post; and the Director of Tax is expected to take up post by January 2019. The Director of Budget and Sustainability has been in post through the whole period of change and provided continuity. Team structures and capacity below director level have been reviewed also and some recruitment has already taken place, with further work planned to build up the capability of the DG Scottish Exchequer area through the remainder of 2018-19 and into 2019-20. Through this whole period, the DG Scottish Exchequer team has continued to deliver its full work programme, including publication of the Draft Budget 2018-19 in December 2017, the new Medium Term Financial Strategy in May 2018, the refresh of the National performance Framework and both the Programme for Government 2018-19 and the new Fiscal Framework Outturn Report in September 2018. DG Scottish Exchequer

No.	Issue/risk	Recommendation	Agreed management action/timing
9	**Performance of portfolios** The Consolidated Accounts do not report on the performance of individual portfolios or the Scottish Government as a whole. **Risk** There is a risk that the reader of the Consolidated Accounts is unable to see the Government's own contribution to national outcomes.	The Scottish Government should prepare a performance report that clearly links to the financial resources outlined in the Consolidated Accounts.	A primary purpose of the Annual Accounts is to report on the use of budget authorised by the Scottish Parliament. The authorisation of budget via portfolios is within the context of the Programme for Government but there is not a direct correlation of contribution to outcome in the way suggested. As reported in the accounts, delivery bodies within the consolidation report directly on their performance in their own accounts and this is not repeated; for the most part, the accounts report the funding provided to delivery partners to operate within the policy context set by Scottish Ministers, and there is signposting to the National Performance Framework. Developments related to the National Performance Framework and the linking of spend to outcomes may facilitate changes to performance reporting in the accounts in the future. The approach to this element of the 2018-19 accounts will be considered in the light of developments as part of the usual planning process. We will also discuss our developing plans for better linking performance reported on the Scottish Government and National Performance Framework websites with Audit Scotland to seek their views. Director Performance & Outcomes By 31 March 2019
Follow up of prior year recommendations			
b/f 1	**Debt Management** We identified a number of areas where effective debt management processes were not being employed. This included late write off of debt, unallocated receipts and the use of credit memos to cancel debt with a view to new invoices being issued that were subsequently not issued. **Risk**	We recommend the Scottish Government review its debt management processes to ensure they are effective.	Business areas are responsible for managing any debt associated with their business (in accordance with the Scottish Public Finance Manual). Finance support can be targeted as appropriate; previous audit findings have centred on European Structural Funds and a short update is provided below. In view of the increase in lending activities by the Scottish Government Financial Management Directorate plans to review debt management during the first quarter of 2019, activity that will be enhanced by the recruitment of a new Corporate Treasurer role.

No.	Issue/risk	Recommendation	Agreed management action/timing
	There is a risk that the recovery of debts is ineffective and that the receivables balance in the accounts is misstated.		Chief Financial Officer/Corporate Treasurer Spring 2019 **European Structural Funds** The European Structural Funds' team has implemented procedures to monitor 2007-13 debts and continues to pursue outstanding amounts. New processes have been established for the 2014-20 programme to improve the timely recoverability of debt and to tighten controls around credit memos and the raising of new invoices. Head of European Structural Funds State Aid Division Implemented
b/f 2	**National Fraud Initiative** There should be more of a joined up approachto NFI across the Scottish Government. The NFI exercise is effective in detecting fraud and error in public sector organisations. In addition, it can help strengthen internal controls to protect against fraud and error. **Risk** Without a joined-up approach and central NFI contact there is a risk that potential fraud is undetected.	The Scottish Government should consider a more joined up approach with a central NFI contact responsible for co-ordinating match investigation work and ensuring that results are reported and disseminated across the Scottish Government.	Responding to the NFI exercise requires action by a number of different areas within the SG (and in each of the bodies within the SG consolidation boundary) so there is a coordinated approach rather than a central contact. Findings from the NFI work are reported internally as appropriate and to SGAAC. The Governance team within Financial Management Directorate has the policy role for the NFI and is working proactively with Cabinet Office and Audit Scotland to promote and develop the NFI. Planning for the next NFI exercise will include consideration of approach, the coordination of activity, and reporting. This will be prompted by Finance but there will be a corporate approach involving the other corporate services areas. We are also tracking the creation and development of a Fraud profession at UK level and discussions have taken place with Internal Audit colleagues within DG Scottish Exchequer to agree how best the SG should respond to this agenda, in particular because of the increasing risk brought about, for example, by new social security powers. This may have implications for how we support the NFI exercise and counter fraud more generally. Deputy Director, Financial Management

