The 2017/18 audit of the Scottish Government Consolidated Accounts

AUDITOR GENERAL

Prepared for the Public Audit and Post-Legislative Scrutiny Committee by the Auditor General for Scotland
Made under section 22 of the Public Finance and Accountability (Scotland) Act 2000
September 2018

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Introduction

1. The Scottish Parliament's new financial powers are substantially changing how public finances are managed in Scotland. The Scottish budget is now more complex and is subject to greater uncertainty and volatility as a result of new tax and borrowing powers arising from the Scotland Acts in 2012 and 2016. The increasing uncertainty over the impact of the UK's withdrawal from the European Union adds further complexity and risk to the Scottish Government's finances as it makes choices over spending and levels of tax and borrowing. Comprehensive, transparent and timely reporting of the Scottish Government's budget and financial performance has never been more important in this new environment.

2. In December 2016, the Scottish Government published its draft 2017/18 Scottish Budget which set out its spending priorities and plans for the year. The Scottish Government's Consolidated Accounts for 2017/18 provides information on how this budget was managed and where money was spent.

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

4. My independent audit opinion on the 2017/18 Consolidated Accounts is unqualified. This means I am content they show a true and fair view, following accounting standards, and that the income and expenditure for the year is lawful. My audit opinion is set out at pages 49 to 51 of the accounts.

5. This report highlights key information in the Consolidated Accounts. It explains what they show about the Scottish Government’s management of its budget. It also provides information on governance, financial and performance management and identifies significant audit findings where further action is required by the Scottish Government.

6. As with previous years, I provide this report on the 2017/18 Consolidated Accounts to support the Scottish Parliament in its important scrutiny role of public finances in Scotland.

Key messages

1. **The Scottish Government's Consolidated Account for 2017/18 meets the requirements of the Government Financial Reporting Manual (FReM) and my opinion on them is unqualified. The accounts show that the total net expenditure during 2017/18 was £34,461 million, £339 million less than budget.**
2. **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 annual limit for 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 needs to finalise the policies and principles within which it will manage its borrowing powers. This will help to improve decision making about the level, type and timing of borrowing.**
3. **The Scottish Government has taken some important steps to improve its financial reporting. The publication of its first medium-term financial strategy and 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. However, the Government has not yet published a consolidated account covering the whole public sector in Scotland. This is an important commitment that will improve strategic public financial management, support Parliamentary scrutiny and enable better decision making.**
4. **During 2017/18, the Scottish Government made further changes to its corporate governance structure following new arrangements established in October 2016. In February 2018, a new Economy board was established to provide strategic oversight across the Scottish Government's activities. In July 2017, a new role of Director General Scottish Exchequer was created to better reflect Scotland's new fiscal responsibilities. 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 for the Scottish Exchequer are finalised, it will be harder for the Scottish Government to manage effectively the fiscal risks and opportunities that may arise in the interim period.**
5. **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 emphasises 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.**

Financial management

Scottish budget performance 2017/18

7. The Consolidated Accounts show that total net expenditure during 2017/18 was £34,461 million, £339 million less than budget (Exhibit 1). The resource budget was underspent by £287 million (0.9 per cent) against a budget of £32,736 million and capital by £52 million (2.5 per cent) against a budget of £2,064 million. Budget management during the year was effective in managing total spending against the limit set although the underspend is significantly more than in 2016/17 (2016/17: £85 million).

Exhibit 1

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

The Scottish Government consolidated total was £339 million under budget in 2017/18.

Portfolio	Actual (£m)	Budget (£m)	Over/(under) spend (£m)
Finance and the Constitution	66	74	(8)
Health and Sport	13,525	13,559	(34)
Education and Skills	3,350	3,465	(115)
Economy, Jobs and Fair Work	386	414	(28)
Justice	2,478	2,477	1
Communities, Social Security and Equalities	10,983	11,020	(37)
Environment, Climate Change and Land Reform	332	357	(25)
Culture, Tourism and External Affairs	263	274	(11)
Rural Economy and Connectivity	2,780	2,854	(74)
Crown Office and Procurator Fiscal Service	113	113	-
Administration	185	193	(8)
Scottish Government consolidated total	**34,461**	**34,800**	**(339)**

Source: Scottish Government Consolidated Accounts 2017/18 (page 52). Further information of individual portfolio spending performance can be found in pages 53 to 63 in the Consolidated Accounts.

8. 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 53 to 63). Further information is given in the accounts of other bodies.

Capital borrowing

9. Under the terms of the Scotland Act 2016, the limit for Scottish Ministers' capital borrowing 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 Scottish Ministers with more flexibility in responding to spending pressures across its capital programme.

10. 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.

11. 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 avoid any excess borrowing and associated interest costs. Details of the overall loan, repayments and interest payments are outlined on page 20 of the consolidated accounts.

12. 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.