No.	Issue/risk	Recommendation	Agreed management action/timing
b/f 3	**Publication of register of interests** The Scottish Government does not currently make the Register of Interests for its board members available on its website. Publishing the register is good practice and in line with guidance issued by the Scottish Government to public bodies and would support the Government in its commitments through the Open Government Partnership to increase transparency. **Risk** There is a risk that the Scottish Government is not compliant with good practice guidance.	We recommend that the Scottish Government makes available its register of interests on its website by October 2018.	The Scottish Government is not required under any legislation to publish its register of interests, however in line with its policy on open and transparent government the Scottish Government is currently reviewing options to make the relevant elements of its register of interests public on an annual basis, alongside the consolidated accounts. Board Secretary Early 2019

Appendix 2

Significant audit risks identified during planning

The table below sets out the audit risks we identified during our planning of the audit and how we addressed each risk in arriving at our conclusion. The risks are categorised between those where there is a risk of material misstatement in the annual report and accounts and those relating our wider responsibility under the *Code of Audit Practice 2016*.

Audit Risk		Assurance procedure	Results and conclusions
Risks of material misstatement in the financial statements			
1	**European Structural Funds programmes 2014-20** We are aware that both the European Structural Fund and European Regional Development Fund 2014-20 programmes have been interrupted by the European Commission (EC). This means that the EC is not reimbursing the Scottish Government until concerns raised in the interruption letter are resolved. These interruptions are an early indication that the control environment is not working as it should and may lead to payment errors in the future. It also affects balances and disclosures in relation to the Scottish Government's Statement of Financial Position and there is a risk that they may be misstated.	Follow up of control weaknesses identified during our audit of the 2016/17 financial statements relating to reconciliation of the European payment system to the general ledger. Substantive testing of balances and disclosures in the financial statements. Consider placing reliance on Internal Audit's work as the Audit Authority (external audit) appointed by the European Commission.	We tested reconciliations of the European payment system to the general ledger and reported our findings in our Management Report. Substantive testing of balances and disclosures found one unadjusted error. We considered placing reliance on Internal Audit's work however the timing of their work is after our audit concludes. We will consider this for our 2018/19 audit.
2	**Common Agricultural Policy (CAP) payments** Common Agricultural Policy payments are administered by the Scottish Government. In 2017/18 the Scottish Government is expected to make payments and then reclaim approximately £540m from the European Union. Failure by the Scottish Government to meet deadlines or adhere with regulations can result in penalties.	Review the disclosure of contingent liabilities, guarantees, indemnities and letters of comfort in the consolidated accounts for completeness and reasonableness. Engage with auditors of the European Agricultural Funds. Review Scottish Government impairment review and associated accounting entries. Substantive testing of CAP futures system expenditure to	Disclosures of contingent liabilities, guarantees, indemnities and letters of comfort were reviewed. We reviewed disclosures in the Consolidated Accounts relating to CAP and the Rural Payments and Services system and engaged with auditors of European Agricultural Funds to support our review. Testing of CAP loans confirmed classification and disclosures in the accounts.

	Audit Risk	Assurance procedure	Results and conclusions
	There are a number of balances and disclosures across the financial statements relating to CAP. There is an audit risk that there may be material misstatements relating to these.	determine if correctly classified. Review of arrangements for issuing and recovering CAP loans. Substantive testing of a sample of CAP loans.	
3	**Estimation and judgements** There are significant degrees of management estimation in the measurement, valuation and disclosures of a number of material account areas including student loans, contingent liabilities, financial guarantees and provisions. This estimation and judgement creates a risk that material areas of the accounts are misstated.	Further review of the student loans model (assumptions and application). Focused substantive testing. Review the identification of and record of contingent liabilities, guarantees, indemnities and letters of comfort. Test assumptions in contingent liability financial modelling. Review the disclosure of student loans, contingent liabilities, guarantees etc.	We assessed the student loans model (assumptions and application) and found minor issues in application and calculations. We performed focused testing across areas of estimation and judgement in the Consolidated Accounts.
4	**Risk of management override of controls** Notwithstanding the existence of a control environment, ISA 240 requires that audit work is planned to consider the risk of fraud, which is presumed to be a significant risk in any audit. This includes consideration of the risk of management override of controls in order to change the position disclosed in the financial statements.	Detailed testing of journal entries. Review of accounting estimates. Focused testing of accruals and prepayments. Evaluation of significant transactions that are outside the normal course of business. Review of internal audit reports. Consideration of the results of controls testing.	We carried out detailed testing of journal entries, accounting estimates and unusual transactions. The results of this audit work were satisfactory. Focused testing of accruals and prepayments identified some issues (reported at paragraph 24) and we increased our testing. We reviewed relevant internal audit reports. We reviewed the results of controls testing and increased our testing of payroll (reported at paragraph 52).
5	**Risk of fraud over expenditure** ISA 240 presumes a risk of fraud in regard to revenue recognition in the financial statements in any audit. Practice Note 10 extends this to include expenditure recognition in some public sector bodies. Given the nature of expenditure in relation to the Scottish Government there is a risk of fraud over expenditure.	Perform detailed testing of significant transactions, particularly around the financial year-end. Carry out analytical procedures. Monitor budgetary process and reporting. Consider internal audit findings.	We tested controls in this area and tested transactions around the financial year end. The result of this audit work was satisfactory as we did not identify any issues.
6	**National Fraud Initiative (NFI)**	Completion of 2017/18 NFI questionnaire.	We completed the NFI questionnaire that auditors are

	Audit Risk	Assurance procedure	Results and conclusions
	In our 2016/17 Annual Audit Report we highlighted that, as with the previous NFI exercise, good progress had been made in the investigation of accounts payable matches but there was slower progress in investigating recommended payroll matches due to resourcing pressures. In addition, no progress has been made on investigating the procurement matches. There is a risk that if NFI matches are not effectively followed up fraud or error could remain undetected.		asked to complete. As we reported in our Management Report, we found no progress with investigation of Procurement matches. As we highlight at paragraph 108, the Scottish Government should consider a more joined-up approach for completing the NFI exercise to co-ordinate the match investigation work ensuring that results are reported across the Scottish Government.
Risks identified from the auditor's wider responsibility under the Code of Audit Practice			
Financial management			
7	**Workforce capacity and capability** Financial devolution under the 2012 and 2016 Scotland Acts is fundamentally changing the shape of Scottish public finances. There is a risk that the Scottish Government does not have the capacity and capability to deliver these changes alongside delivering its continuing responsibilities and preparing for the implications of the UK's withdrawal from the European Union.	Consideration of performance audit report on the implementation of the Scotland Acts. Further consideration on impact of social security agency on core finance functions. Consideration of actions to address recommendations of internal review of finance function.	We undertook a performance audit looking at the Scottish Government's management of the implementation of the Scotland Acts. This reported on the potential impact of the new social security programme on core finance functions. Actions to address recommendations of an internal review of the finance function were also considered.
8	**Supporting economic activity** The Scottish Government's risk environment and appetite are changing, as seen through their increasing use of financial guarantees to support economic development. This increasing involvement in guarantees brings new risk exposure to the Scottish Government. In November 2017 the Scottish Government provided a commercial loan facility of £15 million to Burntisland Fabrications Limited (BiFab) in order to help it unlock additional funding and continue to operate.	Review the record of contingent liabilities, guarantees, indemnities and letters of comfort. Substantively test disclosures of contingent liabilities, guarantees, indemnities and letters of comfort in the consolidated accounts for completeness. Assess due diligence and decision analysis carried out by the Scottish Government for the loan to BiFab. Review scenario planning in this area as the risk exposure increases as more support is offered. Review process for selecting areas of intervention.	Disclosures of contingent liabilities, guarantees, indemnities and letters of comfort were tested leading to enhanced disclosures in the Consolidated accounts. Due diligence and decision analysis assessed and found to be good. We did not see evidence of scenario planning for risk exposure in this area. As we recommend in Appendix 1, the Scottish Government should develop a policy for intervention and the extent of such interventions.