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

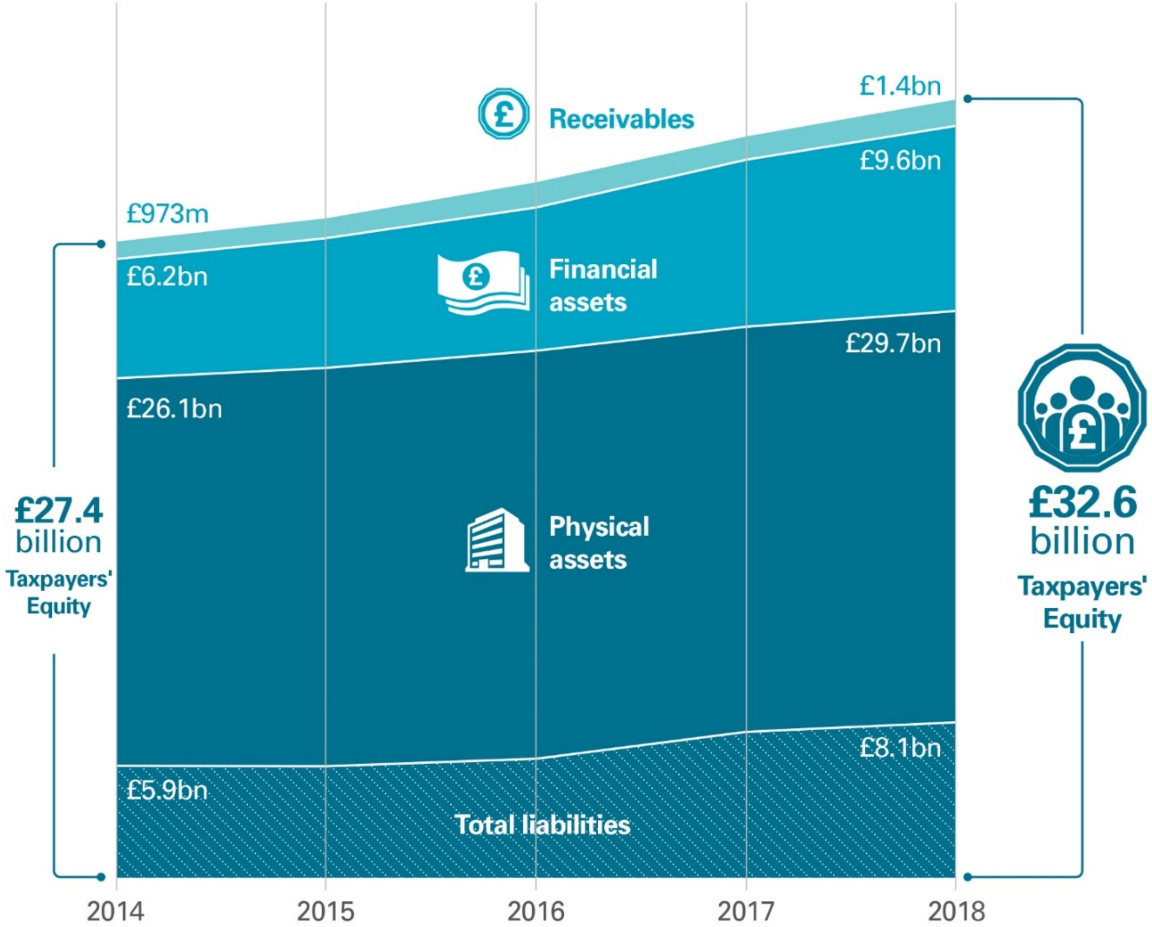
Overall financial position

14. The Consolidated Statement of Financial Position (previously known as the balance sheet) (page 64) is one of the primary financial statements in the Consolidated Accounts. It 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 of taxpayers' money applied that has continuing public benefit. It shows how much of this has arisen from the application of parliamentary funding (arising from the Scottish Block Grant, capital borrowing and devolved taxes) and how much resulted from changes over time in the value of physical assets.

15. The key items in the Statement of Financial Position over the last five financial years are summarised in Exhibit 2. Taxpayers' equity has increased in each of the last five years, largely due to an increase in physical assets (such as property and roads) and financial assets (such as loans and investments). Total liabilities (such as payments for private-financed projects) have also increased from £5.9 billion to £8.2 billion. It is important to note that the position does not reflect all the assets and liabilities of the Scottish public sector. For example, key liabilities are excluded such as capital borrowing, local government borrowing and all public sector pension liabilities funded from the Scottish budget.

Exhibit 2

Scottish Government's year end financial position, 2014 to 2018



Source: Consolidated Accounts 2013/14 to 2017/18

Funding to NHS boards and local authorities

16. 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.

17. In April 2018, I 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 its expenditure and thereby reduce its annual deficit. It was then returned to the Scottish Government as funding allocation credits the following year.

18. In May 2018, the Scottish Government Health and Social Care Directorate's finance team reviewed the funding allocations process in response to the issues relating to NHS Tayside. 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.

19. 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. 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.

Support to private companies

20. In recent years, the Scottish Government has taken a direct role in providing financial support to private companies in addition to support provided through the enterprise agencies such as Scottish Enterprise. This includes the purchase of Prestwick Airport together with loans of £38 million, and a power purchase agreement at the hydro plant and aluminium smelter at Lochaber, involving a financial guarantee valued at £18.7 million in 2017/18.

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

- 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.
- 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.

22. 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.

23. 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. 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.

EU Common Agricultural Policy

24. The Scottish Government provides financial support to farmers and other rural businesses as part of the Common Agricultural Policy (CAP). The Consolidated Accounts record intangible assets of £153 million reflecting the costs of a wider Rural Payments and Services System (RPSS) which includes the previous CAP Futures system. The system is stabilising and the

Scottish Government met the 2018 payment performance targets set by the European Commission.

25. The Scottish Government established two loan schemes during 2017/18 to help farmers and rural businesses receive money more quickly, given the difficulties that the IT system was having in making payments. 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. This included £317 million of loans related to the Basic Payments Scheme 2017. Delays in processing payments meant that £150 million of loans remained outstanding at the year end and additional financial transaction budget cover was required.

26. A further loan scheme of up to £55 million for the LFASS 2017 was announced in February 2018, with loan payments starting in April 2018.

27. Scotland currently receives around £0.5 billion annually from the European Commission to support farming. Uncertainty over the nature of the UK's withdrawal from the European Union means future financial support to farmers remains unclear.

Financial reporting

28. 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.