	Audit Risk	Assurance procedure	Results and conclusions
	The increasing use of financial guarantees to support economic activity presents an audit risk that existing measuring and monitoring arrangements may not be sufficient to mitigate these new risks faced by the Scottish Government.		
9	**Financial management and reporting** We have previously reported a number of areas where financial management and reporting arrangements could be improved. The Budget Process Review Group's recommendations provide a real opportunity for the Scottish Government to strengthen its financial reporting, and support Parliamentary and public scrutiny. To strengthen reporting, the Scottish Government has plans to: produce a shadow public sector consolidated account for Scotland in Spring 2018 develop a medium-term financial strategy covering the next five years finalise policies for borrowing and reserves. There is a risk that the financial management and reporting arrangements are not adequate for the new tax raising and spending environment in Scotland.	Engage with performance audit work on Managing the implementation of the Scotland Acts and consider the findings from the upcoming national report. Engage with the Scottish Government over its plans to produce the shadow consolidated account. Review policies and principles for borrowing and reserves. Review the medium term financial strategy. Review of memorandums of understanding with HM Treasury. Review of a capital borrowing strategy for 2017/18 once this has been finalised.	We undertook a performance audit looking at the Scottish Government's management of the implementation of the Scotland Acts. The Scottish Government has made limited progress over its plans to produce a public consolidated account. The Capital Borrowing memorandum of understanding with HM Treasury was reviewed. The Scottish Government has not developed any further policies and principles and uses the agreed memorandum and the Fiscal Framework as basis for policies and principles. We are reviewing the medium term financial strategy (Scottish Fiscal Outlook) which includes consideration of capital borrowing, alongside the fiscal framework and fiscal framework outturn report as part of our ongoing work.
10	**Debt management** As part of our 2016/17 Annual Audit Report, we identified a number of areas where debt management arrangements could be improved across the Scottish Government. This included identifying balances being written off substantially later than would be expected and receipts not being allocated to debtor accounts. We further identified issues relating to recovery of	Assess the Scottish Government's review of debt management and progress against any recommendations. Review year end receivables balances as part of final accounts testing.	As highlighted at paragraphs 54 - 56 we found a number of issues with debt management across a number of departments of the Scottish Government. A focused sample of year end receivables was tested as part of final accounts testing with no issues found.

	Audit Risk	Assurance procedure	Results and conclusions
	debts for European Structural Funds.		
	Governance and transparency		
11	**Governance arrangements** The Scottish Government introduced new governance arrangements in October 2016 with further changes at Director General level in June 2017. Good governance is important for longer term decision-making, efficient use of resources and accountability for stewardship of those resources. We will review the effectiveness of the revised governance arrangements and assess whether they provide effective oversight, scrutiny and management of resources to achieve intended outcomes and support the Principal Accountable Officer in discharging her responsibilities.	Review of effectiveness of governance arrangements. Engage with Internal Audit. Engage with NXDs including chair of SGAAC. Attendance at SGAAC and DG assurance meetings. Review of the Governance Review undertaken by the Director of Internal Audit and the Crown Agent, reported to SGAAC, December 2017.	Effectiveness of governance arrangements were considered through our attendance at SGAAC and DG Assurance meetings, as well as engagement with Internal Audit. We considered the findings of the Governance Review.
12	**Compliance with wider laws and regulations** We are required to consider laws and regulations which do not have a direct impact on the financial statements. For example: • Freedom of Information (FOI) • Whistleblowing Policies • Data Protection The Scottish Government does not consistently meet the statutory 20 day target for responding to FOI requests. There is a risk to the audit that non-compliance with laws and regulations has a material effect on the application of governance arrangements in the organisation and on disclosures within the financial statements, such as the governance statement, which influence a reader's understanding.	Review of application of whistleblowing policies and procedures. Assess disclosures relating to FOI in the governance statement. Review of progress against interim targets. Review of reporting of progress against actions in FOI improvement plan established by the Information Commissioner Reviewing arrangements for changes to Data Protection.	There were no whistleblowing cases during 2017/18 to test the Scottish Government's application of policies and procedures. We will consider for our 2018/19 audit. Disclosures relating to FOI in the governance statement were complete. The Scottish Government publishes its progress against interim targets for FoI and we considered this reporting. Arrangements for changes to Data Protection were reviewed by Internal Audit and we relied on their findings. See paragraph 113 for further details.

Audit Risk		Assurance procedure	Results and conclusions
13	**Procurement** Procurement of goods and services plays a key role in delivering the Programme for Government. In 2016/17 bodies within the consolidated accounts spent approximately £3.5 billion outwith the public sector. Of this approximately £241 million relates to Scottish Government Core. EU legislation requires the Scottish Government to ensure that procurement of goods and services is undertaken fairly and in line with applicable laws, regulations and policies. In addition, the selection and management of suppliers is key to delivering on policy commitments. There is a risk that proper procedures are not followed.	Review processes and procedures that allow the Scottish Government to manage supplier risk. For a sample of contracts, review how decisions are made about what supplier to use.	We reviewed a sample of contracts awarded during 2017/18 to confirm evidence of supplier due diligence before the contract was awarded and to confirm that the Scottish Government followed its procurement policies. This testing was satisfactory. We also tested a small sample of established and significant suppliers to understand how the Scottish Government manage supplier risk and to see evidence of contract monitoring on an ongoing basis. Our conclusions are at paragraph 50.

Appendix 3

Summary of uncorrected misstatements

We report all uncorrected misstatements in the annual report and accounts that are individually greater than our reporting threshold of £0.1 million and request they be corrected.

The table below summarises misstatements that were identified during our audit testing and have not been corrected by management. Cumulatively these errors are below our performance materiality level as explained in Exhibit 2. We are satisfied that these errors do not have a material impact on the financial statements however we request that they be corrected.

No.	Account areas	Comprehensive income and expenditure statement		Balance sheet	
		Dr £m	Cr £m	Dr £m	Cr £m
1	Income		0.425		
	Receivables			0.425	
2	Expenditure	0.952			
	Payables				0.952
	Receivables			0.952	
	Income		0.952		
3	Expenditure	0.217			
	Creditor				0.217
4	Intangible Asset		0.154		
	Bank			0.154	
	Expenditure	0.949			
	Accrual				0.949
5	Expenditure	0.319			
	Provision				0.319
6	Expenditure		2.906		
	Creditors			2.906	
7	Expenditure	0.453			

No.	Account areas	Comprehensive income and expenditure statement			Balance sheet
	Provisions				0.453
8	Expenditure		0.260		
	Provisions			0.260	
9	Exchange rate gain/loss		0.670		
	Provisions			0.670	
10	Expenditure	2.300			
	Provisions				2.300
11	Expenditure		5.900		
	Accruals			5.900	
12	Receivables			0.128	
	Financial assets				0.128
13	Impairment	13.127			
	Financial assets				13.127
Net impact of SG Core Portfolios		**18.317**	**11.267**	**11.395**	**18.445**
Gross Impact of SG Core Portfolios					**29.712**
NHS Boards					
Gross adjustment of all unadjusted misstatements reported for NHS boards		**2.128**	**19.239**	**24.729**	**7.618**
Gross Impact of NHS Boards					**26.857**
Executive Agencies					
Gross adjustment of all unadjusted misstatements reported for Executive Agencies		**3.971**	**0**	**0.243**	**4.214**
Gross Impact of Executive Agencies					**4.214**

No.	Account areas	Comprehensive income and expenditure statement		Balance sheet
Total Gross Impact				**60.783**

Notes:
Entry 1 – There is a reconciling item in the debtors control account of £425k. Income and receivables have been understated for this amount.

Entry 2 – The Scottish Government recharges bodies who use its offices. The total cost is £952k, which has been netted off against payables and expenditure reduced. Instead, the SG it should have recognised income and a receivable from the other public bodies.

Entry 3 – An error was made in posting to the SG rental recharges at Entry 2. This had the effect of understating expenditure by £217,000.

Entry 4 – This relates to the carbon reduction scheme. The Scottish Government holds £154,000 of carbon allowances that were purchased in advance of year-end. These should have been capitalised as a current intangible asset. The SG has calculated the total amount payable under this scheme as £949,000. However, this cost has not been recognised in the 2017/18 accounts.

Entry 5 – This is the net effect of two misstatements in the early retirement provision. One early retirement provision was overstated by £189,000 and another was understated by £517,000.

Entry 6 – This relates to a creditor recognised in 16/17 for an exchange loss on a payment due to the European Commission. SG paid this in 2017/18 but did not reverse the creditor. Therefore, 2017/18 expenditure has been overstated and creditors have been overstated.

Entry 7 relates to a provision for the Common Agricultural Policy, which was not recognised.

Entry 8 relates to a provision that the SG recognised for funding to compensate farmers who lost livestock during the 2017/18 winter. However, the funding was not announced until April 2018, after the balance sheet date, and should not have been recognised in the 2017/18 accounts.