29. In September 2018, the Scottish Government published its first Fiscal Framework Outturn Report. This is intended to support the Parliament's scrutiny of the operation of the Fiscal Framework agreed between the UK and Scottish governments setting out the arrangements for new tax and social security powers and how the Scottish block grant will be adjusted. The report includes details of the reconciliation process between forecasts and outturn, and how the Scotland Reserve and borrowing powers have been used. Together, Scotland's Fiscal Outlook and the Fiscal Framework Outturn Report are positive developments in the Scottish Government's annual financial reporting. They form a key component of the Scottish Parliament's new budget process, following recommendations made by the Budget Process Review Group in June 2017, and will develop further over time.

30. 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 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.

31. 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.

32. In September 2018, the Scottish Government aims to publish its second action plan to the Open Government Partnership (OGP). The plan aims to give the public a better understanding of how government works so they can have more influence in holding them to account. The plan is expected to contain between three and five commitments to be delivered by September 2020. An independent report on progress with the Scottish Government's first action plan found that the Government showed strong participation in creating and implementing the plan. The review also found that the Scottish Government could improve OGP governance to improve engagement with other civil society organisations, deepen its commitment to financial transparency and build a stronger focus on accountability.

Non-Domestic Rating Account 2017/18

33. Non-domestic rates form a key part of the Scottish budget and are a significant source of funding for local government. The Non-Domestic Rating (NDR) account prepared annually by the Scottish Government shows the amount of non-domestic rates collected by councils and redistributed back to them by the Scottish Government during the year. Due to forecasting and timing differences between collection and distribution, the balance on the Non-Domestic Rating account shows either a surplus or deficit balance.

34. The 2017/18 account shows Scottish Ministers received £2,869 million of non-domestic rates in the year and paid £2,713 million back to local authorities. This means the overall deficit on the account decreased by £156 million, from £297 million in 2016/17 to £141 million in 2017/18. The reduction in 2017/18 is in line with plans outlined in the 2018/19 draft Scottish budget which aim to bring the account into balance by the end of 2018/19 (Exhibit 3).

Exhibit 3

Non-domestic rates contributions and distributions, 2011/12 to 2017/18

Any surplus or deficit on the NDR account is carried forward to the following financial year.

	2011/12 £m	2012/13 £m	2013/14 £m	2014/15 £m	2015/16 £m	2016/17 £m	2017/18 £m
Contributions (from councils to Scottish Government)	2,259	2,442	2,501	2,554	2,628	2,799	2,869
Distributions (from Scottish Government to councils)	2,238	2,311	2,513	2,781	2,843	2,807	2,713
Surplus/(deficit)	21	131	(12)	(227)	(215)	(8)	156
Cumulative surplus/(deficit)	**34**	**165**	**153**	**(74)**	**(289)**	**(297)**	**(141)**

Source: Scottish Government

35. The Scottish Government has taken some steps to improve the transparency of the NDR account through additional information provided in budget documents and the medium-term financial strategy. There remains scope for further improvement to help provide the Parliament and the wider public with a fuller understanding of how NDR funding operates by:

- publishing details of how the distributable amount is calculated, including details about the assumptions used
- undertaking, and publishing, scenario planning and sensitivity analysis to provide more information on how any fluctuations in NDR contributions or distributions affect local government funding over time. [1]

Performance reporting

36. The 2017/18 Consolidated Accounts include a performance report and an accountability report in line with the requirements of the Government Financial Reporting Manual (FReM). The performance report (pages 13 to 21) summarises financial performance for the year, with particular emphasis on performance against budget. It also contains some specific performance information which is required by current guidance on supplier payment

[1] The Scottish Fiscal Commission is responsible for providing independent five-year forecasts on non-domestic rates income. The SFC will focus on forecasting the contributable amount. It remains the responsibility of the Scottish Government to determine what the distributable amount for each year will be.

performance compared with policy targets and signposts where more information is available on sustainability and environmental performance. For information on the Scottish Government's progress towards its overall aims and objectives, users of the accounts are directed to the National Performance Framework (NPF). 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 provides a link to the national performance website where progress against the measures set out in the NPF is regularly updated.