Entry 9 relates to an unrealised exchange rate gain which was not recognised

Entry 10 relates to a provision for late payment penalties in relation to 2105 Common Agricultural Policy which was not recognised

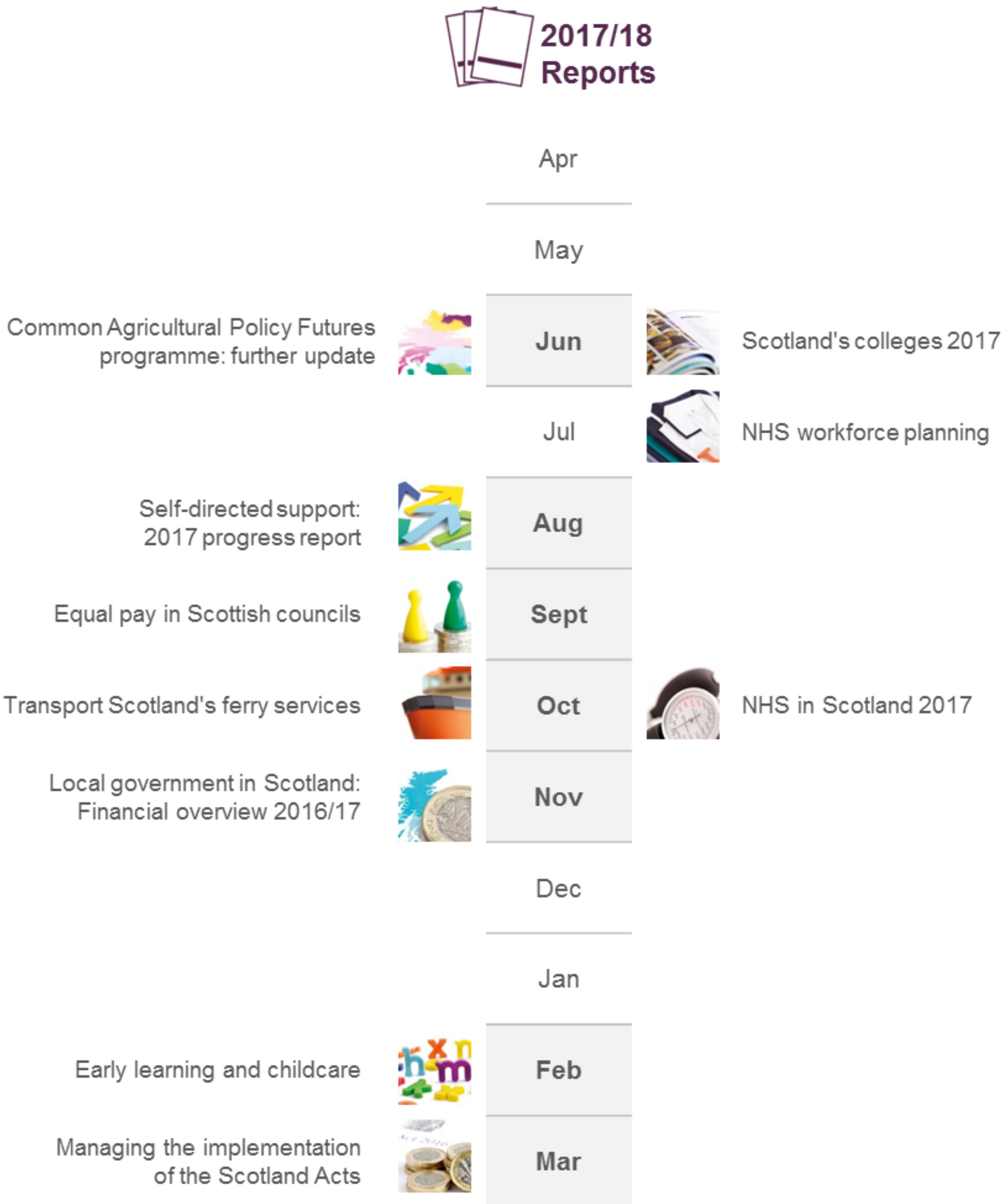
Entry 11 relates to an accrual for £17.5m processed in relation to health expenditure. Our judgement was that there was not sufficient evidence to support £5.9m of this accrued expenditure. Officers do not agree with our judgement.

Entry 12 relates to a CAP loan given to two businesses under common control which subsequently split, and entitlement to the loan was withdrawn. This loan has not yet been pursued as a debt.

Entry 13 relates to a financial asset which was not impaired. See Exhibit 3, issue 2 for more details.

Appendix 4

Summary of national performance reports 2017/18



Central Government relevant reports

Common Agricultural Policy Futures programme: further update – June 2017

Transport Scotland's ferry services – October 2017

Early learning and childcare – February 2018

Managing the implementation of the Scotland Acts – March 2018

Scottish Government

2017/18 Annual Audit Report

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