37. This means that the Consolidated Accounts focus on the Government's finances. As with previous years they do not report on the performance of individual portfolios or the Scottish Government as a whole, limiting the reader's ability to see the Government's own contribution to national outcomes. This means that the reader is unable to see the links between the money spent by the Scottish Government, what it has achieved, and progress made towards achieving national outcomes.

38. 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 Parliament's new budget process places a greater emphasis on the need for better performance reporting to provide a clearer focus on the delivery of outcomes. This includes 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.

39. 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. This would provide a more rounded account of the Scottish Government’s overall performance and would enhance reporting to the Scottish Parliament and the public, and help strengthen accountability and scrutiny.

Governance

40. A Governance Statement (pages 23 to 33) prepared by the Permanent Secretary is a key feature of the Consolidated Accounts. It forms part of a wider accountability report and summarises how the core Scottish Government organisation is controlled and directed. The statement confirms that it complies with relevant guidance on corporate governance. It also highlights some of the main risks and opportunities for the organisation and any significant internal control issues in 2017/18. I am content that the Governance Statement is consistent with the financial statements and has been prepared in accordance with guidance issued by the Scottish Ministers.

41. 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, including 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.

42. 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 responsibilties 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.

43. 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. 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.

44. As I reported in September 2017, 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.

Internal Audit

45. The governance structures within the Scottish Government draw on a number of sources of assurance, with substantial reliance placed on the work of the Internal Audit Directorate (IAD). Internal Audit reviews whether the framework of internal control operates satisfactorily and proper arrangements are in place for the prevention and detection of fraud and corruption. An efficient and effective internal audit function is a key element of good governance.

46. Each year, we undertake an overview of the Scottish Government's internal audit arrangements in accordance with International Standard on Auditing 610 *Using the work of*

internal auditors. Our work found that, although the Internal Audit Directorate meets some of the Public Sector Internal Audit Standards (PSIAS), it does not comply with significant aspects of the standards.

47. 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, but our review found that significant improvements are required in audit planning, audit documentation, audit reporting and management review. 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.

Conclusion

48. The Scottish Government's Consolidated Account for 2017/18 meets the requirements of the FReM and my opinion on them is unqualified. The account is prepared from the perspective of the Scottish Government's role in managing the budget it directly controls and covers the majority of public spending in the Scottish budget. It covers spending against budget for the financial year and sets out what is owned and owed by the core Scottish Government and those bodies within the consolidated boundary as at 31 March 2018. This is a critical component of the Scottish Government's accountability to the Parliament and the public.

49. The Scottish Government has a good record of financial management and reporting. In 2017/18, improvements were made to financial reporting through the publication of its first medium-term financial strategy and Fiscal Framework Outturn Report. Governance arrangements continue to evolve and the revised National Performance Framework provides details on what the Government aims to achieve and performance against national outcomes.

50. My audit work has highlighted a number of areas for further improvement to help support the Parliament and the public in their scrutiny of public finances, which are undergoing significant change. The Scottish Government should:

- Publish a consolidated account for the whole public sector to outline total assets, liabilities, borrowing and investments. The Scottish Government should aim to publish this, using 2017/18 financial information, before the end of 2018.
- 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 avoid any excess borrowing and associated interest costs.
- Be more transparent about its overall approach in providing loan facilities to support private companies. This should include developing a framework that clearly outlines its policy aims, financial capacity, risk tolerance and expected outcomes.

- Ensure there is a robust and transparent process in place for funding public bodies, including allocations to NHS boards and local authorities.
- 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.
- Continue to improve its governance arrangements and strengthen the opportunity for greater scrutiny and challenge through improving information provided to key groups within its governance structure. Finalising the roles and responsibilties for the new Scottish Exchequer should be a priority.

51. 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.

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

The 2017/18 audit of the Scottish Government Consolidated Accounts

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